CHAPTER VI

SELF-REGULATORY ORGANIZATION OVERSIGHT OF RETAIL FIRMS AND THEIR ASSOCIATED PERSONS

I. INTRODUCTION

The self-regulatory organizations ("SROs") are required by law to oversee the conduct of their member broker-dealer firms and to impose sanctions on those firms and their associated persons when violations of the law or SRO rules are detected. This chapter primarily addresses SRO efforts to enforce member firm compliance with rules which relate to retail sales practices. Certain other SRO activities pertaining to the oversight of broker-dealer firms, such as the registration of salespersons and the monitoring of financial and operational developments, are also discussed.

The Commission's release announcing the commencement of the Options Study noted the Commission's concern that lapses in "regulatory programs by options exchanges to detect and deter [selling] practices [abuses] are more serious than the Commission had earlier perceived" 1 /, and directed the Options Study to review, among other things, "the ability of self-regulatory organizations to enforce compliance by brokers and dealers with appropriate selling practices [rules] regarding standardized options." 2 /

As a first step in analyzing the effectiveness of SRO sales practice compliance programs, the Options Study asked each options exchange to

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1 / Exchange Act Release No. 14056, p. 25 (October 17, 1977).

2 / *Id.* at 27.

submit a detailed description of its compliance program. 3 / Similar requests were made of the NYSE and NASD. 4 / After analyzing these submissions, the Options Study conducted on-site inspections of the AMEX, CBOE, NYSE, PHLX and PSE to obtain a better understanding of their compliance programs and to determine the manner in which each SRO followed the procedures that it had described in response to the Options Study's request. 5 / During these on-site inspections, the Options Study reviewed SRO compliance files and interviewed selected SRO compliance personnel. Cumulatively, the Options Study reviewed approximately 1,200 routine options examinations which had been conducted by the exchanges and approximately 300 options related cause examinations and related disciplinary actions. 6 / In addition, approximately 75 interviews were conducted with SRO compliance personnel.

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3 / Appendix A.

4 / Appendices B and C.

5 / This chapter does not include compliance programs of the MSE or NASD, unless otherwise noted. The MSE's submission to the Options Study was submitted in a form that was not usable. Despite the Options Study's requests to remedy that problem, the MSE did not do so. The NASD's submission arrived too late to be included in all phases of the Options Study's analyses.

6 / For a description of routine and cause examinations, see pp. 11-14, *infra*.

The Options Study found serious shortcomings in the SROs' selling practice compliance programs. While the severity of the problems varied among the SROs, the Options Study identified several deficiencies which are common to the programs of all SROs. In summary, these are:

(1) SROs in their compliance activities fail to collect and use available information, in that -

- the SROs frequently fail to seek out and question public customers when inquiries of such customers might be useful in their examinations and investigations of member firms and their salespersons

- the SROs generally do not share among themselves their own compliance data

- the SROs do not attempt to obtain useful compliance information which is available from government agencies

- the SROs do not make adequate use of information available at member firms

(2) SRO procedures for examining and investigating their members are deficient, in that -

- examinations find procedural and record-keeping problems but are not adequately designed to find substantive violations such as fraud, excessive trading, and unsuitable recommendations

- investigations too often focus narrowly on a specific episode or problem and fail to ascertain whether the specific matter is part of a broader pattern of abuse

(3) SRO disciplinary proceedings often are ineffective to deter future violations in that SROs frequently -

- use informal sanctions for serious violations

- allow repeated violations to continue without decisive remedial action.

In describing these problems in the following section of this chapter, illustrative cases are provided. It might be useful at this

point, however, to mention one firm's compliance history since 1973 (summarized in Appendix D) which seems to illustrate a number of these problems.

In the course of their 32 options related examinations and investigations of this firm during this period, the AMEX, CBOE, NASD and NYSE did not collect and evaluate available compliance data (including, information about examinations and investigations conducted by each other), did not conduct sufficiently thorough inquiries, did not coordinate their compliance efforts, and failed to detect apparently serious selling practice abuses in this firm. Moreover, even when violations were noted, the disciplinary action taken by the SROs was ineffective in motivating the firm to cease its improper practices and initiate effective remedial action because, as shown in Appendix D, the firm continued to violate the same or related SRO rules. The Commission's staff undertook an inquiry of this firm in 1977, and found apparently serious violations of the antifraud provisions of the federal securities laws and failures by the firm to supervise adequately certain salesmen.

During the Options Study's interviews, SRO officials have offered two explanations for these systemic deficiencies. First, these officials acknowledge that, because of their preoccupation with the problems which emerged from the establishment and rapid expansion of the new options markets, the exchanges did not devote adequate attention

to selling practice compliance activities. Second, the SROs generally concede that they concentrated on their individual self-regulatory obligations without recognizing the regulatory needs of other SROs and the importance of other SROs' regulatory efforts to their own.

