

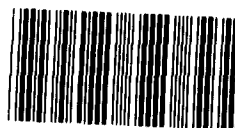
GAO

Report to Congressional Committees

April 1991

SECURITIES
INDUSTRY

Strengthening Sales
Practice Oversight



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The Honorable Donald W. Riegle, Jr.
Chairman, Committee on Banking, Housing
and Urban Affairs
United States Senate

The Honorable John D. Dingell
Chairman, Committee on Energy and Commerce
House of Representatives

This report contains our evaluation of Securities and Exchange Commission oversight of self-regulatory organization monitoring and enforcement of sales practice compliance among securities industry firms. We did the work under our basic statutory authority in response to congressional concerns over the protection afforded investors in the futures market. We are also sending copies of our report to the Securities and Exchange Commission, other interested Members of Congress, appropriate committees, and the public.

Major contributors to this report are listed in appendix III. Please contact me on (202) 275-8678 if you or your staff have any questions concerning this report.

A handwritten signature in black ink, reading "Craig A. Simmons".

Craig A. Simmons
Director, Financial Institutions
and Markets Issues

Executive Summary

Purpose

Investor losses attributable to unscrupulous sellers of low-priced securities (penny stocks) support the need for the Securities and Exchange Commission (SEC) and self-regulatory organizations (SRO) to oversee security industry sales practices. Abusive sales practices, such as high-pressure sales pitches and false claims, can cost investors billions of dollars, and delays in identifying such practices can allow abuses and consequent losses to continue.

Customer complaints about broker-dealer actions during the October 1987 market crash and more recent well-publicized instances of investor abuse raised congressional concern over investor protection. As a result, GAO reviewed the adequacy of SEC oversight of securities industry efforts to monitor and enforce sales practice standards.

Background

Four exchanges and the National Association of Securities Dealers are the SROs that monitor thousands of broker-dealers for compliance with industry and federal standards for marketing and selling securities products to the public. SEC evaluates the quality of SRO oversight in enforcing member compliance with federal securities laws, including provisions related to preventing fraudulent and manipulative practices and protecting investors from such practices.

SEC fulfills this responsibility by inspecting SRO adherence to policies and procedures related to SRO sales practice programs. These programs consist of four parts: (1) cause investigations (investigations of specific customer complaints and employees that broker-dealers have terminated or disciplined), (2) broker-dealer examinations, (3) formal disciplinary action reviews, and (4) broker-dealer advertising reviews. SEC also examines a sample of broker-dealer firms that the SROs previously examined to assess the quality of SRO examinations. Further, SEC maintains a customer complaint system to receive information about investor concerns and possible securities law violations.

GAO reviewed SEC oversight of four SROs from 1986 through 1989—the American Stock Exchange, Chicago Board Options Exchange, New York Stock Exchange, and National Association of Securities Dealers.

Results in Brief

The structure of SEC's program for overseeing SRO sales practice programs includes activities needed for effective oversight. Nevertheless, GAO found that SEC could strengthen its oversight program by improving its coverage of SRO inspections, methods for evaluating the effectiveness

of SRO broker-dealer examinations, and collection and use of customer complaint and management information.

Specifically, except for one SRO, SEC has no timetable for reviewing all parts of SRO sales practice programs and had reviewed parts of these programs sporadically since 1986. In addition, because SEC re-examines broker-dealers using different methods than the SROs use, it generally cannot determine why it finds violations that the SRO missed, and therefore it may lose opportunities to recommend actions to improve SRO examination methods. Finally, SEC information systems do not provide the data needed to fully identify trends in sales practice abuses or weaknesses in SRO sales practice programs.

Strengthening its sales practice oversight program may help SEC to more quickly identify and correct problems in SRO and broker-dealer programs. Left uncorrected, these problems could contribute to investor losses from abusive sales practices.

Principal Findings

Improving Inspection Coverage

From 1986 to 1989, SEC sporadically inspected the sales practice programs of the New York and American Stock Exchanges and the Chicago Board Options Exchange. In some years, SEC inspected three of the four primary parts of the sales practice program, while in other years SEC inspected only one or none of the primary parts. Because SEC lacks a systematic approach for evaluating SRO sales practice programs, opportunities to address program weaknesses may be delayed or lost.

SEC's only timetable for completely inspecting SRO sales practice programs applies to the district offices of the National Association of Securities Dealers. SEC tries to completely inspect most district office programs every 2 years and the programs in the two largest districts every 3 years. SEC achieved this goal between 1986 and 1989. (See p. 16.)

SEC officials said they have no similar timetable for the other SROs because the SROs are too large and thus take too much time to fully inspect. They also said they preferred to target inspections to particular parts of SRO programs on the basis of the results of SEC's routine broker-dealer oversight examinations. However, GAO found that SEC does make

accommodations for SRO size, as exemplified by its 3-year inspection timeframe for the large district offices of the National Association of Securities Dealers. In addition, as discussed in the next section, targeting inspections on the basis of the results of SEC routine broker-dealer oversight examinations may be difficult. (See pp. 17-18.)

Improving Evaluation of SRO Examinations

SROs and SEC have developed differing methods for examining broker-dealer firms. These methods either do not cover the same areas or cover the same areas differently. SEC officials said they do not use SRO examination methods because SRO oversight examinations have a different purpose than SEC routine oversight examinations. Specifically, SEC officials said that SROs only examine broker-dealers to determine adherence to federal securities laws, while SEC also examines broker-dealers to determine the quality of the SRO examinations. (See pp. 18-19.) Using different methods, however, makes it difficult for SEC to directly determine the effectiveness of SRO examinations. As a result, when SEC staff detect violations that the SROs did not, SEC cannot readily determine what caused the SROs to miss the violations—the examination methods used, the way in which the methods were implemented, or other factors. (See pp. 20-21.)

For example, GAO randomly selected 94 SEC routine oversight examinations, of which 56 contained violations that SEC found but the SRO missed. In only 6 of the 56 cases did SEC state the cause for the missed violations. SEC requested explanations from the SROs in the other 50 cases. An SRO official said that missed violations are usually minor and may be from a different time period or sample than the SRO reviewed. Because SEC does not directly determine why SROs miss certain broker-dealer violations, it may lose opportunities to recommend actions to improve SRO examination methods. (See pp. 20-21.)

Improving Complaint and Management Information

SEC uses its automated customer complaint system to help identify trends in complaints against broker-dealers and thus to target its investigations. For example, when SEC began collecting specific information on penny stock violations, patterns of violations indicated a need for a rule change regarding the way penny stocks could be sold over the telephone. However, SEC's system is not designed to store and accurately count complaints that SEC receives, categorize complaints by security type, or link up with customer complaint systems operated by SROs or state regulators. (See pp. 25-26.)

For example, when a customer complaint about a broker-dealer includes multiple allegations, such as unauthorized trading and high-pressure sales tactics involving a penny stock account, SEC's customer complaint system captures only one of the allegations. The system, in this case, records the complaint either as unauthorized trading or high-pressure sales tactics. The system also does not capture the type of security—in this case, penny stock. Further, the system does not include information from SRO and state systems, which may contain other similar complaints about the same broker-dealer. Such information could help SEC identify whether the complaint is an isolated instance or part of a pattern of abuse. SEC plans to replace its customer complaint system. The new system is being developed to accurately count and categorize complaints but not to link up with other customer complaint systems. (See p. 27.)

SEC also has an automated management information system to monitor its regional office examination activities. The system records violations that SEC regional office staff find when they examine a sample of broker-dealer firms that the SROs examined. However, the system counts a violation, such as unauthorized trading by a broker-dealer, only once, whether the violation occurred in one account or in several accounts. In addition, the system includes only violations SEC found during its routine oversight examinations and does not include data from SRO broker-dealer examinations, although SEC routinely collects this information. Complete information on the extent that violations occur at a particular broker-dealer could help SEC identify problem firms sooner. Complete information on violations found at all broker-dealers could help SEC better identify trends in violations. (See pp. 28-29.)

Recommendations

GAO makes several recommendations to the Chairman, SEC, addressing the need for complete SEC inspections of SROs within a specified timeframe, uniform SEC and SRO methods for examining broker-dealer firms, and improved collection and use of customer complaint and management information.

Agency Comments

SEC agreed with GAO's recommendation to establish a formal sales practice program inspection cycle for each SRO. However, SEC disagreed with GAO's recommendation that SEC and the SROs agree on the examination methods to be used, because, among other things, SROs need latitude in designing and conducting examinations. SEC apparently read GAO's recommendation as being more rigid than intended. But SEC agreed to explore ways to better determine why SROs miss certain violations and

to identify whether modifications to SEC's follow-up procedures are needed.

