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SECURITIES MARKETS

Actions Needed to Better Protect Investors Against Unscrupulous Brokers

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Mr. Chairman and Members of the Committee:

We are pleased to appear today to discuss the oversight and discipline of unscrupulous brokers by the Securities and Exchange Commission (SEC) and the securities industry's Self Regulatory Organizations (SROs). We are also issuing today the report we have prepared on this subject in response to your request and the request of Chairman Dingell. In my testimony today, I will briefly summarize our major conclusions and recommendations. These focus on three areas: (1) the extent to which unscrupulous brokers are active in the securities industry, (2) regulatory and industry efforts to discipline unscrupulous brokers, and (3) the capability of the securities industry to identify unscrupulous brokers through its database on brokers' disciplinary histories.

We share your concern that investors are not being sufficiently protected from the activities of unscrupulous brokers, so-called rogue brokers. Even a few unscrupulous brokers can cause serious financial harm to investors and have the potential to damage public confidence in the securities markets. We found that to better protect investors from unscrupulous brokers, surveillance, detection, and disciplinary practices need to be strengthened.

Unscrupulous or "rogue" behavior of brokers can constitute a range of behaviors that can adversely impact investors. We defined unscrupulous brokers as brokers who commit a significant breach of sales practice rules or have a history of repeated sales practice violations. Sales practice violations can involve such activities as: selling securities to an investor that are unsuitable in light of the investor's income, buying or selling securities without the consent or knowledge of the investor, or excessive trading or churning in the investor's account. While these activities can generate additional income for both brokers and securities firms, they can harm investors financially and erode public confidence in the securities markets.

Brokers who engage in such activities are subject to various disciplinary actions, both formal and informal, by SEC, state regulators, SROs, courts and their employers. To address relatively minor violations, SROs can use informal disciplinary actions. They can issue the broker a letter of caution, which is a warning letter, or conduct a compliance conference, which is a conference between SRO staff, the firm, and the individual broker to arrive at corrective actions for the violation. To address more serious violations, formal disciplinary actions can be used. These include imposing monetary fines, censures, restitution orders, suspensions of varying lengths, and bars from certain or all securities-related functions. SEC, state regulators, and SROs can each impose such formal actions.

EXTENT OF UNSCRUPULOUS ACTIVITY IS UNKNOWN

We could not determine the exact extent to which unscrupulous brokers are active in the securities industry. This is because: (1) sales practice abuse is often difficult to detect, (2) the Central Registration Depository (CRD), which is an information system that maintains information on brokers, does not contain data on informal disciplinary actions, and (3) the CRD is not designed to provide summary data by type of violation for the disciplinary histories it does maintain.

However, we were able to obtain CRD data showing the number of active brokers with formal disciplinary histories. These formal histories included actions for securities related violations, such as sales practice abuse and nonsecurities related offenses, such as drug possession and driving while intoxicated. Our analysis of this data indicated that about 10,000 of the almost 470,000 active brokers listed in the CRD as of November 30, 1993, had at least 1 formal disciplinary action taken against them for a variety of violations and 816 brokers had 3 or more formal actions taken against them.

EXISTING DISCIPLINARY POLICIES AND PRACTICES NEED TO BE STRENGTHENED

In our opinion, even a few unscrupulous brokers can cause serious financial harm to investors and have the potential to damage public confidence in the securities industry. Available evidence, however, points to shortcomings in the detection and discipline of unscrupulous brokers. State regulators responding to our survey viewed SEC and SRO actions as being too lenient. Of the 44 state regulators who responded to our survey, 14 believed that SEC disciplinary actions were too lenient, 24 viewed NASD actions as too lenient, and 11 viewed NYSE actions as being too lenient.

We found that certain disciplinary policies and practices could contribute to this perception. For example, we found that even so-called permanent bars, which are bars that prohibit brokers from working in the securities industry in any capacity for an unspecified time period, may not, in fact, permanently remove unscrupulous brokers from the industry. This is because the Securities Exchange Act of 1934, as amended, allows brokers barred by SEC or an SRO (termed statutorily disqualified brokers) to return to the securities industry if SEC and the SRO approve such action. Between October 1991 and December 1993, SEC permitted one permanently barred broker to return to the industry and approved employment changes for five permanently barred brokers whom SEC had earlier approved for reentry. In its May

1994[1] study, SEC staff recognized the need to strengthen disciplinary safeguards and recommended to the Commission the use of truly permanent bars--bars with no possibility of reentry.