To remedy these deficiencies the Options Study's principal recommendations are that the SROs: (1) broaden the scope of their investigations and examinations and routinely question public customers when necessary to determine whether there may have been a violation of the federal securities laws or SRO rules, to resolve disputed issues of fact, or to verify information obtained from another source; (2) develop ways to better share information and allocate responsibility, including the establishment of a central repository of information concerning common member firms and their employees; (3) establish industry-wide minimum standards and procedures for conducting their compliance programs; (4) restrict informal disciplinary actions to cases in which public customers have not been injured and in which rule violations are minor or isolated; and (5) amend their rules (if necessary) to permit restitution to be awarded to injured investors as a remedial sanction in appropriate enforcement cases.

Many of the Options Study's concerns were brought to the attention of the SROs at a meeting held with the members of the Options Study staff in August, 1978. 7/ Thereafter, the SROs in a series of meetings,

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7/ See Chapter IV.

informally referred to as the Self-Regulatory Conference, 8 / agreed, among other things, "to review current industry compliance practices toward the goal of developing a more standardized compliance program" and "to review the feasibility and usefulness of creating a central repository for compliance information." The Options Study believes that the proposals under study by the SROs are a good first step in developing solutions to remedy many of the problems identified in this chapter.

II. AN OVERVIEW OF SRO COMPLIANCE PROGRAMS

Before reviewing the problems in SRO sales-practice compliance programs, it is useful to have an overview of such programs. While each SRO's program has certain unique features, there are some features which are common to all. SROs have monitoring programs, conduct cause examinations and routine examinations, and have procedures for imposing disciplinary and other remedial sanctions. 9 /

A. Monitoring programs

There are five monitoring programs which have relevance to member firm oversight: (1) regulation of the employment and termination of employment of registered representatives; (2) review of customer complaints; (3) review of member firm advertising; (4) oversight of

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8 / See Chapter IV.

9 / In some instances, however, SROs have allocated responsibility among themselves for the administration of certain programs. See pp. 30-32, infra.

the financial and operational condition of retail firms; and (5) control of extensions of credit to public customers.

1. Employment and termination of registered representatives: The SROs are required to prevent their members from employing, without appropriate authorization, individuals who have been prohibited from selling securities because they have been found to have violated the federal securities laws or certain other statutes or rules as specified in the Exchange Act 10/, or who are subject to a "statutory disqualification" as defined in the Exchange Act. 11/ In addition, each SRO has specified qualification standards for registered representatives which include the passing of certain qualification examinations. 12/ As an initial step in the qualifying process, an applicant must apply for registration with the SROs to which his prospective employer belongs. The standard application form used by the SROs requires the applicant to respond to questions about his background and employment history, and to state whether he is currently the subject of any investigation by an SRO, the Commission, or other securities regulatory bodies. Through this registration process, SROs should be able to identify those individuals who may require special supervision by the employing firm, or who should be excluded from the securities business.

10/ See Section 15(b)(4), 15 U.S.C. 78o(b)(4).

11/ See Section 3(a)(39), Exchange Act, 15 U.S.C. 78c(a)(39); see also Sections 6, 15(b) and 15A of the Exchange Act, 15 U.S.C. 78f, 78o(b), and 78o-3.

12/ For a discussion of these examinations, see Chapter V.

When a salesperson leaves a firm, the firm is required to notify each SRO of which it is a member so that the salesperson's registration with the SRO may be cancelled. SROs require these termination notices to specify the circumstances of termination, including whether the salesperson was fired because he violated a provision of the securities laws or an SRO rule, is or has been the subject of a customer complaint, or has been named as a defendant in a civil action for alleged violations of the securities laws. The SRO compliance staffs believe that termination notices aid significantly in detecting potential problems.

2. Customer complaints: Some securities customers complain directly to the SROs about problems they have experienced as well as to the brokerage firm and the Commission. During 1977, the options exchanges and the NASD received approximately 750 customer complaints, of which approximately 150 involved options related selling practice problems. Only the NYSE requires its members to forward to it a copy of all "major complaints" the members receive. 13/ SROs have procedures to review customer complaints which they receive directly or by referral from other SROs or the Commission. In addition, most SRO examinations include a review of the firm's complaint files or customer correspondence files.

3. Advertising: The SROs have adopted standards governing their members' advertising with respect to options. To help ensure that misleading options related advertising is not used in violation of these

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13/ NYSE Rule 351(c). For a discussion of this reporting requirement, see pp 38 - 40, infra.

standards, the options exchanges require their members to submit options related advertising to them for review and approval prior to use. 14/ Some SROs relieve their members of the obligation to submit options advertising for clearance prior to release if the advertising has been approved by another SRO. 15/ In addition, there are informal agreements between or among SROs by which one SRO may review advertising on behalf of other SROs.