SEC also disagreed with GAO's recommendations to (1) include in SEC's customer complaint system complaints received by SRO and state customer complaint systems and (2) revise its automated information system to include both the number of times SEC finds specific violations at broker-dealer firms and the results of SRO examinations. GAO's intent is to endorse SEC efforts in implementing a new customer complaint system and to encourage SEC to enhance the design of that system by interfacing with other such systems. Similarly, GAO wants to improve the information so SEC can better target firms for cause examinations. However, while disagreeing with the wording of the recommendations, SEC agreed to take actions that are consistent with GAO's intent. (See agency comments at the end of each chapter and in app. II.)

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Abbreviations

Amex	American Stock Exchange
CBOE	Chicago Board Options Exchange
NASD	National Association of Securities Dealers
NYSE	New York Stock Exchange
SEC	Securities and Exchange Commission
SRO	self-regulatory organization

Introduction

The 1987 market crash raised congressional concerns over the need to protect individual investors in the securities market. Part of this protection comes from laws that specify how securities are to be sold to the public. When these laws are violated, it can cost investors billions of dollars. For example, in the market for low-priced securities, called penny stocks, the North American Securities Administrators Association¹ stated that abusive practices used to sell penny stocks may have cost investors as much as \$2 billion annually.²

Sales practice abuses are fraudulent or manipulative acts by broker-dealers³ that jeopardize customer funds. Some of the more familiar acts include using high-pressure sales tactics, selling securities that are unsuitable for customers because of the amount or source of their income, and buying or selling securities for customers without their knowledge or consent to generate commission income. To ensure that firms or their employees are not carrying out such fraudulent or manipulative acts, the Securities Exchange Act of 1934 charges the Securities and Exchange Commission (SEC) with enforcing laws that seek to protect the investing public. SEC's program to fulfill this responsibility is carried out with assistance from self-regulatory organizations (SRO)—stock and options exchanges and the National Association of Securities Dealers (NASD). SROs have the power to adopt and enforce standards of conduct for their members.⁴ As of September 1990, about 6,000 broker-dealers were SRO members that offered securities to the public.

Both SEC and the SROs examine various aspects of broker-dealer firms. They have programs for evaluating a firm's financial integrity and for evaluating a firm's trading integrity. They also have sales practice programs for evaluating a firm's compliance with SEC regulations and SRO

¹The North American Securities Administrators Association is an organization of 65 state, provincial, and territorial securities administrators in the United States, Canada, Mexico, and Puerto Rico. In the United States, it represents the 50 state agencies responsible for investor protection in the capital markets.

²According to a North American Securities Administrators Association official, this dollar estimate is based on penny stock investor complaints gathered in a 50-state study by the Office of State Securities Administrators.

³Broker-dealers combine the functions of brokers and dealers. Brokers are agents who handle public orders to buy and sell securities. Dealers are principals who buy and sell stocks and bonds for their own accounts and at their own risk.

⁴NASD, the New York Stock Exchange, the Chicago Board Options Exchange, and the American Stock Exchange are the SROs authorized by SEC to examine broker-dealer firms. They also examine broker-dealers that are sole members of exchanges that SEC has not authorized to do broker-dealer examinations.

rules pertaining to fair and nonmanipulative sales practices. An effective sales practice oversight program is important because abusive sales practices can result in the loss of both investors' money and their confidence in the market. This report focuses on sales practice oversight programs.

The SROs are responsible for examining broker-dealers for compliance with sales practice program requirements, obtaining corrective action from broker-dealers when noncompliance is identified, and disciplining broker-dealers that have violated securities laws. Except for options oversight examinations,⁵ SEC assigns broker-dealers to SROs for examination when the broker-dealers are members of more than one SRO. SEC oversees the SROs by inspecting their methods for examining and disciplining broker-dealers and by doing routine oversight examinations of broker-dealers that the SROs examined. SEC also does cause examinations at firms to investigate potential fraudulent or illegal activity when indications of problems exist. In fiscal year 1989, SEC did 19 SRO inspections, 328 routine broker-dealer oversight examinations, and 148 cause examinations. SEC assigns about six headquarters staff to inspecting SRO programs. It also assigns from 4 to 30 staff at each region to inspect NASD district offices and do routine oversight examinations of broker-dealers. According to an SEC official, the number of staff assigned to inspections depends, in part, on the size of the region. In addition, the size of a broker-dealer firm and staff expertise dictate the number of staff that will be assigned to a routine oversight examination—from one to five people may be assigned.

SEC officials emphasized the importance they place on sales practice regulatory programs at the SROs and cited recent program enhancements as evidence. The number of cause examinations SEC conducted in 1989, primarily to review for sales practice abuses, represented a 114.5-percent increase over the number it conducted in 1986. During this same period, SEC also experienced a 47-percent increase in matters referred for enforcement consideration. SEC officials said that during the last 2-1/2 years they have committed substantial resources to combat sales practice abuses relating to sales of low-priced securities, which has required

⁵Firms doing options business require separate options oversight examinations. The Options Self-Regulatory Council, of which all SROs with examining authority are members, biannually assigns to the SROs firms to examine. The SRO is then the designated options examining authority for the assigned firms for that 2-year period. The American Stock Exchange and the Chicago Board Options Exchange do only options oversight examinations, while NASD and the New York Stock Exchange do both options and nonoptions oversight examinations.

enhanced cooperation with NASD. Furthermore, SEC heightened its scrutiny of how NASD's regulatory program addressed sales practice-related problems associated with penny stocks. SEC officials further said that over the last 5 years, in large part as a result of SEC oversight inspections, NYSE has made significant increases in the number of enforcement personnel and has improved both the quality and depth of investigations and the types of cases being brought.

Additionally, SEC and the SROs individually maintain investor complaint and inquiry systems for assisting the public with questions about the operations of broker-dealers and for assisting their respective staffs in fulfilling their oversight duties. SEC records and tracks its customer complaints and inquiries through its Complaint Management and Processing Index system. Each SRO has its own complaint system.

In October 1988, because of the number of complaints received on penny stocks, SEC established a penny stock task force. To combat penny stock fraud, the task force developed penny stock-related regulations, educated investors about purchasing securities over the phone, increased coordination and information sharing with other regulators and with prosecutors, and increased enforcement activities.

Objectives, Scope, and Methodology

During hearings before congressional oversight committees on the 1987 market crash, the Comptroller General testified that GAO planned to continue reviewing investor protection issues. This review is part of that work.⁶ Our objective was to evaluate SEC oversight of SRO monitoring and enforcement of sales practice standards in the securities industry. To do so, we assessed SEC's (1) SRO inspection and routine oversight examination programs and (2) collection and use of oversight information, including customer complaints.

To assess SEC's inspection and routine oversight examination programs, we interviewed officials at SEC headquarters and its two largest regional offices—Chicago and New York City. We also interviewed officials at the American Stock Exchange (Amex), the Chicago Board Options Exchange (CBOE), NASD, and the New York Stock Exchange (NYSE). We chose these SROs because they are the only ones with broker-dealer

⁶See related GAO reports on the Commodity Futures Trading Commission, Futures Industry: Strengthening Sales Practice Oversight (GAO/GGD-91-41, Apr. 1991), and on investment advisers, Investment Advisers: Current Level of Oversight Puts Investors at Risk (GAO/GGD-90-83, June 26, 1990).

examination authority, and they receive the most SEC oversight inspections. In addition, we reviewed SEC's methods, including its guidelines and checklists, for inspecting and examining SROs and broker-dealers and compared its examination guidelines and checklists with those the SROs⁷ use. We also analyzed SEC statistics on inspections and routine oversight examinations for January 1986 through December 1989. We selected this timeframe because it covered the period since completion of our last report on SEC oversight of the SROs.⁸ For the four SROs we selected, we reviewed all 51 SEC sales practice inspection reports in which the field work was completed in fiscal years 1986 through 1989. We also reviewed specific SEC routine oversight examination reports of broker-dealers that NYSE originally examined. We reviewed 82 of 96 reports that SEC issued in 1985 and 111 of 120 reports that it issued in 1987. SEC was unable to provide all of the routine oversight examination reports issued in these 2 years.

To assess SEC's collection and use of oversight information, we reviewed and analyzed SEC's customer complaint information system; SEC plans for a new complaint system; and SEC budget estimates from 1989 through 1991, which contain customer complaint information. We also reviewed and analyzed a sample of each type of report that SEC requires the SROs to submit on examination results, as well as SEC regional office reports.

Finally, because penny stock sales practices became a significant problem during this period, we examined customer complaint and other penny stock-related reports, noting what information SEC collected and distributed about these firms and how the information was used.

We did our field work between August 1989 and December 1990 in accordance with generally accepted government auditing standards.

We provided a draft of this report to SEC for formal review and comment. SEC's comments and our evaluation are summarized at the ends of chapters 2 and 3. SEC's letter and our additional comments are in appendix II. We also discussed the contents of this report with officials of Amex, CBOE, NASD, and NYSE and have incorporated their comments, as appropriate, throughout this report.

⁷We could not compare SEC's and NASD's checklists. NASD would not provide its checklist to us because it considers the checklist to be proprietary information.