In our review of current laws and regulations that are intended to safeguard investors, we also found regulatory gaps that allow unscrupulous brokers to migrate to other sectors of the financial services industry. Currently, SEC and the Commodities Futures Trading Commission (CFTC) are authorized by law to honor each other's bars. That is, they can choose to prevent barred individuals from migrating between the securities and futures markets. However, there is no similar law or agreements with SEC and other regulators. This creates an investor protection gap. An unscrupulous broker can migrate to work in an industry that is not federally regulated, such as insurance, and sell certain financial products in that industry. Similarly, such a broker can work as a bank employee in a federally insured bank selling bank-sponsored mutual funds if he or she has a disciplinary history, but has not been convicted of a crime. We found examples of migration in our sample of disciplined brokers and in our follow-up of potentially unscrupulous brokers that SEC identified in its recent staff study.

SEC's recent study on industry practices also found problems in the detection and discipline of unscrupulous brokers. In July 1992, SEC initiated an examination of the employment and supervisory practices of nine of the largest broker-dealers in the United States. On the basis of customer complaint information, SEC identified these branch offices and brokers most likely to have problems and reported that problems existed with the hiring and supervision of brokers at 25 percent of the 161 branch offices reviewed. SEC also made 40 referrals for potential enforcement action. The staff study made specific recommendations to improve the hiring, supervision, detection, and discipline of problem brokers.

IMPROVEMENTS ARE NEEDED IN BROKER SURVEILLANCE SYSTEMS

To safeguard investors and maintain public confidence in the nation's securities markets, SEC, state regulators, and SROs need effective broker surveillance monitoring systems that can help them identify brokers who have engaged in questionable sales practices and sales practice abuse. The National Association of Securities Dealers (NASD) and state regulators maintain CRD, which is the only centralized source of information on brokers'

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[1]The Large Firm Project: A Review of Hiring, Retention and Supervisory Practices, Division of Market Regulation, Division of Enforcement, U.S. Securities and Exchange Commission, (May 1994).

employment and disciplinary histories. Information in CRD is available to both regulators and investors and is now relied on as a regulatory surveillance tool. However, we found that CRD, originally designed as a broker registration system, has design limitations that weaken its capability to support regulatory surveillance of unscrupulous brokers. Also, CRD maintains records only of formal disciplinary actions, not informal actions. Further, SROs are not required to report to CRD information about customer complaints, including information about complaint disposition. The reporting of certain customer complaint information is left to the individual broker[2]. The direct reporting of such information by SROs to CRD would help regulators and SROs monitor questionable sales practice activities at member firms and industrywide.

In our opinion, the protection of investors and safeguarding of public confidence in the nation's securities markets is of paramount importance. We are making a number of recommendations to SEC and the Secretary of the Treasury to strengthen the detection and discipline of unscrupulous brokers. We believe SEC should implement the recommendations of its staff study to strengthen disciplinary standards, including the imposition of a permanent bar with no opportunity for reentry, when warranted. NASD is currently working on a major redesign of CRD. To enhance regulatory surveillance of unscrupulous brokers, we believe SEC should: (1) monitor the redesign of CRD and (2) require SROs to report directly all disciplinary actions, both formal and informal, and customer complaints and their disposition. Regarding disclosure of information on customer complaints and their disposition, SEC should work with NASD to develop procedures that balance regulatory surveillance and investor interests, yet protect brokers from disclosure of unsubstantiated complaints.

Also, we believe the Treasury and SEC should work with other financial regulators to reduce the potential for unscrupulous brokers to migrate freely from the securities industry to other segments of the financial services sector. Actions they should take include: (1) increasing disclosure of CRD information to regulators and employers in related financial services industries and (2) determining whether legislation or additional reciprocal agreements between SEC and other financial regulators are necessary.

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Mr. Chairman, this concludes my prepared statement. I will be pleased to answer questions.

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[2]Brokers are required to report to CRD customer complaint information that alleges damages of $10,000 or more, fraud, the wrongful taking of property, or is settled for $5,000 or more.

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