Other sales literature, such as market letters that contain analyses, reports, recommendations, or comments on options, is not required to be filed with an SRO prior to distribution. All SRO procedures call for a review of both options advertising and options sales literature as part of their routine examinations of member firms. The CBOE is the only SRO, however, which reviews sales literature throughout the year even when there is no routine examination. Each week the CBOE staff

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14/ See also Chapter V. The AMEX, CBOE, MSE and PHLX have filed with the Commission proposed rule changes which, if approved, would establish uniform standards for the review of options sales literature. See SR-AMEX-1978-21, 43 Fed. Reg. 50512 (Oct. 30, 1978); SR-CBOE-1978-26, 43 Fed. Reg. 50515 (Oct. 30, 1978); SR-MSE-1979-1 (unpublished); SR-PHLX-1978-21, 43 Fed. Reg. 52795 (Nov. 14, 1978). The Commission's staff has been informed that the PSE intends to submit similar proposed rule changes, but as of January 20, 1979, such proposals have not been filed with the Commission.

15/ The NASD requires that member firms file proposed options advertising with the Association. Unless the NASD staff objects to the proposed advertising within 10 days, the firm may release it. At the NYSE, member firms are not required to obtain NYSE approval before issuing advertising, although NYSE firms are required to adhere to certain NYSE advertising standards.

selects several firms and requires those firms to submit all of their options sales literature for a particular month for review by the staff; each CBOE firm is selected for review twice a year.

4. Financial responsibility early warning systems: To assure that retail firms are in compliance with applicable net capital, margin and similar requirements, every firm is required to make confidential periodic filings with an SRO disclosing information on its financial condition and significant operational developments. To avoid unnecessary duplication, the Commission has allocated responsibility for reviewing these filings among the SROs, and requires a firm to file its financial reports only with the designated SRO. In addition, a firm is required promptly to notify the Commission and the designated SRO whenever its financial condition reaches certain prescribed levels or its operational responsibilities are impaired. 16/

At least once a year, the designated SRO makes an in-depth examination of each retail firm's financial and operational condition.

5. Credit monitoring: Federal law requires purchasers of securities to pay for their cash purchases within a specified time period, but permits retail firms to apply for and receive on behalf of a customer from an SRO an extension of the payment date for "exceptional circumstances". Applications for extensions of time ("Regulation T

16/ See 17 CFR 240, 17a-11; See also Chapter VII.

requests") may be filed with an appropriate SRO. SROs prefer, however, that applications be filed with the SRO which has been designated to process the firm's financial reports.

Each SRO has its own system for processing Regulation T requests. All SROs, except the NYSE, process complaints manually. The NYSE, which receives about 450,000 requests per year (more than any other SRO), uses a computer to process and, in most instances, grant automatically extension requests.

B. Cause examinations

Cause examinations, generally, include examinations, inquiries and investigations into problems identified in the monitoring programs, described above, which the SRO believes warrant immediate or special attention. Most cause examinations consist of a written or oral request made to the firm by an SRO for information, statistics, or related data pertaining to a specific problem. Upon receipt of the response, the SRO staff decides whether the federal securities laws, Commission rules, or an SRO rule may have been violated and, if so, whether disciplinary action seems necessary. The SRO conducting a cause examination does not always visit the firm, take testimony from witnesses or the subjects of the investigation, or inquire whether other SROs are engaged in or have recently completed a similar inquiry. During 1977, the options exchanges, the NASD and the NYSE conducted approximately 300 cause examinations into potential options related problems.

C. Routine examinations

There are two types of routine examinations: (1) capital examinations, which focus principally on the financial and operational condition of a firm; and (2) sales practice examinations, which review the sales practices of a firm. Sales practice examinations may be product oriented — for example, a review of how a firm sells options —or may include, as in the case of the NYSE, a review of the firm's entire securities retailing effort.

In general, capital examinations are designed to determine whether the firm is in compliance with the net capital, books and records, and related customer protection rules.

Sales practice examinations, on the other hand, are intended to detect selling practice abuses. These examinations normally are preceded by a review of the files of the examining SRO which relate to the firm, including the report of the preceding SRO sales practice examination. 17/ The examinations usually include interviews with representatives of the firm, examination of the firm's advertising and correspondence files, its exercise allocation and account opening procedures, and a review of customer accounts to determine whether requisite account opening forms, agreements and approvals are on file and whether there are violations of the applicable suitability standards. 18/

17/ In some instances, where the preceding examination of the particular firm was conducted by another SRO, the report is not made available to the examining SRO. See pp. 21-30, infra.

