B. Poor selection of accounts for review

There appears to be no uniform practice among the SROs concerning the type of accounts selected for review during a routine examination, although most SROs include a review of some discretionary trading accounts and examiners are starting to focus more frequently on accounts serviced by registered representatives with high options commission income. The options exchanges allow their examiners to select the accounts to be reviewed, and, in most cases, the examiners make their selections on a "random" basis, but no SRO has evaluated its account selection procedures to determine whether the "random" selection made by its examiners is, in fact, random and whether the number of accounts reviewed is a statistically valid sample given the number of accounts at the firm.

In any event, random selection of accounts alone has not proven to be an effective way to identify sales practices problems, such as unsuitable recommendations or excessive trading. A process which includes a statistically random selection together with more structured account selection procedures would be more likely to detect accounts which may disclose sales practice violations. 62/ To supplement a statistically valid random selection of accounts, an examiner could select the accounts of:

(1) salespersons who have been the subject of SRO or firm disciplinary action for excessive trading, executing unauthorized trades or similar activity;

62/ Accountants and statisticians refer to this process as "stratification" and recognize that judgment is an important element of this process in order for the selection to be effective.

(2) salespersons who are the subject of multiple or serious customer complaints;

(3) branch offices which have a high ratio of options commissions to total commissions, which employ high volume salesmen, or which have been the subject of multiple customer complaints; and

(4) accounts which have extensive or irregular trading activity, which repeated Regulation T extensions have been requested, or which are managed by an investment advisor.

The NYSE is the only SRO which utilizes account selection techniques of this nature. 63/ When the NYSE examination team enters a firm, the examiners review monthly account statements, commission runs, credit records and internal audit reports to identify those accounts, including those maintained by certain salespersons and branch offices, which should be examined more closely. Perhaps because of its account selection techniques, the NYSE identifies more potential violations of rules relating to supervision, suitability and handling of discretionary options accounts than do the options exchanges, as reflected in Table V on the next page.

To improve the ability of the SROs to detect selling practice abuses, the Options Study recommends:

> SROs SHOULD REVISE THEIR ACCOUNT SELECTION PROCEDURES WHEN CONDUCTING ROUTINE EXAMINATIONS TO USE A STATISTICALLY VALID RANDOM SELECTION OF ACCOUNTS TOGETHER WITH AN ACCOUNT SELECTION PROCESS WHICH WOULD BE DESIGNED TO IDENTIFY THOSE ACCOUNTS WHICH HAVE A HIGHER PROBABILITY OF BEING THE SUBJECTS OF PARTICULAR SALES PRACTICE ABUSES.

63/ Other SROs have begun to emphasize to their examiners the need for better account selection. As one SRO official put it: "We've been trying to beat it into their heads. Use some thought in their [account] selection procedures."

Table V

Summary of Types of Options Related Violations Detected by SROs in their 1977 Sales Practices and Capital/Sales Practice Examinations of Firms with Options Commission Income in Excess of $1,000,000

	SRO				
	PSE	PHLX	AMEX	CBOE	NYSE
Examinations Analyzed by the Options Study	2	4	17	10	13
No. of Apparent Rule Violations	5	19	92	46	26
Percentage of Violations by Type of Rule 1/					
Opening of Account 2/	40%	31%	78%	41%	35%
Registration of Salesmen and ROPs	0	0	2	2	0
Supervision, Suitability of Recommendations, and Discretionary Accounts	0	10	7	9	31
Exercise Assignment Procedures	0	16	3	7	0
Reports Required to be Filed with SROs	40	16	1	7	0
Financial Responsibility and Credit	0	5	2	15	8
Fraud or Churning	0	0	0	0	0
Other 3/	20	22	7	19	26
Total	100%	100%	100%	100%	100%

1 / The submission by the NYSE did not cite specific rules; percentages are computed on the basis of the categories provided by the NYSE.

2 / Includes obtaining option agreement and statement of customer's financial condition, investment objectives and needs; branch office manager approval; ROP approval.

3 / For example, defective confirmation notices; OCC rules; sharing of offices without SRO authorization; defects in brokers' blanket bond; delivery of the OCC prospectus; marking of order tickets.