⁸Securities and Exchange Commission Oversight of Self-Regulation, (GAO/GGD-86-83, Sept. 30, 1986). Our 1986 report drew broad conclusions about SEC programs for supervising and overseeing SROs. The report discussed SEC's inspection and routine oversight examination programs for SROs but not the results of specific oversight methods.

SEC Needs to Strengthen Oversight of SRO Sales Practice Programs

SEC's methods of overseeing SRO sales practice programs provide it incomplete information for assessing the effectiveness of these programs. Except for NASD district offices, SEC inspections of SRO operations are done sporadically and are not designed to cover all parts of SRO sales practice programs over a specific timeframe. In addition, SEC examines broker-dealer firms that the SROs examined using different examination methods than the SROs used. Thus, when SEC finds violations that the SROs missed, it cannot readily determine what caused the missed violations—the examination methods used, the way in which the methods were implemented, or other factors—and SEC generally does not directly make such a determination. More systematic inspections and better identification of the causes of missed violations could help SEC improve SRO oversight programs and better ensure that these programs meet the legislative mandate to protect the public against sales practice abuse.

SEC Oversight Programs

SEC oversees SRO sales practice programs to evaluate their effectiveness in deterring and detecting violations of federal securities laws. SEC inspects SRO operations and examines a sample of broker-dealer firms that the SROs examined. SEC inspects SRO policies and procedures for scheduling broker-dealer examinations, assessing broker-dealer compliance with securities laws, disciplining broker-dealers or employees violating these laws, and investigating customer complaints. SEC's routine oversight examinations of broker-dealers that the SROs examined evaluate and provide feedback to the SROs on the quality of their examination programs and help ensure broker-dealer compliance with securities laws.

The SEC Division of Market Regulation, Self Regulatory Inspection Branch, at SEC headquarters periodically inspects NASD headquarters¹ and the securities exchanges, while the SEC regional offices inspect the 14 NASD district offices. SRO inspections are done in three stages: (1) preinspection, (2) on-site visit, and (3) report or summary memorandum. Before an inspection, SEC reviews such information as previous inspections, customer complaints, and SRO rules and examination procedures. SEC's goal is to familiarize itself with the status of SRO operations and to determine which area(s) of an SRO's activities to inspect. Once at the SRO, SEC follows up on areas in which the previous inspection identified weaknesses.

¹Because the NASD district offices implement NASD sales practice programs, with the exception of advertising reviews, SEC focuses its oversight inspections on the district offices. NASD officials told us that NASD headquarters establishes policies and procedures but has no investigative or examining responsibilities.

An SRO sales practice oversight program has four parts—cause investigations, broker-dealer examinations, formal disciplinary action reviews, and broker-dealer advertising reviews. When SEC inspects the cause investigations part, it reviews SRO procedures for investigating customer complaints, employees terminated for cause, and broker-dealer notices of disciplinary actions. When SEC inspects the broker-dealer examination part, it reviews the thoroughness and completeness of SRO workpapers of completed broker-dealer examinations and the adequacy of SRO procedures used to discover sales practice violations. When SEC inspects the formal disciplinary action part, it reviews the adequacy of SRO procedures for disciplining members and the types of disciplinary actions taken. And finally, when it inspects the advertising review part, it reviews SRO methods of sampling and approving broker-dealer advertisements. After completing the inspection, SEC summarizes its findings, indicating areas where deficiencies were found. The report is then sent to the SRO for comment.

The SEC Division of Market Regulation at SEC headquarters establishes goals and objectives for the routine oversight examination program, and SEC regional offices implement the program. These guidelines state that regional offices should examine at least 6 percent of all SRO members with main offices in a region, with a minimum of one examination for each SRO represented in a region. The guidelines further state that selection of firms should focus on where customer exposure is the greatest and the greatest business is being done. The regional offices select firms that the SROs recently examined and then independently re-examine these firms, using their own methods. Before visiting a firm, SEC staff accumulate and review information, such as previous SRO examination results and related workpapers, previous SEC routine oversight examination reports, and customer complaints to SEC and the SRO.

Once at the firm, SEC staff obtain and review additional documents, including the firm's customer complaint log, transaction journals, and customer files. Staff use SEC's examination guidelines to select customer accounts that would be most likely to have violations of securities laws. For example, they might select the accounts of firm officers and directors and their family members, accounts with the largest debit or credit balances, or accounts generating the most commissions. The SEC guidelines require SEC staff to ensure the firm's current compliance with financial responsibility rules. The guidelines also require SEC staff to review firm activity at least for the period in which the SRO examined the firm, and they may also review firm activity from the period after

the SRO examination to the time of the SEC routine oversight examination.

SEC Inspections Need to Provide Systematic Coverage of SRO Oversight Programs

SEC periodically inspects the SROs to assess their oversight capabilities. However, while SEC has a regular schedule for completely inspecting the sales practice oversight programs of NASD district offices, it has no equivalent commitment to regularly and completely inspect the programs of other SROs. As a result, SEC only sporadically inspected the programs of the other three SROs that we examined. In some years, SEC inspected several parts of SRO programs, in other years SEC only partially inspected some program parts or inspected no parts. In sum, SEC had no systematic approach to evaluating the adequacy of the complete sales practice programs of these SROs.

SEC has established a timetable for inspecting the complete sales practice programs of the 14 NASD district offices. SEC tries to inspect all four program activities every 2 years in 12 offices and every 3 years in the 2 largest offices. SEC achieved this goal from 1986 to 1989. During this same period, however, SEC's inspections of the other three SROs we examined were not systematic. Table 2.1 shows when SEC did inspections and what portions of the programs SEC covered between 1986 and 1989.

Chapter 2
SEC Needs to Strengthen Oversight of SRO
Sales Practice Programs

Table 2.1: SEC Sales Practice Inspections

SRO	Fiscal year	Cause investigations	Part of SRO sales practice program		
			Broker-dealer examinations	Disciplinary actions	Advertising reviews
Amex	1986	No	No	No	No
	1987	Yes	Yes	Yes	No
	1988	No	No	No	Yes
	1989	No	No	No	No
CBOE	1986	Yes	Yes	Yes	No
	1987	No	No	No	Yes
	1988	Yes	Yes	Yes	No
	1989	No	No	No	No
NYSE	1986	^a	Yes	^b	No
	1987	^a	No	^b	No
	1988	Yes	No	^b	Yes
	1989	^a	No	^b	No

^aSEC inspected part of the NYSE cause program.

^bWe gave SEC partial credit for these inspections. Although SEC's inspections caused NYSE to make substantial improvements to its enforcement program, the inspection reports included only an evaluation of case referrals to NYSE's Enforcement Division, not the disciplinary procedures or types of actions taken.

Source: SEC Division of Market Regulation.

SEC officials told us that they have not established a timeframe for fully inspecting SRO programs other than the NASD district offices because SROs like NYSE have many more files and records to review. They said that a full inspection at each visit is not a goal because they prefer to tailor each SRO inspection to specific areas. The officials also said that a complete inspection is not necessary because findings from routine broker-dealer oversight examinations give them insight into each SRO's sales practice program.

The rationale SEC officials provided for the lack of SRO inspection timetables seems to conflict with SEC practices. First, size alone is not necessarily a deterrent to complete inspections. For example, while the other SROs may be larger than most NASD district offices, SEC has an approach for completely inspecting the two largest NASD districts—inspections are broken down into thirds, with one-third of each district's program inspected every year, so that at the end of the third year SEC has inspected the entire program. In addition, while the SROs vary in size, they all have the same four parts to their sales practice program and the same responsibilities.

Second, SEC officials said that a complete inspection is not necessary given the information it gains from routine oversight examinations. However, SEC does about two-thirds of all routine oversight examinations at NASD firms; yet, it still does a complete sales practice inspection at each NASD district office. Furthermore, each time SEC has inspected an SRO program segment it has found deficiencies. We found that every SEC inspection report for 1986 through 1989 contained comments about SRO program weaknesses. The weaknesses ranged from those that SEC characterized as serious, such as low standards for sales practice investigations compared to other SROs, to those that it characterized as minor, such as underutilized automated resources.

Third, SEC has little information relevant to the quality of SRO oversight from its routine oversight examinations because, as will be discussed in the next section, SEC's routine oversight examination results provide it with little direct information about SRO sales practice program quality.

SEC Routine Oversight Examinations Could Better Enhance the Quality of SRO Examinations

When SEC examines broker-dealer firms, it often finds violations that the SROs did not find. However, because SEC uses different examination methods and timeframes than the SROs use, it cannot always directly attribute the missed violations to weaknesses in SRO examination methods. Directly testing the quality of SRO oversight by using the same examination methods and timeframes that the SROs use could help SEC better identify causes of missed violations and thus provide better suggestions to SROs about how to improve their examinations. The violations SEC finds from activities it reviews that are outside the scope of the SRO examination probably indicate little about the effectiveness of SRO oversight, although they provide an indicator of broker-dealer compliance with securities laws. In addition, because applying SEC and SRO examination methods surfaces different violations at broker-dealer firms, some of these methods may be better than others. Both SEC and the SROs should use the best possible examination methods.

