

Table III

Summary of SRO Information
on Selected Securities Salesmen 35/

<u>INDIVIDUAL</u>	<u>NYSE</u>	<u>NASD</u>	<u>CBOE</u>	<u>AMEX</u>
A	Preliminary investigation into churning and misrepresentation in options account.	Pending investigation arising out of termination for cause.	No data *	No data
B	No data	No data	No data	No data
C	No data	No data	No data	No data
D	Letter of caution sent by Amex 1/78.	No data	No data	Letter of caution 1/78
E	Subject of investigation in 1974 for alleged churning and unsuitable trades in options. Closed without action.	No data	No data	No data
F	Named as defendant in private civil action.	No data	No data	No data
G	No data	No data	No data	No data

* No data means that the SRO informed the Options Study staff that its files did not contain any relevant information on the individual in question.

35/ Although not summarized in this table, some, but not all, SROs were aware of the Commission's investigation into certain of these individuals.

Table III (continued)

<u>INDIVIDUAL</u>	<u>NYSE</u>	<u>NASD</u>	<u>CBOE</u>	<u>AMEX</u>
H	No data	No data	Pending cause examination arising out of customer complaint of unsuitable recommendations.	No data
I	No data	No data	No data	No data
K	No data	No data	No data	No data
L	No data	Censured 1976 for permitting unregistered salesman to solicit orders.	No data	No data
M	No data	No data	No data	No data
N	Pending cause examination into termination for cause.	No data	No data	No data **
O	No data	No data	No data	No data
P	Defendant in private civil action.	No data	No data	No data
Q	No data	No data	No data	No data
R	Subject of investigation in 1970 for alleged unsuitable transactions. Closed without action.	No data	No data	No data

** The NYSE originally deferred to the Amex on this matter, but the Amex "lost" jurisdiction when the salesman changed firms. The Amex advised the Options Study, however, that it had no information on this individual.

Table III illustrates how the SROs' failure to share information may handicap severely each SRO's compliance program. In monitoring customer complaints and employee termination notices, an SRO may be unaware that other SROs have additional information bearing on the same problem or individual. In addition, in planning routine examinations an SRO may be unaware of registered representatives who, because of past questions as to the propriety of their conduct, may warrant close scrutiny.

Sharing of information about a firm's credit practices would also help the SROs to identify potential sales practice abuses. For example, changes in the number or pattern of Regulation T requests made by a firm, branch office, registered representative, or involving a particular security may signal potential trading abuses or compliance problems. ^{36/} Such a situation occurred in 1978 when requests for extension of credit filed with an SRO by a small retail firm increased from an average of about 70 to 400 per month. Because in this instance the SRO did alert another SRO, which was responsible for examining the firm, a cause examination was made, which revealed that the firm had serious supervisory problems.

The Options Study believes that a sharing of these and other types of regulatory information among the SROs is of critical importance to their compliance programs. This view was brought to the attention

^{36/} See Chapter V.

of the SROs, which after evaluating the issue, have agreed, in principle, to share certain compliance data. Some SROs have expressed reservations, however, about whether any such interchange should go beyond customer complaints and the results of routine examinations and, perhaps, cause examinations. Although these SROs have voiced concern about releasing to other SROs letters of caution and other informal disciplinary actions and information pertaining to Regulation T requests, the Options Study believes, and the above examples demonstrate that, these are very useful sources of information for effective enforcement of SRO rules and the Federal securities laws.

The Options Study staff recognizes that it may be time consuming and expensive for an SRO, in connection with an inquiry into each customer complaint or termination for cause, or in anticipation of each routine examination, to contact all other SROs and obtain necessary information. ^{37/} Moreover, it would be costly for every SRO to maintain a set of records on its member firms and their salesmen that would be duplicated at other SROs of which the firm is a member. These problems could be effectively overcome through the centralization of such information.

The Self-Regulatory Conference recently agreed to seek to establish programs "to promote a sharing of relevant information about broker/dealer compliance activities and to assist in the execution of complete,

^{37/} See, e.g., Table III, supra, and Appendix D.

comprehensive and thorough examinations of such firms." 38/ Toward this end, the Conference has agreed "that a [central] repository could be utilized to provide each self-regulatory organization with more information than is presently utilized for purposes of registration of personnel, customer complaints, investigations and examinations." 39/ The repository would include "at least all information regarding [registered representative] registration and termination, customer complaints, and formal actions taken by [the self-regulatory organizations] and other regulatory bodies...." 40/ The Options Study believes that the initiatives taken by the Conference are constructive and that they should be implemented as expeditiously as possible.