C. Inadequate depth of account examinations

The Options Study asked the SROs to submit certain information pertaining to their routine sales practice examinations, including, the number of: hours spent conducting examinations; interviews conducted; accounts reviewed; and days required to prepare the examination report. 64/ These statistics indicate that the scope of sales practice examinations varies markedly among the options exchanges and the NYSE. The Options Study has also documented variations in the scope of examinations conducted by the same SRO. In one instance, an options exchange examined a firm in 1976 and reviewed 600 of the firm's 2,200 options accounts. The following year the sales practice examination by the same options exchange included a review of only 47 of the firm's 2,900 accounts. The examining exchange could not account for the reduction in the number of accounts reviewed.

The Options Study has also reviewed several examinations in which the account review may not have been as thorough as the SRO's representations suggest. In one instance, an SRO represented that it spent 95 hours at a large retail firm conducting an options sales practice examination, and that 6,000 of the firm's 7,000 options accounts, were "reviewed." Assuming that the entire 95 hours were devoted to such "reviews," the examiner spent an average of 57 seconds per account.

64/ For a summary of this data, see Appendix G.

With regard to the depth of routine examinations, none of the SROs routinely review accounts for possible excessive trading. As for general "suitability" reviews, the CBOE and NYSE contend that as a part of every sales practice examination their examiners review customer accounts for compliance with applicable suitability standards. The AMEX, PHLX and PSE represent that a suitability review is made "when necessary." The nature of suitability reviews varies significantly among SROs, but, in general, the examiner compares information on the customer's account card to the latest monthly statement to determine whether the trading is consistent with the customer's objectives and financial situation.

CBOE examiners appear to conduct the most thorough options related suitability reviews among the SROs whose procedures were examined by the Options Study. In addition to reviewing the new account card, the CBOE examiner prepares a written evaluation of every account reviewed, which includes an assessment of the trading strategies utilized by the customer and the salesman and, frequently, the relative risks of selected transactions. At the other SROs, the examiners usually limit their suitability review to a check of the account documentation to verify that the customer is properly approved to trade options and a review of the latest monthly statement to determine whether the customer's trading is consistent with such approval. If deficiencies are encountered, additional inquiries may be made, including an assessment

of trading strategies. None of the SROs routinely conduct a profit and loss analysis of customer accounts. 65/

There is evidence, however, that even the suitability reviews conducted by the CBOE are not sufficiently thorough. In most instances, the CBOE review does not include a computation of actual gains and losses, and, when such an analysis is made, the examiner frequently does not take into consideration open options positions which, due to their contingent or actual liabilities, may affect the profitiabilty of the account. 66/ Moreover, in virtually every routine examination reviewed by the Options Study, when potential suitability violations were detected by the CBOE examiner, the problem was resolved in favor of the brokerage firm, not the customer. In most instances, this resolution was based primarily upon information obtained from the firm, which was not supported by other written documentation, such as a statement from the customer to the firm stating his financial objectives or the source of his income. Despite the seriousness of some potential suitability violations noted in the examination reports,

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65/ The Options Study believes that the profitability of an account should be readily ascertainable by the customer and the firm. Accordingly, in Chapter V the Options Study recommended that customer account statements reflect the status of the account marked to the market and commissions charged against the account. The Options Study believes that SROs should routinely evaluate the profitability of accounts reviewed during routine examinations.

66/ For a discussion of the need for a profit/loss analysis, see Chapter V.

the examiner did not contact the customer to obtain additional information, or otherwise attempt to verify representations made by the firm.

One reason for the lack of thoroughness exhibited by SROs in their account reviews is the time consuming nature of such reviews. In fact, supervisory personnel at each SRO have explained that the two most time consuming tasks in an examination are (1) to review customer account documentation to assure that the relevant documents are present and complete, and (2) to analyze trading in a customer account for suitability, excessive trading and abusive selling tactics.

The NYSE has begun to explore whether these and similar tasks could be performed more efficiently through the use of computers. With the cooperation of certain of its members which utilize a particular service bureau, the NYSE has developed a computer program that analyzes customer accounts using information from the firms' own computerized account records. The program became operative for capital examinations in 1977.

For those firms which utilize the particular service bureau, the NYSE computer program can (a) select customer accounts for review based on securities held, (b) select margin accounts for review, (c) prepare a list of partner, office and employee accounts, (d) analyze security positions for concentration, (e) prepare summary reports on customer equity and the distribution of customer debit and credit balances. Within the next few months, this program will be further enhanced to permit the identification of those customer accounts that (1) are missing relevant account documentation, (2) have incurred large commissions, and (3) have extensive options positions.