SEC guidelines to its regions for conducting routine oversight examinations do not require staff to retrace the SRO's examination steps or to select the same accounts that the SRO staff selected. Instead, SEC staff use a checklist of SEC-developed questions and sample customer files according to their own examination guidelines. These questions and guidelines differ from those the SROs use. SEC officials told us they do not use SRO examination methods because the oversight examinations the SROs conduct have a different purpose than the routine oversight examinations SEC conducts; that is, SROs examine broker-dealers for adherence

to SRO rules and SEC regulations, while SEC re-examines them to determine the quality of SRO broker-dealer examinations as well as for adherence to SRO rules and SEC regulations.

We analyzed the examination procedures reflected in the checklists that SEC and the SROs use and found substantial differences among them. While some checklists covered similar categories, such as supervision or registration, some had categories that others did not, such as restricted stock or extension of credit. When we compared the supervision category on SEC's checklist with each SRO's checklist, we found that none of the SROs had questions that were the same as, or similar to, all of the questions on SEC's checklist. Of the eight supervisory questions asked on SEC's checklist, one SRO had four similar questions and two others had three. In addition, as mentioned previously, SEC's examination may cover a longer timeframe than the SROs'.

SEC finds violations that the SROs missed in numerous categories, as shown in table 2.2. One category where violations occur—supervision—is missed most frequently, and another category where they occur—markups and markdowns—is being missed more frequently each year.

Table 2.2: Categories in Which SEC Found Violations That the SROs Missed, by Fiscal Year

Category	1986		1987		1988		1989	
	SEC found	SRO missed	SEC found	SRO missed	SEC found	SRO missed	SEC found	SRO missed
Unauthorized transactions	14	3	16	1	29	8	20	4
Disclosure	14	3	16	4	18	4	27	5
Markups/markdowns	24	3	26	4	49	6	95	8
Secret profits	2	0	5	1	2	0	4	0
Best execution	2	1	2	0	11	4	10	0
Suitability	24	17	15	5	31	16	18	1
Churning	4	2	13	3	23	9	17	2
Supervision	74	29	57	21	66	20	79	20
Conversion of funds	7	1	6	1	3	0	4	0
Switching	2	2	2	0	5	2	5	5
Breakpoint	5	3	11	0	7	2	2	1
Market manipulation	12	1	6	2	15	5	29	3
Unregistered securities	9	3	6	3	9	1	20	3
Insider trading	8	1	6	3	5	1	9	1
Free-riding & withholding	12	3	12	3	9	2	12	3

Note: The categories are defined in app. I.

Source: SEC Examination Activity Tracking System.

The numbers in table 2.2 may be misleading indicators of SRO examination effectiveness. An SRO official told us that the missed violations are usually minor and may be from a different sample of broker-dealer accounts than the SRO reviewed. SEC did, however, classify some of the missed violations as significant. We did not compare the SEC and SRO examination workpapers to determine the extent to which violations SEC found were outside the scope of the SRO examination. However, SEC examination reports generally provide no indication of why violations were missed. They usually noted that no definitive statement could be made regarding why the SRO did not discover the violations. For example, we reviewed 93 randomly selected SEC routine oversight examinations, some from each SEC region. Of these, 56 contained violations SEC found but the SRO missed. Of the 56, SEC determined why the SRO missed the violations in 6 cases. In the other cases, SEC sought written explanations from the SROs.

SEC officials also said that because they almost always find violations in their routine oversight examinations that the SROs did not find, the SRO

examination methods are not as thorough as SEC's in detecting violations. While SEC does find violations the SROs did not find, this does not necessarily mean that SEC's checklists are better than the SROs'. Because SEC reviews SRO examination reports before examining broker-dealers, it knows the violations that the SROs identified and can then more thoroughly review those areas to find additional violations. A review of examination methods to determine which are better at detecting non-compliance among broker-dealers was beyond the scope of our report. However, both SEC and the SROs should be using the best methods available.

Without knowing the cause of missed violations, SEC may not be able to identify what, if anything, an SRO needs to improve. By not directly testing the SRO examinations, SEC is missing an opportunity to determine whether faulty examination methods or faulty implementation of those methods led to missed violations by the SROs. For example, if the cause of the missed violations was the way in which guidelines or checklists were implemented, SEC could recommend that the SRO improve its examination instructions or procedures, provide better training to staff, or hire more skilled staff. By using different examination methods, SEC primarily gains direct knowledge of broker-dealer compliance with securities laws. However, measuring broker-dealer compliance with securities laws is the SROs' primary responsibility.

Conclusions

SEC could improve its sales practice oversight program by establishing timetables for fully inspecting SRO sales practice programs. Such timetables could help ensure that SEC inspections are systematic and provide more comprehensive and continuous program assessment. In addition, directly testing SRO examinations of broker-dealers could provide SEC a better indication of the effectiveness of these examinations. This could help SEC identify improvements needed in the way SROs do their examinations. In that regard, SEC and the SROs should use the best examination methods when they review broker-dealers. SEC could work with each SRO to identify the best methods and to develop more comprehensive evaluation methods tailored to an individual SRO's needs that both SEC and the SRO could use.

Recommendations

We recommend that the Chairman, SEC, take the following actions:

- Develop a timetable for fully inspecting the sales practice programs of all SROs.

- Include direct testing of each SRO's examination methods and results in SEC's program for reviewing the adequacy of SRO oversight. To the extent that either SEC or the SRO examination methods prove superior, SEC should ensure that both use the better methods.

Agency Comments and Our Evaluation

SEC agreed with our recommendation to establish a timetable for fully inspecting the sales practice programs of all SROs. However, SEC disagreed with our recommendation that it and the SROs agree on the examination methods to be used in SRO and SEC oversight of sales practices.

SEC believed that our report indicated a basic misunderstanding of SEC's purpose in conducting oversight examinations in that we assumed that SEC had but one goal—to audit the SRO's program. SEC noted that, conversely, it has two primary goals: (1) to evaluate and provide feedback to the SROs on the quality of SRO examination programs and (2) to ensure broker-dealer compliance with the securities laws. Given these goals, SEC does not believe its oversight examinations of broker-dealer sales practices should replicate SRO examinations. SEC also believed that SROs need latitude and should be creative in conducting examinations. SEC noted further that it is equally interested in what the SROs are not finding, which is why it conducts examinations of broker-dealer compliance with the securities laws. Nonetheless, SEC agreed to review its procedures to determine why SROs miss violations that are later found in SEC examinations.

We recognized and understood both of SEC's goals. We chose, however, to focus primarily on the first one—SEC's evaluation of the quality of SRO oversight. We chose to do so because this goal affords the broadest protection coverage for the consumer. In fulfilling their oversight responsibilities, the SROs are required to visit every broker-dealer. Conversely, SEC's second goal—ensuring broker-dealer compliance—is accomplished through a sample, usually at least 6 percent, of broker-dealers. Further, while that sample includes firms that do most of the customer-related securities business, sales practice violations that cause customers to lose considerable funds can occur in smaller firms that SEC might not routinely visit. This has been amply illustrated by the penny stock problem.

We believe SEC misinterpreted our recommendation by reading it as being more prescriptive and rigid than we intended. It was not our intent to limit SEC to merely replicating SRO examinations; we fully recognize

that SEC needs the latitude to also ensure that broker-dealers are complying with the securities laws. Neither was it our intent to stifle creativity in devising examination methods; we applaud creativity and innovation in the interest of consumer protection.

The intent of our recommendation was to make it easier for SEC to identify why SROs miss violations, give the SROs feedback for improving their programs, and ensure that SEC and the SROs use the best evaluation methods available. We continue to believe that the best way for SEC to evaluate SRO broker-dealer oversight examinations and to determine why violations are missed is to directly test the SRO examination. SEC does not need to replicate every step the SRO did, but it does need to satisfy itself that the examinations are thorough and complete. The extent of this type of assessment could diminish as SRO oversight examinations improve. Further, this process would not keep SEC from doing whatever additional work it judges necessary to ensure broker-dealer compliance with securities laws.

While expressing disagreement with our recommendation, SEC agreed to undertake a review of its procedures to evaluate whether additional steps could be taken to shed further light on why the SROs miss certain violations and whether modifications to regulatory follow-up procedures are necessary. We view this action as being fully consistent with the point of our recommendation. Thus, we clarified the language of our final recommendation to better convey our intent.