Accordingly, to improve the sharing of relevant information among SROs, the Options Study recommends:

SROs SHOULD CREATE A CENTRAL REPOSITORY OF
REGULATORY INFORMATION ABOUT THEIR COMMON
MEMBERS AND EMPLOYEES OF SUCH MEMBERS FOR
SHARED USE ON A DAY-TO-DAY BASIS.

2. Coordination of compliance programs: Because SROs have not shared or interchanged information on a regular basis they have been unable properly to coordinate member firm examinations or to

38/ Letter to Richard Teberg, Director, Special Study of the Options Markets, from the Self-Regulatory Conference, p. 7 (Oct. 6, 1978). A copy of this letter is attached as Appendix E.

39/ Id. at pp. 7-8.

40/ Id. at p. 8.

allocate among themselves, in an efficient manner, the compliance responsibilities they share. For example, although the options exchanges have allocated among themselves responsibility for doing routine examinations of common member firms, 41/ there is little coordination between the options exchanges and the NYSE and NASD. 42/ Since there is substantial overlap in membership among these SROs, multiple sales practice examinations of the same firm within a short period of time are not uncommon. 43/ At one firm, for example, there were eight SRO routine examinations in four years. (Table II, supra) In three of these years, there were two separate routine examinations within a month of each other, but the SROs did not compare their findings. Even among the options exchanges, there are overlapping cause examinations stemming from reviews of registered representative termination notices and customer complaints.

The duplication of work which characterizes the present SRO compliance effort not only may be unnecessarily disruptive of broker-dealer offices, but also increases costs to the SROs.

Better coordination also would help to assure that important regulatory responsibilities are not overlooked, as has happened when one SRO mistakenly

41/ The allocation is accomplished under a five party agreement among the AMEX, CBOE, MSE, PHLX and PSE, filed with the Commission in June 1977.

42/ The NYSE and NASD have experimented with scheduling simultaneous sales practice examinations of the same firm. While the coordinated examinations apparently have reduced the burdens which duplicated examinations would otherwise have imposed upon the firm, the NYSE and NASD do not allocate responsibility for the conduct of their examinations, nor do they compare the results of related, but nonetheless distinct, examinations.

43/ See Table II, supra, and Appendix D.

thinks another is pursuing a matter. The Options Study is particularly concerned about gaps that sometimes appear in SRO monitoring programs designed to screen and oversee the conduct of registered representatives. As already noted, such monitoring programs suffer when firms are not truthful about the reasons for terminating an employee. 44/ But these programs also suffer if an adequate investigation of a termination-for-cause is not undertaken by an SRO because each SRO believes another is investigating the matter.

The Options Study staff discussed with the SROs its concerns about the need to better coordinate compliance programs. The Conference has stated that "measures should be taken . . . to decrease or eliminate duplication of efforts among self-regulatory organizations and increase overall efficiency . . . within the industry." The Options Study believes that the SRO resources saved by any decrease or through the elimination of duplicative efforts should be devoted to increasing the scope and effectiveness of SRO compliance problems.

C. Government agencies

Government agencies, particularly the Commission and the state securities regulatory agencies, in many instances have information that parallels the types of information retained by the SROs.

44/ See Chapter V.

The Commission, for example, has extensive information on file about retail firms and their registered representatives. Some of this information is publicly available, including records pertaining to pending and closed administrative proceedings and civil actions, broker dealer registration files, and certain periodic filings required to be made by retail firms. In addition, the Commission receives annually more than 5,000 customer complaints against broker-dealers and their registered representatives - more than all the SROs combined. These complaints usually are available to SROs upon request. Finally, there are certain categories of documents which may not be released to the public or SROs without formal Commission authorization. In general, these are subpoenaed documents, transcripts and other records which are part of investigative files.