Chapter V includes a recommendation that brokerage firms selling options be able to review customer accounts to determine commissions as a percentage of equity, realized and unrealized losses as a percentage of equity, and unusual credit extensions or trading patterns. Adoption by the SROs of a similar capability would provide additional information to examiners and significantly assist in identifying accounts that require detailed analysis.

To help ensure that SRO examiners detect potential sales practice violations, the Options Study recommends:

> SROs SHOULD CONDUCT MORE COMPREHENSIVE ANALYSES OF CUSTOMER ACCOUNTS, INCLUDING AN EVALUATION OF THE NUMBER AND TYPE OF TRANSACTIONS IN THE ACCOUNT, RELATIVE RISKS, ACTUAL AND UNREALIZED PROFITS AND LOSSES, COMMISSIONS, AND SUITABILITY OF TRADING STRATEGIES FOR INDIVIDUAL CUSTOMERS. SROs SHOULD ALSO DEVELOP AND USE COMPUTERIZED SYSTEMS TO AID IN THE ANALYSIS OF CUSTOMER ACCOUNTS.

D. Reliance on firm for assistance

In addition to their often limited analysis of firm records during on-site examinations, SROs tend to rely heavily upon the member firm to gather and furnish much of the information required in a cause examination or other follow-up inquiry, such as documents pertaining to a customer's account. The reliance by SROs on member firms to get and analyze compliance information, if reasonably applied, might result in more efficient use of the SRO's resources. The existing prominent role given member firms to provide assistance in developing investigative information, however, raises obvious questions about the accuracy of the result.

The SROs' reliance on member firms for information is particularly suspect when questions arise concerning the activity in the account of a customer dealing with a branch office, since most SROs do not ordinarily inspect branches, either routinely or in connection with a cause examination.

SROs not only rely on member firms to gather information, but also generally accept the firm's explanation of disputed issues of fact which have developed during an investigation. In one case, a widowed judge complained that her equities account had been converted to an options account without her permission and then had been mishandled. The firm told the investigating SRO that the customer had been fully advised by the firm concerning the handling of her account and in response to a specific SRO question, represented that the customer had signed an options agreement which was on file at the firm. The firm promised that a copy of the agreement would be sent to the SRO. Based upon these representations, which were made in August 1977, the SRO informed the customer that, due to conflicting statements, the SRO could not resolve the dispute and the matter would be closed.

Two months later, despite repeated requests by the SRO - and an assurance from the firm that the agreement had been located - the SRO still had not received a copy of the agreement. Finally, on October 27, the firm informed the SRO that an agreement could not be found, but that one had been signed when the account was with another firm. No further inquiry was made at that time into the circumstances surrounding the handling of this or other accounts of the firm.

In 1976, an SRO's routine examination of one of its members identified a registered representative who had discretion over seventeen customer accounts, including the account of a parochial school teacher with an annual income of $10,000. Trading analysis of the teacher's account showed that it had generated more than $10,000 in commissions in five months and losses in excess of $6,000. The SRO's examiner questioned the suitability of the options transactions in this account, and requested an explanation from the brokerage firm.

Ten months later the SRO investigator's memorandum to his supervisor recommending closing the inquiry paraphrased the brokerage firm's earlier explanation concerning the customer's recorded net worth and trading losses. 67/ On the basis of the firm's response and conversations with firm employees but without talking to the customer, the investigator recommended that the case be closed. The closing memorandum also reported:

> ...While the trading in [the school teacher's] account over the five month period did result in $10,000 of commissions generated, the above activity does not appear to warrant any action with respect to violation of "churning" activity (sic) especially in view of the fact that there is no evidence to indicate that [the school teacher] did not affirm all of the transactions effected by [the registered representative]... (Emphasis added.)

67/ During the investigation, however, the SRO staff did learn that this registered representative had been sued several years earlier by a customer for excessive trading, settling the dispute out of court.

Had the investigator talked to the customer he might have obtained "evidence" that she did not approve the transactions. In fact, several months after the closing memorandum was written the teacher sued the firm and the registered representative for fraud.

To remedy the deficiences noted above the Options Study recommends:

> IN INVESTIGATING COMPLAINTS, INQUIRIES OR QUESTIONABLE ACTIVITIES, SROs SHOULD DEVELOP PROCEDURES WHICH ASSURE TIMELY INDEPENDENT VERIFICATION OF EVIDENCE, WHENEVER POSSIBLE.