SEC Needs to Enhance Two of Its Information Systems

The two information systems that SEC uses to keep informed about investor complaints and examination results could collect more complete information. The Complaint Management and Processing Index system for categorizing investor complaints is not designed to store and accurately count complaints received or to categorize complaints by security type, and does not interface with complaint systems SROs and state regulators maintain. In addition, the Examination Activity Tracking System for summarizing violations found during routine oversight examinations is not designed to accurately count those violations or capture data on violations at firms that only SROs examined. Because these two systems collect incomplete information, their usefulness in identifying trends in violations is limited.

SEC's Investor Complaint System Has Limitations, but Improvements Are Planned

SEC receives complaints from investors who telephone or write to allege improprieties by broker-dealers or their employees. It then uses these complaints to target its oversight examinations and cause investigations. However, SEC's complaint system is designed so that only one complaint can be recorded for each letter or phone call, and security type cannot be recorded. In addition, SEC's database does not include complaints filed only with the SROs or state regulators. Thus, SEC officials may not be able to fully assess the significance of the complaints received. SEC is designing a new customer complaint system that is intended to eliminate many of the current system's limitations.

Customer Complaint Information Is Useful

Customer complaint information is important because SEC uses it to determine, among other things, whether to further scrutinize specific firms or employees for violations of security laws. As shown in table 3.1, from fiscal years 1986 through 1989, SEC received a total of about 110,000 complaints from investors. Of these, between 7 and 11 percent related to sales practices.

Table 3.1: Investor Complaints SEC Received (Fiscal Years 1986 Through 1989)

Fiscal year	Total complaints	Sales practice complaints	Percent of total
1986	24,960	^a	
1987	29,114	3,085	10
1988	29,721	3,363	11
1989	26,183	1,792	7
Total	109,978^b	8,240	

^aNot available.

^bThis total includes all complaints to SEC, including those about banks and financial planners as well as those about broker-dealers.

Source: SEC Office of Consumer Affairs and Information Services.

SEC officials use these complaints as one tool to determine whether specific employees or practices of a firm warrant closer scrutiny during routine oversight examinations or cause investigations. Historically, between 20 and 25 percent of the cause investigations SEC's Enforcement Division opens each year result, at least in part, from information obtained from investor complaints. As table 3.2 shows, information from complaints provided about 20 percent of all leads for investigations opened each year since fiscal year 1986.

Table 3.2: Sources of SEC Investigations

Figures in percent				
Sources	Investigations opened by fiscal year			
	1986	1987	1988	1989
Investor complaints	23	19	18	20
Informants	14	19	16	15
SEC examination program	16	15	15	15
News media	11	12	12	11
SROs	10	11	12	14
Other SEC divisions	9	8	9	9
All other sources	28	32	31	28

Note: The sum of the percentages exceeds 100 because an investigation may emanate from more than one source.

Source: SEC budget estimates for fiscal years 1989, 1990, and 1991.

Incomplete Recording of Investor Complaints

SEC officials told us that when SEC receives an investor complaint, it is routinely entered into SEC's Complaint Management and Processing Index system, which was established in the early 1970s. Under this system, SEC can record the name and address of the firm or firm

employee being complained about, the nature of the complaint, and disposition of the complaint. However, because only one complaint for each letter or phone call can be entered into the complaint system when multiple complaints are made, the system is unable to accurately count the types of allegations made in customer complaints. For example, if an investor alleges that unauthorized trading occurred in his/her account, he/she was pressured to buy securities, and his/her account was mishandled in other ways, the system requires the person entering the data to choose only one of the allegations. In addition, the system does not contain a data element to record the type of security involved in the complaint.¹ Therefore, SEC is unable to routinely determine whether investors are complaining more about one security type than another. Instead, special efforts must be made to track these data. For example, in 1990, SEC's task force on penny stocks requested that SEC staff provide the total number of penny stock-related complaints. SEC staff first had to manually review all complaints to identify those related to penny stocks and then code them so that they could be tracked. Because this effort was so labor intensive, SEC staff could only provide the task force complaint information beginning with 1988. Further, to collect data for its analysis of the October 1987 market crash, SEC had to first create a special computer program to capture data elements not tracked by its complaint system and then enter these data into its system.

Finally, although SROs and state regulators also receive investor complaints, their complaint systems are not linked to SEC's system. Without such a linkage, regulators do not know the total universe of customer complaints. Table 3.3 shows the number of investor complaints SROs received from fiscal year 1986 through 1989.

**Table 3.3: Total Customer Complaints
SROs Received** (Fiscal Years 1986 Through
1989)

SRO	1986	1987	1988	1989
Amex	369	641	480	381
CBOE	195	483	343	344
NASD	4,252	5,337	5,069	4,911
NYSE	2,556	2,179	3,012	2,493

Sources: Amex, CBOE, NASD, and NYSE officials.

If penny stock complaints are indicative of the number of complaints state regulators received, including state-received complaints would also be an important addition to SEC's information base. For example, the

¹Security types include penny stocks, foreign securities, mutual funds, and U.S. government and U.S. government agency securities.

North American Securities Administrators Association reported in September 1989 that in 1987 and 1988, state regulators received about 4,400 penny stock-related complaints.

Some SEC and SRO officials we spoke with agreed that all regulators could benefit from a centralized customer complaint system, because more comprehensive data could better depict patterns of complaints related to specific firms or sales practice abuses. However, some SROs were concerned about which agency would operate the system, how it would be paid for, and who would have access to it.

SEC Is Designing a New Customer Complaint System

In an August 1989 letter to the Office of Management and Budget, SEC cited its tracking of investor complaints as a material weakness and proposed a new complaint system called the Correspondence Automated Processing System. According to an SEC official, the new system, scheduled for implementation in March 1991, will allow for tracking of multiple complaints and security types. While these proposed improvements would address many current system limitations, one key limitation may remain—no linkage with SRO or state systems. According to an SEC official, SEC has initiated a preliminary dialogue with NASD to establish a link. However, the official added that lack of resources to establish such a system keeps this project from moving forward.

System limitations and differences in how complaints are defined and coded hamper the effective use of data from SRO and state regulators. No indication exists that SEC plans to eliminate these differences. SEC is aware that system differences currently make complaint sharing among regulators virtually impossible. For example, SEC and NASD cannot easily transfer complaint information because the complaints are in different, incompatible computer formats. SEC officials told us that an attempt to exchange complaint information with NASD was stopped because the process was too labor intensive.

However, system differences can be overcome. For example, NASD started a pilot customer complaint program in April 1986 to incorporate complaints the securities agencies of three states received. These states agreed to provide all their customer complaints to NASD in exchange for a monthly NASD printout of all customer complaint information pertaining to their state that NASD and other states received. The program now includes 21 states.

An NASD official told us NASD intends to alter the system to allow states to access and enter data into the system. This official also said that NASD began the pilot program to avoid duplication of investigative efforts on customer complaints and that, although the program has no mechanism to filter out duplicate complaints, the complaint listing includes where each complaint was initially sent (that is, SEC, NASD, or a state). Thus, anyone following up on a particular complaint can call the appropriate office to determine the extent to which it has already been investigated.

SEC Makes Limited Use of Examination Information

SEC has one automated information system for tracking the violations its staff find in their routine oversight examinations. However, SEC does not use this system to identify trends. Instead, it uses it to monitor its regional office activities.

SEC requires its regional offices and the SROs to regularly submit various status reports conveying the results of their oversight examinations. SEC regional offices submit information from their routine oversight examinations to headquarters on the Examination Activity Tracking System form. This information includes the dates routine oversight examinations were started and completed, types of violations found, number of repeat violations, number of violations SROs missed that the regional office found, and case disposition. SEC headquarters then summarizes the examination data every fiscal year to show, by region, the numbers and types of violations SEC found, the numbers and types of repeat violations, and the numbers and types of violations SROs missed.

However, the summary data do not reflect the extent of problems found because multiple violations of the same type are reported as a single violation. For example, if SEC staff find that a broker has made unauthorized trades in several accounts, this violation would appear on the status report as occurring only once. By capturing data in this way, SEC is receiving incomplete information on the violations occurring in the securities industry.

SEC's overview is further hampered, and therefore so is the information's usefulness at depicting trends, because the format of the Examination Activity Tracking System does not include violations SROs found at firms they examined. SEC received broker-dealer violation information from the SROs in summary form from three of the four SROs we

examined.² However, SEC does not further summarize the information. Instead, it uses it as needed after a particular broker-dealer has been selected for an SEC routine oversight examination. SRO information would be particularly useful because the SROs examine all broker-dealers, and SEC examines only about 6 percent of them each year.

Conclusions

SEC could make better use of its investor complaint and oversight examination information systems. Complaint system limitations stemming from an inability to interface with SRO and state systems hamper the effective use of customer complaints to fully identify trends and thus better target investigatory resources. To more effectively use routine oversight examination information in its Examination Activity Tracking System, SEC needs to better summarize data from its regional offices and SROs so that it can quickly identify variances in the quality of firm operations and patterns of customer abuse, such as those associated with the widespread penny stock fraud. Recording the exact number of violations by a firm in each category to portray the frequency of each violation might assist SEC in targeting specific firms for cause examinations. Summary data on frequent, similar violations across many firms could also help SEC detect developing trends in violations.