The Options Study believes that information in the Commission's files relating to SRO member firms and their salesmen would be useful to the SROs in the conduct of their compliance programs. The SROs have expressed an interest in receiving such information, if the materials can be provided on a timely basis. But, perhaps because of the formalities involved in getting information from the Commission, most SROs have not sought such information on a routine basis. 45/

Accordingly, the Options Study recommends:

SROs SHOULD ROUTINELY SEEK ACCESS TO RELEVANT
COMPLIANCE INFORMATION RETAINED BY GOVERNMENT
AGENCIES, INCLUDING THE COMMISSION.

45/ The Commission's Office of Consumer Affairs, which is responsible for the receipt and disposition of customer complaints, has informed the Options Study that the Office receives more requests for customer complaint information from compliance officers of retail firms than from SROs.

D. Retail firms

Retail firms are required to maintain books and records which are the primary source of information regarding their current financial condition and recent operational developments, and also the manner in which they and their registered representatives service public customer accounts. ^{46/} Some of this information is required to be reported to the SROs, the Commission, or both, and some information is typically reviewed by SROs only during routine examinations.

The Options Study found two problems concerning the utilization of member firm data by SROs. First, while most information kept by member firms is readily available to SROs, there are two important types of data which are not always easily accessible -- customer account information and customer complaints. Second, since customer complaints and member firm internal disciplinary proceedings are not routinely filed with the SROs, the SROs cannot make effective use of this information.

1. Accessibility of customer complaints and account information:

The problem of locating documents is twofold: first, firms frequently keep customer complaints only in the branch office which received them - instead of keeping them there and also centralizing them in the firm's headquarters office. Second, there is no requirement or general practice that retail firms maintain in their branch offices full information

^{46/} See 17 CFR 240.17a.

respecting customers who have accounts at those offices, although some firms do so.

The Options Study's own ability to find customer-related information was hampered by firms which either could not find, or could not assemble, complaints or customer account records. In February 1978, as part of its information gathering phase, the Options Study requested more than 50 major registered brokerage firms to submit copies of all options related customer complaints received by those firms since the commencement of listed options trading. One national firm responded nearly two months later:

"At the time of our recent merger [with another national firm], almost all of [the other firm's] documents were sent to a warehouse. It would impose a great hardship upon [this] firm to retrieve this information. The records that were sent to the warehouse were filed in a manner that would make it very difficult for us to retrieve them at this time."

In addition, several other major wirehouses took months to comb their branch offices for options related customer complaints and even then failed to produce the large numbers of letters which the Commission's own files indicated the firms had received.

The Options Study's letter also included a request for the account statements, new options customer account cards, and options agreements for all complaining customers. Some firms had great difficulty locating these materials, although the firms are required to keep such documents

in an accessible place. ^{47/} Some firms never did locate or produce all such records.

The Options Study's experience is similar to that of the staff of the Commission's regional offices who have provided the Options Study with copies of reports of their inspections of broker-dealer firms. Those reports describe repeated difficulties in locating documents. In many instances the firm's documents, when ultimately provided, were illegible.

The SROs have encountered similar difficulties in obtaining relevant retail firm records. The CBOE, for example, recently spent over 1,000 man-hours conducting an examination of a nationwide retail firm which maintained customer records at 140 branch offices. The examiner concluded in his report that it was "virtually impossible to conduct an adequate examination" of the firm and noted:

"The time spent was not caused by the complexity of what proved to be the final regulatory problems at issue in the Report which follows, but rather the difficulty in getting to the point of being able to gather information so as to objectively measure the degree to which a problem existed."

Customer complaints about a brokerage firm or its registered representatives are a significant information source about the firm's sales practices. Recognizing the importance of complaint information, the NASD adopted a rule in 1965 requiring that member firms establish either a complaint

^{47/} See 17 CFR 240.17a-4.

file or an index of complaints in each branch office where a person having supervisory responsibility is assigned. The NYSE, NASD and the options exchanges review available complaint files during examinations of a firm's headquarters office, but the NYSE is the only SRO which has represented that it examines branch offices routinely. Thus, examiners from SROs frequently are not aware of customer complaints that are not on file at the firm's home office.

Conversely, absence of relevant customer account records in many branch offices has been found by the Commission's staff to be a substantial impediment to meaningful branch office examinations. In fact, the absence of these records has been cited by the options exchanges as one rationale for not conducting branch office examinations. It is not surprising that the Options Study has found in branch offices a high incidence of selling practice abuses that have gone undetected by the SRO compliance programs. 48/

The CBOE has recently interpreted its general recordkeeping rule to require that a "separate, central file for all options-related complaints" be maintained by every member firm. The file may consist of a "log, index or other listing" which would allow complaints to be "easily identified and retrieved." 49/ The CBOE interpretation

48/ See Chapter V.