E. Failure to resolve disputed issues of fact

SROs frequently terminate a cause examination when a factual dispute develops between the firm and one of its customers without deciding whether or not an SRO rule may have been violated. SROs are apparently concerned that a determination of wrongdoing by them may prejudice the firm in subsequent litigation between the firm and the customer. Accordingly, SROs sometimes inform customers that they do not have "the authority to attempt to resolve" disputed issues of fact or that, due to such a dispute, the matter will be closed without action. Consequently, potentially serious violations are not investigated.

SRO resolution of disputed issues of fact is further hampered because SROs rarely take testimony during cause examinations. During the period 1973-1978, it appears that the options exchanges, in the aggregate, have taken testimony in less than 15 cause examinations into possible improper selling practices or procedures. Relying almost

exclusively upon firm records and written submissions, the options exchanges have attempted to evaluate a wide range of potentially serious matters, some of which involve issues as to the credibility of the investor on the one hand and the registered representative (or firm officials) on the other.

The Options Study believes that SROs have a statutory duty to investigate allegations of wrongdoing, and adoption of the Options Study's foregoing recommendations will help to ensure that such investigations are more extensive than are current cause examinations. Moreover, SROs have a duty to determine, on the basis of such examinations, whether the firm or its salespersons have violated an SRO rule or Federal law, irrespective of the implications of such a determination in any litigation against the firm.

While, of course, situations may arise when the investigating SRO is unable to make such a determination, as, for example, when a customer refuses to talk to an SRO, such situations should not arise frequently.

Accordingly, the Options Study recommends:

> EACH SRO SHOULD USE DUE DILIGENCE TO ASCERTAIN ALL RELEVANT FACTS BEFORE CLOSING A CAUSE EXAMINATION OR INVESTIGATION WITHOUT ACTION AND DETERMINE WHETHER THERE IS A REASONABLE LIKELIHOOD THAT AN SRO RULE OR PROVISION OF LAW HAS BEEN VIOLATED.
>
> SROs SHOULD ESTABLISH PROCEDURES TO ASSURE THAT AN INTERVIEW OR TESTIMONY OF MEMBERS, SUPERVISORS, SALESPERSONS AND OTHERS IS OBTAINED WHEN APPROPRIATE IN SALES PRACTICE CAUSE AND ROUTINE EXAMINATIONS IN ORDER TO DETERMINE WHETHER THERE MAY HAVE BEEN A VIOLATION OF APPLICABLE LAWS OR RULES, TO VERIFY INFORMATION OBTAINED FROM ANOTHER SOURCE, OR TO RESOLVE DISPUTED ISSUES OF FACT.

F. Inadequate resources

A final problem with SRO examinations and investigations is that they are frequently undertaken without adequate committment of resources by the SRO. 68/

Senior options exchange officials have frequently suggested that their SROs have not committed sufficient resources to their sales practice compliance programs. Instead, SRO resources have been committed to market operations, and, in response to heavy inter-market competitive pressures, to market promotion.

Manpower limitations have severely inhibited sales practice oversight programs. AMEX officials have noted, for example, that because of limited manpower, the exchange staff was unable to complete its routine examinations of member firms in 1975 and had to hire eleven temporary examiners to catch up. In addition, because available manpower at the AMEX is usually committed to routine examinations, cause examinations of customer complaints and of registered representative terminations are often delayed. At the CBOE, manpower limitations caused that exchange to fail to complete its required inspections during both 1976 and 1977. The exchange admitted that this failure resulted from inadequate staffing of its inspections unit.

Manpower limitations generally force all the options exchanges to send only one examiner to a firm to conduct a sales practice

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68/ For a summary of SRO resources, see Appendix H.

examination. As a result, disputes regarding the examiner's factual findings may necessitate re-examination of the firm or acceptance of the firm's representations. Finally, SRO compliance supervisors admit that they do not routinely examine branch offices since such examinations would place too great a strain on the SRO's limited sources. Similarly, limited manpower has restricted the SROs' ability to conduct branch office inspections in conjunction with cause examinations into customer complaints, terminations of salesmen for cause and similar investigations or inquiries that, in most instances, are conducted from the SRO's offices without a visit to the subject firm or interviewing in person the registered representative.