Recommendations

We recommend that the Chairman, SEC, take the following actions:

- Continue to place a high priority on implementing a new customer complaint system but also improve the proposed system by including the ability to interface with SRO and state customer complaint systems.
- Explore ways to record and maintain information on the actual number of each type of violation found in SEC and SRO broker-dealer oversight examinations. Options could include accessing existing SRO databases or incorporating the data into the Examination Activity Tracking System.

Agency Comments and Our Evaluation

In commenting on a draft of this report, SEC reiterated that the complaint system was being redesigned and that the redesign addressed certain deficiencies in the current system. It said that the new system would greatly increase the information available on-line; track multiple allegations or complaints, the type of security involved, and number of referrals made; and provide several comment fields. SEC noted, however,

²Officials of the one SRO that currently does not furnish this information told us it would do so if SEC requested.

that it did not believe a centralized customer complaint tracking system would significantly enhance detection of sales practice abuses or that such an endeavor would be desirable or cost effective. It cited several practical obstacles to a centralized tracking system, which it characterized as "formidable."

We believe that SEC read too much into the words of our recommendation. We did not use the phrase "centralized tracking system," and it was not our intent to suggest that SEC develop one. Rather it was our intent to endorse SEC's efforts in implementing a new customer complaint system and to encourage SEC to enhance the design of that system by interfacing with other such systems. SEC commented that it has already had discussions with NASD regarding developing an electronic link so that SEC and NASD could access each other's systems. SEC said that this system, once developed, could be expanded to include other SROs. These actions meet the intent of our recommendation concerning customer complaint information.

SEC disagreed with our recommendation that it revise the Examination Activity Tracking System to incorporate the actual number of each type of violation found in SEC oversight examinations and SRO examinations. SEC said that modifying the system to record the number of times a particular violation is found would not substantially improve SEC's ability to identify trends. It also noted that modifying the system to include all SRO examinations would not be cost effective. It said SRO examination findings are included only when SEC has done an oversight investigation of a broker-dealer and to include the results of all SRO examinations would create a significant data input burden on limited SEC staff. It further questioned the need for the data by stating that its regular meetings with SRO officials permit SEC to follow any trends identified by SRO examinations.

We agree that SEC's present system produces useful information on what is occurring industrywide. However, it does not give SEC accurate information on the extent of problems at particular firms. Under the current system, SEC headquarters has statistical information on the types of violations that occur at a particular firm but not on the extent or frequency of violations. Such information would be useful when targeting firms for cause examinations under the premise that a firm with multiple violations of the same type would probably be a better candidate for a cause examination than a firm with only one violation. Under the current system, SEC headquarters, which selects firms for cause examinations,

can get this information only by contacting its regional offices and the SROS.

The intent of our recommendation was to better position SEC to target firms through improved information. We continue to believe that this is a valid need but recognize that there are options for achieving this end. One of SEC's primary concerns with revising its tracking system was the data input burden that would accrue to its limited staff. A way to achieve the intent of our recommendation and ensure that the input burden is not placed on SEC's limited staff would be for SEC to gain access to the data by interfacing with other systems. In this regard, SEC noted that NASD is implementing a new system, which will contain the kind of information we have in mind. SEC said it plans to discuss ways in which it might obtain real time access to NASD's database. This action is in keeping with the intent of our draft recommendation. We modified the language of our final recommendation to be less prescriptive.

Categories in Which Sales Practice Violations Occur

Unauthorized transactions: Transactions executed in a customer's account without the knowledge or consent of the customer.

Disclosure: When acting as a dual agent, a broker-dealer must disclose to each customer the commission and/or other remuneration received from both parties. If a broker-dealer is making a market in (buying or selling for its own account) a security, it must disclose its role as market maker on each confirmation involving the security so that the customer is aware that the price paid was determined by the broker-dealer as a result of the broker-dealer's market maker role.

Markups/markdowns: When broker-dealers buy from or sell to customers as principals, i.e., they own the security being sold to the customer, or they buy for their own account the securities the customer sells, the sales charges are known as markups or markdowns, respectively.

Secret profits ("clipping"): SEC rule 10b-10 requires a broker-dealer executing a transaction for a customer to provide the customer with a written confirmation at or before the time the transaction is completed that discloses the firm's capacity (agent or principal) and specific information about the transaction, such as transaction price and commission for agency transactions or dollar price of the transaction and yield to maturity for principal debt transactions. If a firm confirms to a purchaser a price per share higher than that paid to the seller, or conversely, if a firm confirms to a seller a price per share lower than that received from the purchaser, the firm has taken a secret profit.

Best execution: Broker-dealer execution of a trade at the best displayed price at the time of the trade.

Suitability: Appropriateness of investments based on a customer's financial means and expressed investment strategy.

Churning: When a broker abuses control over a customer's account to generate commissions by conducting transactions that are frequent and disproportionate to the size and charter of the account (taking into consideration the customer's financial situation, needs, and objectives).

Supervision: Broker-dealers are required to establish, maintain, and enforce written procedures that will enable them to properly supervise the activities of each representative and associated person to ensure compliance with all applicable laws, rules, and policy statements.

Conversion of funds: Changing customer-owned securities or monies for improper use by a firm or sales agent.

Switching: Moving a customer from one mutual fund to another in a pattern of activity that is inappropriate for the customer and has the prime result of excessive sales commissions.

Breakpoint: Soliciting mutual fund orders in dollar amounts just below the dollar level where a purchase qualifies for a discounted sales charge (breakpoint) to obtain higher commissions than if the orders were above this dollar level.

Market manipulation: The Securities Exchange Act specifically prohibits manipulation of securities registered on national securities exchanges, and the general anti-fraud provisions of the 1933 and 1934 acts prohibit manipulation of over-the-counter securities. Manipulative transactions must (1) effect a series of transactions in a security; (2) either cause a rise or decline in the price of a security, or create actual or apparent active trading in its market; and (3) be effected to induce the purchase or sale of such security by others.

Unregistered securities: Trading of securities not registered for sale with SEC.

Insider trading: Trading securities based on nonpublic, advance knowledge of tender offers or forthcoming announcements of material information expected to affect the value of the traded security and give the trader windfall profits.

Free-riding and withholding (NASD): Failure of a NASD member to make a bona fide offering of a security it is distributing as underwriter or selling group member.

Comments From the Securities and Exchange Commission

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



DIVISION OF
MARKET REGULATION

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

January 4, 1991

Richard L. Fogel
Assistant Comptroller General
General Government Division
General Accounting Office
Washington, D.C. 20548

Dear Mr. Fogel:

I am writing in response to your December 6, 1990 letter to Chairman Breeden requesting the comments of the Securities and Exchange Commission ("Commission" or "SEC") on the General Accounting Office's ("GAO") draft report entitled Securities Industry: Strengthening Sales Practice Oversight. The draft report concludes that the Commission's program for overseeing SRO sales practice activities "seems to contain the activities necessary for effective oversight."^{1/} The draft report makes four specific recommendations for strengthening the Commission's oversight program. First, the draft report indicates that the Commission could strengthen its oversight program by improving its coverage of self-regulatory organization ("SRO") inspections. Second, the draft report recommends that the Commission change its method of evaluating the effectiveness of SRO broker-dealer examinations. Third, the draft report recommends the Commission continue to place a high priority on implementing a new customer complaint system and should work with other regulatory entities to include complaints received by SROs, broker-dealers, and state regulators in its system. Finally, the draft report recommends that the Commission revise its existing computer system for tracking SEC broker-dealer examinations, the Examination Activity Tracking System ("EATS"), to incorporate the actual number of each type of violation found in oversight examinations and SRO examinations.

I welcome the opportunity to correct certain factual inaccuracies contained in the draft report, clarify certain misunderstandings about the Commission's SRO sales practice oversight programs, and address the specific recommendations suggested in the draft report.

^{1/} Draft Report at 3.

See comment 1.

Before discussing these four specific areas, however, I would like to emphasize the importance the Commission places on effective sales practice regulatory programs at the SROs and highlight some of the recent enhancements that have been made both to the Commission's sales practice oversight programs and the SROs' sales practice programs. Between 1986 and 1989, the Commission's broker-dealer sales practice examination efforts increased substantially. More specifically, the number of cause examinations conducted primarily to review for sales practice abuses during this time period increased 114.5%, from 69 exams in 1986 to 146 exams in 1989. In addition, the number of matters referred for enforcement consideration during this same period increased 32%, from 72 in 1986 to 106 in 1989. 2/

In addition, the Commission has committed substantial resources to combat sales practice abuses relating to those firms engaged in the sales of low-priced securities during the last two and a half years. This effort has required enhanced cooperation with the National Association of Securities Dealers, Inc. ("NASD") and, at the same time, a heightened scrutiny of how the NASD's regulatory programs address the sales practice related problems associated with penny stocks. More specifically, during the period from June 1988 to September 30, 1989, the regional offices completed 165 sales practices examinations of firms engaged in selling penny stocks. These examinations discovered serious violations involving excessive markups, market manipulation, high pressure boiler room sales practices, and misrepresentations about business and financial conditions of issuers or securities. Fifty percent (82) of the completed examinations were referred for enforcement consideration, while an additional nine percent (14) were referred to the NASD for enforcement consideration. In FY 1990, the cause examination program continued to place special emphasis on examination of firms engaged in selling penny stocks. In this regard, penny stock examinations accounted for 114 (65%) of the 176 cause examination completed during FY 1990.