49/ CBOE Rule 15.1, Interpretation .01.

represents a forward step, but, of course, is limited in scope since it applies only to CBOE members and only to options-related complaints. The Options Study believes that all firms should keep copies of all customer complaints and customer account and suitability information in their home offices as well as the branch office where the customer account in issue is serviced.

Accordingly, the Options Study recommends: 50/

THE SELF-REGULATORY ORGANIZATIONS SHOULD ADOPT RECORDKEEPING RULES WHICH REQUIRE THAT MEMBER FIRMS KEEP COPIES OF CUSTOMER COMPLAINTS, CUSTOMER SUITABILITY INFORMATION AND CUSTOMER ACCOUNT STATEMENTS AT BOTH THE BRANCH OFFICE WHERE THE ACCOUNT IN ISSUE IS SERVICED AND THE HEADQUARTERS OFFICE.

2. Reporting requirements: Customer complaints often come to an SRO's attention only when the SRO does a routine inspection of a broker-dealer firm, and by that time it may be too late for the SRO to protect the complainant or other customers from injury. Recognizing this fact, the NYSE in 1971 adopted a rule which requires that member firms notify the exchange of "major complaints." 51/ The NYSE staff has interpreted this rule to require that member firms report "any written complaint" that involves a "claim of actual damages in excess of \$10,000, . . . [a] claim for damages which is settled for an amount exceeding \$2,500, or . . . allegations of theft . . . forgery . . . or similar dishonesty."

50/ See also Chapter V.

51/ NYSE Rule 351(c).

The NYSE is the only SRO that requires its members to report customer complaints.

Under the current NYSE rules, the complaints required to be reported to the NYSE constitute only a small percentage of the total number of complaints received directly by member firms. The following Table compares the estimated number of customer complaints received by two major NYSE member firms with the number of customer complaints regarding those two firms reported to the NYSE.

Table IV

Selected Comparison of Complaints
Reported to NYSE and Complaints
Received by Two NYSE Member Firms
in 1977

<u>Firm</u>	<u>No. Complaints</u> <u>Reported to NYSE *</u>	<u>Estimated</u> <u>No. Complaints</u> <u>Received by the Firm</u>
A	73	540
B	41	1140

* Statistics as to the number of complaints reported to the NYSE were furnished by the NYSE. Statistics as to the number of complaints received by these firms were furnished to the Options Study by the Commission's Office of Consumer Affairs based upon submissions to that Office by these firms.

Most of the comparatively large number of complaints which are not reported to the NYSE involve the administrative operations of the firm, such as the alleged failure to deliver securities or funds to a customer, and are not direct allegations of selling practice abuses. Nonetheless, as

the Special Study of the Securities Markets noted in 1963 and, as the Commission's staff has experienced on several occasions, operational complaints can be important enforcement leads and can aid in evaluating other indications of possible violations. 52/

The Options Study believes that customer complaints are such an important source of information that all complaints should be filed by member firms with the SROs of which they are members and included in a central repository of compliance information accessible to all SROs.

In addition to providing expeditious, economical access to such data, the centralized file could enhance significantly the ability of SROs to detect potential selling practice abuses. 53/ The file could be programmed to automatically identify individuals, firms and branch offices which have been the subject of a large number of customer complaints or certain types of complaints. Periodic analyses of complaint data could be provided to SROs to enable them to identify trends and subjects which appear to warrant close attention.

The centralized file could also assist SROs when evaluating new complaints and termination notices to decide whether the situation requires immediate attention or may be deferred to the next routine examination. Moreover, in anticipation of a routine examination, the

52/ See Special Study Report, Part IV, p. 522.

53/ See pp. 28-30, infra.

file could provide the examining SRO with data that may help identify matters that deserve special review, such as

- registered representatives with multiple complaints of alleged selling practice abuses,
- branch offices with concentrations of complaints, and
- registered representatives with particular types of complaints, such as unsuitable recommendations or excessive trading. 54/

As previously noted, the Self-Regulatory Conference tentatively has agreed that a centralized repository could enhance the efficiency and effectiveness of their compliance programs. 55/ The Conference also agreed that such a repository would assist in overseeing the conduct of a registered representative and "provide SRO's with more comprehensive data by which to judge his actions."