V. REMEDIAL ACTIONS

A primary objective of SRO disciplinary action is to cause member firms and their registered representatives to cease improper conduct and to initiate corrective action where necessary. In addition, disciplinary sanctions serve a deterrent function both with respect to those disciplined and to others. The Options Study believes that the SRO disciplinary programs, as they relate to options sales practices, do not achieve these objectives satisfactorily.

One reason for their ineffectiveness is that SRO investigations, which provide the factual basis for disciplinary actions, are often too narrow in scope, are incomplete, or are conducted without the SRO having access to all available information necessary to develop a proper

record. Implementation of the Options Study's recommendations including the use and sharing of compliance information should make SRO investigations and fact finding more useful. But unless SROs also impose meaningful sanctions on those who are found to have violated SRO rules, their sales practice compliance programs will not achieve the required objectives.

SRO disciplinary proceedings are too often ineffective in dealing with violations of important options selling practice rules and in applying appropriate sanctions for the following reasons:

- The majority of formal disciplinary actions brought by SROs have involved primarily procedural rule infractions.
- SROs sometimes allow a firm repeatedly to violate the same rules or related rules without taking formal disciplinary action.
- SROs do not limit the use of letters of caution or other informal disciplinary sanctions to minor or inadvertent rule violations, but sometimes use these mild remedies to sanction aggravated rule violations. And in some cases, where serious violations are detected, no action - either formal or informal — is taken.

A. Extent of formal disciplinary proceedings

As noted in Chapter V, the major options selling practice problems involve suitability of recommendations made to customers, excessive trading, abuse of discretionary accounts, misleading promotional materials, and misrepresentations as to risk and return available from listed options trading. Many of these problems have developed because of inadequate screening of registered representatives and

inadequate supervision of these registered representatives by retail brokerage firms.

Between 1973 and 1978, the SROs initiated at least 750 options related disiciplinary actions against retail firms and/or their registered representatives charging sales practice violations. Only 108 of these actions were formal proceedings. Despite the critical importance of suitable recommendations to options customers, and disturbing indications that suitability standards are being disregarded, formal SRO proceedings for suitability rule violations are rare (19 of 750), as are those relating to fraud or to excessive trading problems (8 of 750). Table VI below classifies, according to the nature of the violation, the number of options related formal disciplinary proceedings which have been instituted by the various SROs.

TABLE VI

Options related Sales Practice Formal Disciplinary Actions brought by the SROs from 1973 through March, 1978

	CBOE	NASD	AMEX	PHLX	PSE	MSE	NYSE
Total Number of Disciplinary Actions	47	34	7	6	0	0	14
Violations Charged							
No ROP	0	0	5	2	0	0	0
Failure to Use Due Diligence to Learn Essential Facts on Account Opening	14	0	4	2	0	0	0
Trading Prior to ROP Approval	15	0	5	4	0	0	0
Customer Account Agreements	13	1	5	3	0	0	0
No Prospectus Delivered	3	1	0	1	0	0	0
Inadequate Supervision	22	13	6	5	0	0	0
Discretionary Trades Without Written Authorization	11	13	3	0	0	0	5
Unsuitable Recommendations	11	8	0	0	0	0	0
Misleading Promotional Materials	0	1	0	0	0	0	0
Failure to File Advertising	2	0	0	0	0	0	0
Excessive Trading	2	1	0	0	0	0	0
Embezellment, Conversion or Use of Customer Funds	1	4	0	0	0	0	1
Forgery	1	1	0	0	0	0	0
Fraud or Misrepresentation	0	6	0	0	0	0	1
Books & Records, Margin, Reg T and Net Capital	18	7	0	1	0	0	0
Other	5	9	2	1	0	0	7

B. Use of informal sanctions

Instead of instituting formal disciplinary proceedings against a person or firm found to have violated the stated SRO rules, an SRO may choose to proceed against a respondent in a more informal manner, such as by issuing a "letter of caution," a "letter of education" or a "letter of admonition". In deciding whether to take action and what form the action should take, most SROs consider such factors as the seriousness of the misconduct, the extent of injury to public investors, any remedial action already taken by a firm and/or its employees, and whether similar or related violations by the respondent have been detected previously. Approximately 85 percent of all SRO options related sales practice disciplinary actions initiated since listed options trading commenced were resolved by informal sanctions.