It is extremely important to note that the Division of Market Regulation ("Division"), through its compliance inspection

- 2/ Although the number of staff years authorized for regulatory matters during the 1986-89 period increased by 9%, the number of staff days devoted to each examination increased by 19%. The increased time devoted to conducting examinations is directly attributable to the broker-dealer examination program's objective to expand the scope of sales practice reviews on all broker-dealer examinations.

program, has contributed to improved and enhanced SRO sales practice regulatory and disciplinary programs during the 1986-89 period. The changes made at the New York Stock Exchange's ("NYSE") Division of Enforcement are illustrative of this effort. Over the last five years, in large part as a result of our oversight inspections, NYSE's enforcement staff has increased from a staff of 21 attorneys and investigators with an active docket of approximately 500 cases in 1986 to approximately 130 individuals with an active docket of approximately 800 cases today. In addition to significant increases in NYSE enforcement personnel, the quality and depth of investigations and the types of cases being brought by the Division of Enforcement have improved.

The Division's compliance inspection program also has had a material impact on the approach of the NYSE toward conducting sales practice examinations of member firms. The NYSE has substantially modified its sales practice examination module for its financial and operational examiners.^{3/} In addition, the NYSE now requires one financial and operational examiner to solely address sales practice issues during the regular annual financial and operational examinations of member firms so as to assure a more detailed sales practice review.

We find it surprising that these major initiatives are simply ignored in GAO's draft report.

A. Improving Coverage of SRO Inspections

In the area of SRO oversight inspections, the draft report recommends that the Commission develop a timetable and goal for inspecting the sales practice programs for all SROs. The analysis upon which this recommendation is based, however, contains factual errors which need to be corrected. Specifically, Table 2.1 on page 19 of the draft report purportedly represents the Division's inspection in four sales

^{3/} The NYSE has a separate Sales Practice Review Unit that does only sales practice examinations of member firms. This unit, however, does not examine every NYSE member firm on a yearly basis. The NYSE examination units, however, which primarily have been concerned with examining the financial and operational condition of member firms on an annual basis also perform a limited sales practice examination.

Now on p. 17.

4

See comment 2.

practice areas 4/ for four SROs, NASD Headquarters, Amex, CBOE and NYSE. This table, in our view, is inaccurate in several respects. First, the table indicates that the Division has conducted no inspections of NYSE disciplinary programs since 1986 and has reviewed cause investigations only in 1987 and 1988. The Division, however, has conducted inspections of disciplinary actions by the NYSE's Division of Enforcement in each of those four years. 5/ The NYSE Division of Enforcement conducts cause investigations, based on Form U-5 and RE-3 reports filed with it by NYSE member firms, 6/ and those investigations were reviewed as part of the four inspections of Enforcement conducted between 1986 and 1989. In addition, the Division conducted yet another comprehensive inspection of the NYSE Division of Enforcement in 1990.

See comment 3.

With respect to the NASD, GAO's primary concern is that the Commission should be directly examining the administration of the districts' programs by NASD headquarters, particularly the development of procedures and national guidelines for the district offices. The report fails to mention, however, that the Division has recently conducted three inspections that address this very point. More specifically, the Division conducted inspections of how the NASD district offices were calculating markups in low priced equity securities in January 1989. The

- 4/ These four areas are: 1) cause investigations; 2) broker-dealer examinations; 3) advertising; and 4) disciplinary actions.
- 5/ In 1986 the Division focused on referrals to the Division of Enforcement from the NYSE's Sales Practice Review Unit ("SPRU") as part of the Division's inspection. In 1987 the Division looked in detail at the way the Enforcement Division was handling referrals from the Commission's regional offices. In 1988 the Division conducted a follow-up inspection of the previous inspections in 1986 and 1987. Finally, in 1989 the Division looked at 80 cases that the NYSE closed pursuant to a discretionary proposal.
- 6/ Form U-5 (Uniform Termination Notice for Securities Industry Registration). This form, which must be completed and submitted upon the termination of an employment relationship, requires a description of the circumstances surrounding the termination and information as to any instances of specified types of problems or conduct occurring during the individual's employment. Form RE-3 must be submitted promptly upon the occurrence of specified events or the existence of conditions relating to possible misconduct by members, member organizations and their associated persons.

Division also inspected the NASD's Anti-Fraud Department in October 1989 to assess how it was addressing complex investigations involving, among other things, penny stock firms. Additionally, the Division conducted an inspection of the NASD's National Business Conduct Committee ("NBCC") in 1990 to assess how effectively the NBCC fulfilled its mandate to ensure consistency among district offices' disciplinary actions.

It is important to emphasize, however, that these headquarters inspections either focused on areas for which headquarters has operational responsibility or where our oversight and district office examination programs identified a national problem. Outside of these areas, headquarters inspections would not be a useful expenditure of resources. The draft report fails to recognize that the NASD's sales practice programs, with the exception of advertising reviews, are implemented in the 14 NASD district offices that are geographically dispersed across the country. More specifically, cause investigations, broker-dealer examinations and formal disciplinary actions all are conducted by the NASD's district offices, and not by the headquarters office. While the NASD headquarters office establishes overall program objectives and goals to be carried out by the district offices, the Commission's regional offices review these areas as part of their routine inspections of NASD district offices. The compliance inspections of NASD district offices also evaluate the policies and procedures set forth by the NASD's headquarters. We believe this compliance inspection process, in addition to regular quarterly meetings between senior NASD and Division staff, provides an effective review of the NASD's sales practice program including the overall program goals and objectives of that program.

Finally, the draft report notes that, except for the NASD district offices, there is no similar goal or timetable for examination of each segment of the other SROs' sales practice program. While it is true that there is no formal timetable for inspecting the other SRO sales practice programs, the Division does employ an informal four year cycle. In fact, as the draft report indicates (or as we have clarified with respect to the NYSE), the Commission did in fact look at all SRO's sales practice programs during the period 1986-89.^{1/} We concur, however, with your recommendation that a formal inspection cycle for other SRO sales practice programs be established, and intend to do so.

See comment 4.

^{1/} The comment in the draft Report that this is a function of size is not accurate. The only SRO for whom size is a relevant consideration with regard to its sales practice programs is the NYSE.

B. Changing Commission's Method of Evaluating the
Effectiveness of Broker-Dealer Examinations

The draft report recommends that the Commission "develop, with the cooperation of the SROs, one agreed-upon checklist and examination procedures to be used in all SRO examinations and SEC re-examinations of broker-dealer sales practices." For the reasons discussed below, we strongly disagree with this recommendation.

When describing the Commission's broker-dealer oversight program, the draft report indicates that the SEC reexamines broker-dealers. This statement is incorrect and, we believe, indicates a basic misunderstanding of the Commission's objectives in this area.

The Commission conducts oversight examinations. GAO appears to assume that the sole goal of these examinations is to audit the SRO's program. Instead there are two primary goals of an oversight examination: 1) to evaluate and provide feedback to the SROs on the quality of their examination program; and 2) to assure broker-dealer compliance with the securities laws. We do not believe the Commission's examinations should replicate the SRO's examination or necessarily cover the same customer accounts reviewed by the SRO. We believe that the SROs should be creative in designing their examination modules and conducting examinations. The Division believes that SROs, under the Exchange Act, have latitude in conducting their routine examinations, assuming their approach is thorough and effective. Moreover, the SRO's routine examination informs us about what the SRO is doing and what they find. The Commission's oversight examination program, on the other hand, is equally interested in what the SROs are not finding. During the past several years a few Commission regional offices have conducted oversight examinations that replicated examinations conducted by SROs. However, our experience from these examinations was that they were unproductive, inasmuch as these examinations only confirmed the SROs findings. Additionally, while our oversight examinations primarily test the effectiveness of the SROs, they also determine whether firms are presently complying with all applicable securities rules and regulations.

We also do not agree with the assertion that the "SEC needs an effective program for recommending remedial actions so that any systemic weaknesses in SRO oversight programs do not continue". For the reasons discussed above, we believe the present examination methodology meets the twin goals of the oversight examination program. In that connection, we believe that we already have in place an effective program for dealing with systemic SRO examination weaknesses. In addition to our

See pp. 22-23.