Accordingly, the Options Study recommends:

THE SROs SHOULD AMEND THEIR RULES TO REQUIRE THEIR MEMBER FIRMS TO SUBMIT ALL COMPLAINTS RECEIVED FROM CUSTOMERS TO A CENTRAL DATA FILE, WHICH SHOULD ALSO CONTAIN COMPLAINTS RECEIVED DIRECTLY BY THE SROs AND THE DISPOSITION OF SUCH COMPLAINTS.

In order to ensure that this centralized file is complete, the Options Study believes that complaints received by the Commission should be included in it. Accordingly, the Options Study recommends:

54/ For a more detailed discussion of the possible uses of the file, see letter from Van P. Carter to Gerald Foley (NASD), Oct. 11, 1978 (Appendix F).

55/ See pp. 28-30, infra.

THE COMMISSION SHOULD TRANSMIT FOR INCLUSION IN THE CENTRAL FILE A RECORD OF RELEVANT INFORMATION ABOUT ALL BROKER-DEALER COMPLAINTS IT RECEIVES UNLESS RELEASE OF SUCH INFORMATION WOULD BE CONTRARY TO LAW OR WOULD HAVE AN ADVERSE AFFECT UPON A PENDING OR PROPOSED INVESTIGATION, OR OTHERWISE WOULD BE INAPPROPRIATE.

The Options Study has been advised that the NASD, with the concurrence of the other SROs, has established a pilot program for the centralization of sales practice related complaints. This program, which is scheduled to commence in late January, 1979, envisions the inclusion in a central data file of all sales practice related complaints received by the SROs, to be filed under the name of the firm or the registered representative against whom a complaint has been filed, if furnished.

The SROs are evaluating how they may interchange other categories of compliance information, including customer complaints that are not directly sales practice related.

Information about a firm's discipline of its employees and related compliance matters also can be an important source of regulatory information. As previously noted, a retail firm is required to advise the SROs about one form of employee discipline — i.e., the firing of an employee for cause. 56/ In addition, when an employee is terminated from employment,

56/ The staff of the PHLX informed the Options Study that the PHLX has never received a notice of a termination for cause, although the Options Study has verified that certain PHLX members have filed such notices with other SROs.

the firm is required to state whether the registered representative had been the subject of any customer complaints. 57/

Firing an employee for misconduct is a rather drastic action, however, and retail firms frequently sanction their salespersons in other, less severe ways, including levying fines and withholding commissions. Nevertheless, the NYSE is the only SRO that requires that its members file reports of such actions against employees.

The Options Study has found, moreover, that, on occasion, firms have failed to report the termination of a registered representative so that such information cannot be known by the SROs until the next routine sales practice examination, which may not occur for a year or more due to the SROs' inspection cycles. By that time, the examining SRO may have lost jurisdiction over the registered representative because he is no longer in the securities industry or is affiliated with a firm that is not a member of the examining SRO. The examining SRO, therefore, may be unable to investigate thoroughly apparent violations of SRO rules or Federal law, or to seek effective remedial action.

57/ As noted in the Selling Practices Chapter, the Options Study has found instances in which termination notices did not describe accurately the circumstances surrounding the termination of employment of some salesmen. At least one SRO compliance official has acknowledged to the Options Study that most firms "say as little as they possibly can" on termination notices and that in many cases the reasons for the discharge are "oblique," apparently because firms are concerned about possible civil liability for defamation in the event that statements made on the termination notice cannot be verified. See Chapter V.

Accordingly, the Options Study recommends:

SROs SHOULD AMEND THEIR RULES: (1) TO REQUIRE MEMBER FIRMS TO NOTIFY SROs PROMPTLY OF ALL INTERNAL DISCIPLINARY ACTIONS AGAINST EMPLOYEES, AND (2) TO PROVIDE THAT WHEN A REGISTERED INDIVIDUAL'S EMPLOYMENT IS TERMINATED OR HE RESIGNS FROM A MEMBER FIRM, THE SRO SHALL RETAIN JURISDICTION OVER THE INDIVIDUAL FOR A REASONABLE TIME. THE SROs SHOULD ALSO VIGOROUSLY ENFORCE MEMBER FIRM COMPLIANCE WITH NOTIFICATION REQUIREMENTS.