The SROs assert that informal disciplinary actions generally are reserved for only minor or inadvertent violations in which there was no injury to public customers. The Options Study found, however, numerous informal disciplinary actions in which various SROs apparently did not adhere to this self-imposed standard.

Some letters of caution even characterize the conduct as "serious violations of Exchange Rules." In one such situation, a letter of caution noted that a firm failed to advise a customer of an exercise assignment until "nearly one month after the option expired" and concluded that the firm's actions were "not fair and equitable in accordance with Exchange Rules."

The SROs also have issued repeated letters of caution to member firms which have continued to engage in the same or similar rule violations for consecutive years, as illustrated by the experience of one firm as set out in Table VII.

Table VII

Summary of Disciplinary Action
by an SRO Against Firm ABC

Year	Type of Options Problem Detected	Action Taken
1974	Inadequate or improper account documentation; unsuitable trading or churning.	Educational letter sent to firm
1975	Inadequate or improper account documentation; departure from firm procedure manual regarding option or other position information.	Educational letter sent to firm
1976	Inadequate or no suitability information; inadequate or improper account documentation; departure from firm procedure manuals regarding option or other position limits; inadequate supervision over discretionary accounts' activity; improper distribution of OCC prospectus and amendments thereto.	Educational letter sent to firm
1977	Inadequate supervision or proof of supervision over discretionary accounts.	Educational letter sent to firm.
1978	Inadequate or improper account documentation; inadequate supervision or proof of supervision over discretionary accounts; unsuitable trading or churning;	Educational letter sent to firm.

Five "educational letters" were sent to this firm, yet the problems detected in 1974 persisted in 1978.

In another example, an SRO conducted an options selling practice examination of a medium sized retail firm in 1975. The examination disclosed several problems generally pertaining to the opening of options accounts and account documentation. The firm was sent a letter of caution. In 1976, the same SRO conducted a second options sales practice examination and, according to the examination report, the "same violations were found to exist [as existed in] the previous routine examination." In view of "the serious nature of the violations uncovered," the SRO held a "special interview" with the senior manager of the firm. During the interview, the SRO staff warned that a "re-occurence of any of these rule violations could result in a formal disciplinary action." A special options sales practice examination of the firm was conducted a few months later. All of the firm's active options accounts were reviewed and substantially the same violations were found again. Nonetheless, the firm was sent only another letter of caution.

In deciding whether to initiate their own disciplinary action, SROs also appear to give substantial deference to internal disciplinary action previously administered by a member firm, which may or may not be appropriate, depending upon the circumstances. In one situation, a registered representative admitted to an SRO that he had exercised discretionary authority over an account without written authorization from the customer. During an eight week period, due to this registered

representative's handling of the account, the customer had lost $53,000, while the firm earned $9,000 in commissions. Because the firm had censured the salesman and fined him $1,000, and because the customer had already sued the firm, the SRO did not take any formal disciplinary action but, instead, issued a letter of admonition to the registered representative.

In another situation, a registered representative admitted that he affixed the names of customers to certain documents including options agreements. One of these customers lost in excess of $20,000 as a result of the salesman's unauthorized trading activity. Yet, because the firm had already taken action against the registered representative by fining him approximately $5,000 and suspending him from the firm without pay for 30 days, the investigating SRO sent the salesman only a letter of caution.

The Options Study's concern about the use of informal sanctions by the SROs stems not only from the recognition that these sanctions are the mildest form of remedial action, but relates also to the fact that such informal actions are not publicized in any manner. They need not be reported to the Commission, 69/ and since the SROs do not

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69/ As noted above, the "violations" on which such actions are based have not been the subject of a formal adjudication and therefore are not final and reportable "sanctions" within the meaning of Section 19(d) of the Exchange Act. See pp. 14 - 15, above.

announce the results of such actions, neither the Commission, other SROs, nor the investing public learn about the misconduct or of the identity of the parties involved. Moreover, if a registered representative is employed at a firm other than the one where he committed the violation, the new firm is usually not advised of the issuance of a letter of caution.

The mildness of the sanction plus the absence of publicity obviously reduces the impact of informal actions as a deterrent to future infractions. The lack of publication of informal actions also decreases the public accountability of the self-regulatory process. Moreover, unlike formal actions, an informal action does not result in an adjudicated finding of culpability and, therefore, does not give rise to a record which some SROs consider to be admissible in subsequent administrative or disciplinary actions. 70/

Finally, the Options Study found one type of rule infraction for which SROs seem reluctant to take any action or impose even informal sanctions. These rule infractions involve SRO regulation of the options promotional materials used by member firms. As noted in the Chapter V, misleading or exaggerated materials are too often used to promote options. The following case illustrates the problem.