See comment 5.

regional offices communicating examination weaknesses to SROs in written form and in face-to-face meetings, the Division of Market Regulation meets quarterly with the NASD and the NYSE to discuss regulatory matters, including systemic problems identified from oversight examinations. Whatever would be gained from simply repeating the methodology employed by SROs would be at a cost to identifying additional securities violations through the employment of independent SEC techniques. Consequently, we cannot agree with the recommendation that the SEC and the SROs use uniform methodologies for conducting examinations.

See p. 23.

While we do not believe that the oversight examination program should be changed so that its exclusive purpose is to audit the sales practice activities of the SROs, we will undertake a review of our procedures to evaluate whether additional steps could be taken, with due regard to resource limitations, which would shed further light on why the SROs miss certain violations and whether modifications to our regulatory follow-up procedures are necessary. Among other approaches, we will consider inclusion of a review of NYSE and NASD sales practice examination modules and techniques in our SRO oversight examination program.

C. Collection and Use of Customer Complaint and Management Information

The draft report recommends that the Commission "continue to place a high priority on implementing a new customer complaint system, but also improve the proposed system by working with other regulatory agencies to include in its system complaints received by the SROs, their member firms and state regulators." The draft report also recommends that the Commission revise EATS "to incorporate the actual number of each type of violation found in re-examinations and SRO examinations."

As the draft report notes, the Commission's complaint system is currently being redesigned. This redesign is intended to address certain deficiencies the Commission identified, a number of which the draft report also noted. The new system has been fully designed and currently is undergoing programming and testing, with implementation scheduled for early March 1991. The new system, among other things, will greatly increase the information available on-line, tracking multiple allegations or complaints, the type of security involved, referrals made, and several comment fields. Moreover, the system will have enhanced query and report generation capability to better support SEC examination and investigatory staff.

See pp. 29-30.

We do not believe, however, that a centralized customer complaint tracking system would significantly enhance detection of sales practice abuses, nor that such an endeavor would be either desirable or cost-effective. More specifically, our examination staff currently receives from and reviews appropriate SRO customer complaints that the SRO has received before conducting a broker-dealer examination. In addition, upon arrival at the firm, Commission examiners always request the broker-dealer's log or file of customer complaints for review. Consequently, Commission examiners are aware of all relevant complaints against a broker-dealer before or during the broker-dealer examination. In addition, we believe that a review of the Commission's customer complaint data base, when combined with our regular dialogue and inspections of the SROs, provides an adequate basis for identifying sales practice abuse trends.^{8/}

See comment 6 and pp. 30-31.

The practical obstacles to a centralized tracking system are formidable. In addition to the cost, maintenance and information access concerns cited in the draft report, difficulties in agreeing on standardized procedures for data entry, quality control and uniform complaint codes designed to meet different needs would have to be addressed.

We also cannot agree with the draft report's recommendation that the Commission revise EATS to incorporate the actual number of each type of violation found in SEC oversight examinations and SRO examinations. The Division of Market Regulation receives and reviews monthly downloads of all examination information from EATS, along with broker-dealer examination reports and other information, for trends relating to violations discovered in SEC and SRO examinations. Modifying EATS to record the number of times a particular violation of the securities laws is found during an examination, in our view, would not substantially improve our ability to identify trends. More specifically, from a trend analysis perspective, the Commission is interested in the number of examinations where a particular violation (e.g., churning or unauthorized trading) is found, not the number of times at one broker-dealer where that particular violation has

^{8/} The Commission's Office of Consumer Affairs and Information Services routinely shares information it has with the NASD and state regulators. In this regard, preliminary discussions with the NASD have already commenced concerning the development of an electronic link for transmitting data so that the Commission and NASD could have access to each other's complaint data. This concept, once it proves workable, could be expanded to include other SROs.

occurred. 2/

Moreover, to modify EATS to include all SRO examination findings would not be cost-effective. Currently, EATS data is generated only for Commission examinations, whether oversight or cause. SRO examination findings only are included where the Commission has done an oversight examination of a broker-dealer. To include the results of all SRO examinations would create a significant data input burden on limited Commission staff resources. The substantial costs associated with such an effort, in our view, would not enhance materially the effectiveness of EATS as a Commission management tool. Instead, we believe our regular meetings with SRO officials permits us to follow any trends identified by SRO examinations. In this connection, we note that effective January 1, 1991 the NASD will be implementing its new District Management Information System ("DMIS") in all of its district offices. This data base will contain complete information on all NASD examinations. The Commission will be discussing with the NASD ways in which it can obtain access to this data base on a real-time basis.

See comment 7.

We would separately note that the draft report's conclusion that the recommended changes would have led the Commission to an earlier establishment of the Commission's Penny Stock Task force is simply untrue. This unfounded assertion appears to be based on the assumption that the Commission, unlike NASAA, was unaware of the increase in penny stock fraud prior to 1988. Nothing could be further from the truth. The Commission staff, particularly the Denver and Atlanta Regional Offices and the Miami Branch Office, had committed substantial resources to penny stock fraud investigations throughout the 1980s, including investigations of First Jersey Securities, Blinder Robinson, Stuart James, Wellshire Securities, and Power Securities, that had led to penny stock enforcement actions during that period far in excess of the number of enforcement actions commenced by the fifty states.

See comment 7.

- 2/ If EATS included the number of times a churning violation or a customer securities possession and control violation occurred at one broker-dealer, the trend analysis could easily be skewed. For example, if an examination revealed 100 accounts were churned at a particular broker-dealer there clearly is an indication of a severe problem with that firm. This would not necessarily indicate that the frequency of churning generally has increased. At the same time, however, if churning were discovered during 100 different broker-dealer examinations, serious questions would be raised concerning the frequency with which this sales practice abuse was being identified.

Appendix II
Comments From the Securities and
Exchange Commission

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See comment 8.

The Report also describes briefly what the Penny Stock Task Force was intended to do (page 13), but neglects to mention that all of those purposes, - development of regulations, education of consumers, coordination with other regulators and increasing enforcement activities - have been accomplished. While the work of the Commission is ongoing, I believe it is very important that the Report recognize its very substantial achievements to date.

The Division appreciates the opportunity to comment on the draft report. We would be happy to meet with GAO staff at your convenience to discuss our comments further. If you have any questions regarding this letter, please feel free to telephone me at (202) 272-3000.

Sincerely,


Richard G. Ketchum
Director

The following are GAO's comments on the Securities and Exchange Commission's letter dated January 4, 1991.

GAO Comments

1. SEC provided additional statistics on various aspects of its enforcement activities. We verified this information and included it on pages 11 and 12.

2. SEC primarily disagreed with the accuracy of data in table 2.1. It noted we did not give SEC credit for inspections it did of NYSE that covered cause investigations and disciplinary actions. SEC's disagreement appears to be due primarily to a misunderstanding of how we categorized the different activities in the oversight examinations we reviewed. We needed to make these categorizations when a particular activity covered more than one of the four commonly accepted parts of a sales practice oversight program. The categorizations we made were based on discussions with SEC staff and a review of each SRO's program structure.

Initially, we did not credit SEC for formal disciplinary action inspections at NYSE because we thought SEC had not evaluated disciplinary procedures and disciplinary actions. However, SEC noted that the 1986, 1987, 1988, and 1989 inspections did cover referrals, which are part of the disciplinary action process. After reviewing the reports, we added a note to table 2.1 to recognize the disciplinary action inspections. After discussions with SEC officials, we also changed the table to credit SEC for partial cause examinations in 1986 and 1989, because SEC reviewed SRO forms that were related to cause examinations.

3. SEC disagreed with our initial decision to include NASD headquarters in table 2.1. It said that except for advertising reviews, NASD's sales practice programs are implemented in the 14 NASD district offices and therefore headquarters inspections would not be useful. It added that it does headquarters inspections on areas for which NASD headquarters has operational responsibility or where district examinations identified a national problem. SEC said that it had done three inspections at NASD headquarters that addressed the development of procedures and national guidelines. After verifying SEC's comments we deleted NASD headquarters from the table.

4. We have clarified the language on page 17 of the report to indicate SEC's belief that size is an important factor for NYSE. Nevertheless, the arguments we make that allowances can be made for size in setting an

inspection timetable apply to any large SRO. Further, SEC agrees that a formal timetable is needed for all the SROs.

5. We have deleted our discussion regarding SEC's program for recommending remedial actions to SRO oversight programs.

6. We agree that the trend analysis could be skewed if the Examination Activity Tracking System included the number of times a violation, such as churning or a customer securities possession and control violation, occurred at one broker-dealer without associating the violation with the firm. However, we also believe that the system can be set up to differentiate between violations that occur at one broker-dealer and violations that occur at many firms.

7. We have deleted from the report the conclusion regarding the earlier establishment of the penny stock task force.

8. We have revised the report on page 12 to recognize the accomplishments of the penny stock task force.

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