IV. DEFICIENCIES IN SRO EXAMINATIONS

Sales practice compliance programs of SROs not only often fail to make use of all available information; they also frequently fail to detect violations because of ineffective examination and investigative procedures, and because of inadequate allocation of SRO resources in their examination programs.

A. Limited scope of examinations.

The most common procedural failure noted by the Options Study was that SRO examinations, both routine and for cause, were so limited in scope that clear patterns of abuse were overlooked. For example, cause examinations conducted by SROs usually focus on only the transaction or narrow problem reported to the SRO staff and are seldom broadened to determine whether there are additional, unreported problems. The Options Study reviewed numerous SRO cause examinations which were closed without remedial action or with inadequate sanctions because the limited analysis did not disclose serious selling practice violations which an inquiry of broader scope should have detected.

A recent example of the unnecessarily narrow scope of SRO investigations is a cause examination of a member's branch office initiated

by an SRO in 1977. The SRO's market surveillance system detected apparently improper transactions in restricted options. 58/ A cause examination was commenced which established that the registered representative, Mr. X, had effected discretionary opening sales in a restricted options series for the accounts of 24 customers. The examination also found certain violations of the SRO account opening rules and rules relating to discretionary accounts.

Therefore, the SRO, in January, 1978, sent Mr. X a letter of caution noting the following apparent violations: (1) opening sales in restricted options, (2) effecting trades in three accounts prior to the receipt of options trading authorizations and approval of those accounts for options trading by the firm's Registered Options Principal, and (3) discretionary trades in two accounts without written authorization from customers.

Shortly thereafter, the Commission's staff reviewed the activities of Mr. X and found evidence suggesting serious additional selling practice problems. In summary, the staff has alleged that: Mr. X developed and promoted an options writing program and represented to customers that this program was designed to give his clients a 20 percent to 30 percent "consistent annual return;" and Mr. X handled approximately 40 discretionary options accounts, some of which were for members of his family.

58/ For a discussion of restricted options, see Chapter III.

Although the accounts managed by Mr. X for his family realized net gains during the period January - October, 1977, a preliminary analysis of 23 other discretionary accounts managed by Mr. X showed that all 23 accounts had sustained a net loss during this period. Total losses to these customers appear to exceed \$197,700, with the average customer loss being about 16.4 percent of the original investment. Commissions appear to have accounted for about \$129,900 of this loss, or about 10.8 percent of the funds invested. Firm records disclosed that in 1977 Mr. X generated gross commissions of about \$400,000, of which \$320,000 arose through options transactions, making Mr. X the branch's largest producer and accounting for about 58 percent of the branch's total options business. The Commission has approved a recommendation from its staff that Mr. X be named as a respondent in an administrative proceeding, but the guilt or innocence of this individual has yet to be adjudicated. 59/

The SRO which conducted the cause examination reviewed six of the 23 accounts analyzed by the Commission's staff, but the SRO only sought to determine whether trades had been effected in restricted options and whether the firm had complied with the appropriate account opening and approval requirements. Other firm records which would have suggested the additional problems were not reviewed. The senior SRO staff official who supervised the inquiry stated that further inquiry

59/ The staff also recommended, and the Commission concurred, that the firm be named as a respondent for its alleged failure to supervise Mr. X. adequately.

was unnecessary once the cause examination established purchases of restricted options and the absence of account approval to trade options.

Another example concerns a 1974 episode in which a customer complained to a large retail firm that he had been induced to open an options account based on misrepresentations by one of the firm's registered representatives, Mr. P, who allegedly had told the customer that he should expect to receive a 12 to 20 percent return on his investment with a maximum loss potential of only 1 percent of the capital invested. The customer also complained that unauthorized trades had been effected in this options account. When the firm confronted Mr. P with these charges, he admitted, in the presence of the customer, that the complaint was "basically true." Mr. P. was therefore permitted to resign from the firm and his personal account was charged about \$9,000 to reflect adjustments by the firm in the customer's account.

The same customer thereafter complained to one SRO which referred the complaint to another SRO. The second SRO conducted an investigation during which Mr. P again admitted executing unauthorized trades in the customer's account. A statement of charges was thereafter filed against Mr. P. In his response, Mr. P again admitted that he had effected unauthorized trades in the account and that the customer "just did not understand the risks involved."