In late November, 1976, a large broker-dealer firm sent to two SROs a proposed advertisement about an options seminar. The seminar was described, among other things, as a "[d]ramatic, illustrated

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70/ At the PHLX and AMEX, however, prior letters of caution are sometimes acknowledged in decisions in formal disciplinary actions.

course for both Men and Women" which, in "simple, nontechnical language", would "answer questions like..."

* * *

> "How can option writers receive 20-40% annual premium on their stocks?"; and

* * *

> "Why does a call buyer have limited risk but unlimited profit potential?"

Both SROs objected to the use of the term "dramatic", to the reference to specified percentage gains, and to the "question" about limited risk but unlimited profit potential. In accordance with their procedures, both SROs edited the copy to remove or rephrase the unacceptable passages and then approved the advertisement for use with the appropriate changes.

Four months later, in April 1977, a member of the public complained to one of these SROs about the "gross misrepresentation" and "misleading information" contained in a seminar invitation from the same broker-dealer firm. The format of the invitation received by this investor was different from the November 1976 advertisement (which the SROs had edited), but much of the language — including that previously stricken as offensive by both SROs — remained virtually unchanged. The SRO again revised the language, and requested an explanation from the firm as to why the mailer was used without prior clearance. (The SRO did not mention that much of the language had not only not been cleared by it, but had been

plainly rejected several months earlier.) The firm, in response, blamed a "local oversight" for use of the mailer, and the matter seemed closed.

Three months later, however, the firm again submitted to these two SROs proposed invitations for a seminar. The format and language were identical to the second (April 1977) version of the invitation. For a third time, the SRO edited out the same offensive language. No disciplinary action was taken against the firm.

In order to improve the effectiveness of SRO disciplinary proceedings and the accountability of the self-regulatory process the Options Study recommends:

> EACH SRO SHOULD RESTRICT INFORMAL DISCIPLINARY ACTIONS TO THOSE CASES INVOLVING MINOR, ISOLATED VIOLATIONS THAT DO NOT INVOLVE INJURY TO PUBLIC CUSTOMERS.
>
> EACH SRO SHOULD ADOPT A POLICY WHEREBY A COPY OF EACH LETTER OF CAUTION OR OTHER DOCUMENT NOTING AN INFORMAL DISCIPLINARY ACTION IS SENT TO THE CURRENT EMPLOYER OF THE REGISTERED REPRESENTATIVE AND TO THE FIRM WHICH EMPLOYED HIM AT THE TIME OF THE VIOLATION.
>
> THE COMMISSION SHOULD ADOPT A RULE WHICH REQUIRES SROs TO NOTIFY THE COMMISSION OF ALL INFORMAL REMEDIAL ACTIONS. 71/

71/ In 1963, the Special Study of the Securities Markets made a similar recommendation. Special Study Report, Pt. IV, pp. 577, 682.

c. Reasons for inadequate sanctions - restrictive SRO policies

The shortcomings of SRO disciplinary sanctions can be attributed at least in part to certain restrictive SRO policies or practices. Some SROs, for instance, follow a practice of maintaining strict consistency in the sanctions imposed upon violations of identical or similar rules. Thus, for example, if an SRO fined a firm $1,000 in 1975 for sales practices violations, similar violations in 1978 by another retail firm likely would result in a similar fine. This practice does not recognize that, after five years of listed options trading and numerous examinations by SROs, retail firms should now be expected to understand and comply with SRO options rules. Fines also may not take into account the relationship between the cost of the fine and the profitability of the improper conduct. Some firms may find it more economical to pay an occasional predictable fine than to incur the expense of corrective action. 72/

The SROs also follow a policy of permitting a certain level of rule violations to exist at a firm, because, in their view, it is impossible for a firm to comply with all SRO rules and applicable laws. These SRO officials assert that what is important is that the level of violations remains "manageable" in the sense that the number

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72/ An official at one SRO informed the Options Study that, during the "early" years of listed options trading, member firms were reluctant to undertake remedial action because they were uncertain whether options commissions would be sufficient to defray the compliance expenses.