In early 1976, the SRO's disciplinary panel found that Mr. P had violated SRO rules by effecting trades without written authorization

from the customer. The panel, however, also found, as mitigating circumstances, "that there [was] no evidence of a profit motive" on the part of Mr. P - and suspended Mr. P. from association with any member firm for only 30 days.

The SRO's investigation consisted only of asking the firm for certain documents relevant to the precise allegation of the complaining customer. The SRO did not inquire whether the firm was aware of any other problems involving Mr. P. None of Mr. P's other options accounts was examined; none of his supervisors were interviewed; none of Mr. P's other customers were spoken to; no investigative testimony was taken.

Had a broader inquiry been made, the SRO would have found that during the pendency of the investigation Mr. P and the firm were sued by another of Mr. P's customers in the same office. This second customer's complaint against Mr. P included all the allegations made by the first customer and several additional more serious charges. An SRO investigator probably would also have uncovered apparently misleading advertising materials used by Mr. P without the required SRO clearance. The SRO disciplinary panel did not have any of this additional information before it when it reached its mitigating conclusion that Mr. P. did not have any "profit motive" in violating SRO rules.

The sales practice examination checklist designed by each SRO to "guide" its staff in their examinations also reflects the limited orientation of SRO routine examinations. The examination normally

focuses only on those rules concerning (1) reporting and filing requirements, for example, verification of registration and qualification of salesmen; (2) opening new accounts; (3) supervision of accounts; (4) suitability; (5) options position and exercise limits; (6) margin requirements; (7) exercise allocation procedures; (8) sales literature and advertising; and (9) books and records. A review is also usually made of the firm's records of customer complaints. The NYSE is the only SRO that represents that it routinely evaluates the firm's internal compliance system for overseeing the conduct of registered representatives. SRO officials contend that these checklists are only "guides" to be used by examiners, but the examination files reviewed and interviews conducted by the Options Study indicated that, in general, most examiners appear to limit their examination to the items and procedures covered by the checklists.

The limited scope of routine examinations by SROs seems to result from deliberate SRO policy. In interviews with the Options Study, SRO staff members have consistently maintained that an SRO should not examine an area of firm activity not covered by their checklist unless there is independent evidence of abuse in that area. Therefore, examiners do not routinely review those additional aspects of a firm's operations which may provide material leads to possible selling practice abuses. ^{60/} Such areas include a firm's programs for acquiring new customers,

^{60/} The Options Study also found that some SRO examiners fail to respond to items on the checklist or respond in an incomplete or cryptic fashion, which adversely affects the likelihood of adequate supervision of examiners.

and the use of worksheets and other selling tools used by salespersons. ^{61/} Moreover, as previously noted, the NYSE is the only SRO which represents that it routinely examines branch offices.

A further indication of the limited scope of options sales practice examinations is that options exchange examiners are often unaware of the firm's non-options activities. Most retail firms offer a range of securities products, and information about other areas of firm activity may be relevant to the examination. If, for example, a registered representative has been the subject of several customer complaints for his alleged abuse of discretionary trading authority in connection with transactions in stocks, an options sales practice examination should include a review of the discretionary options accounts serviced by this individual. Likewise, if a firm has been censured for inadequate supervision standards with respect to trading in listed or over-the-counter stock or municipal securities, the examiner should take that fact into consideration during an options sales practice examination.

Accordingly, the Options Study recommends:

SROs SHOULD REVISE AND BROADEN THEIR SALES PRACTICE EXAMINATIONS, INCLUDING THEIR CHECKLISTS AND GUIDELINES, TO (1) ASSURE THAT EXAMINERS WILL REVIEW ALL ASPECTS OF A FIRM'S PROCEDURES AND DEALINGS WITH THE PUBLIC, INCLUDING THE SOLICITATION OF CUSTOMERS AND MARKETING OF SECURITIES, (2) PROVIDE THAT EACH SALES PRACTICE EXAMINATION WILL INCLUDE A THOROUGH EVALUATION OF THE FIRM'S INTERNAL COMPLIANCE SYSTEM AND (3) PROVIDE FOR ON-SITE INSPECTIONS OF BRANCH OFFICES AS APPROPRIATE.

^{61/} For a discussion of the uses of worksheets, see Chapter V.