18/ See Chapter V.

Some SROs report the findings of the examination by letter to the firm, and some do so orally. 19/ Each SRO requires its staff to prepare an examination report either in narrative form (NYSE), in the form of a fill in-the-blank checklist (AMEX, PHLX, and PSE) which also serves as the examiners' instructions for the conduct of the examination, or both (CBOE).

During the period 1973-1977, there were a total of 3,017 options-related sales practice and combined capital/sales practice examinations. Of these, 1577, or 52 percent, were conducted by the NYSE. Among the options exchanges, the AMEX conducted the most sales practice examinations, 691, which accounted for about 23 percent of all such examinations.

19/ When the results of an examination are reported orally to the firm, the examining SRO normally transmits some sort of written summary of its findings or acknowledgment to the firm. Such transmittal, however, may not reflect all of the violations found by the examination. See n. 26, infra.

TABLE I

Number of Options Related Sales Practice
(or Capital/Sales Practice) Examinations Conducted by SROs

SRO	1973	1974	1975	1976*	1977*	Total by SRO
NYSE	359	287	311	310	310	1,577
CBOE	58**	119	121	87	64	449
AMEX			146**	329	216	691
PHLX			25**	72	76	173
PSE				26**	13	39
MSE					88**	88
Total	417	406	603	824	767	3,017

Note: Figures include some duplication in sales practice examinations of some firms.

The NASD also conducted sales practice examinations, some portion of which evaluated options trading, but not to the same degree as those of other SROs. Accordingly, the NASD was not requested to provide statistics as to all NASD examinations which included a review of options related sales practices.

* The addition of the PSE, PHLX and MSE as options exchanges and assumption by those exchanges of sales practice examination responsibilities for certain of their members reduced the examination responsibilities of the CBOE and AMEX.

The number of AMEX options sales practice examinations in 1976 increased from the preceding year because of the AMEX's inability to complete all of the sales practice examinations scheduled for 1975, which resulted in a carryover of the 1975 cycle into early 1976. See p. 63, below. In 1977, when the AMEX met its cycle, the number of sales practice examinations conducted by the AMEX declined.

** First year that SRO traded listed options.

D. Disciplinary proceedings

Each SRO has procedures to impose disciplinary sanctions or to seek other necessary remedial action based upon violations uncovered in the above programs. Disciplinary action may be either formal or informal. In formal disciplinary proceedings, written allegations of misconduct are served on the respondent, who is given an opportunity to appear at a hearing and defend against the charges. Then, if the securities laws, Commission rules, or an SRO rule is found to have been violated, the SRO may impose a remedial sanction including fines, suspension, or expulsion from membership and a bar from associating with any member. 20/ The result of every formal proceeding must be reported to the Commission and, upon receipt by the Commission, is available publicly. 21/ Respondents may appeal the final decision to the Commission, which may affirm, dismiss, remand for further hearing, or reduce the sanction. 22/ The Commission does not have the authority to increase the sanction imposed by an SRO. 23/ Any person aggrieved

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20/ See Sections 6(b)(6), 15A(b)(7) and 19(g)(1), Exchange Act, 15 U.S.C. 78f(b)(6), 78o3(b)(7), 78s(g)(1).

21/ Securities Exchange Act Rel. No. 34-13726, 42 Fed. Reg. 36415 (Jul. 14, 1977).

22/ Section 19(e), 15 U.S.C. 78s(e).

23/ The Commission, of course, may bring its own civil action or administrative proceeding if it determines that Federal securities laws have been violated, or that the SRO has not enforced adequately its own rule. See Sections 15(b) and 21 of the Exchange Act, 15 U.S.C.§§ 78o (b) and 78u.

by the Commission's final order may petition a United States Court of Appeals for a review of that order.

Informal disciplinary actions primarily take the form of letters of caution, oral warnings or admonitions, or interviews with the senior management of a firm conducted by the compliance staffs of the SROs. Informal actions do not involve strict procedures such as notice, hearing and right of appeal. Further, such proceedings do not result in an adjudicated finding of a violation of the federal securities laws, Commission rules or an SRO rule. Informal disciplinary actions are not filed with the Commission or made public.

III. OBTAINING COMPLIANCE INFORMATION

For SRO compliance programs to operate effectively, SROs must have adequate information about the activities of member firms. There are four primary sources of such information: public customers; the SROs themselves; governmental agencies, such as the Commission; and member firms. The Options Study found that the SROs often fail to obtain the full range of relevant compliance data available from these sources.

A. Public customers

Public customers have important, perhaps indispensable, compliance information for SROs. Customers, for example, know their investment objectives, the circumstances surrounding the opening of an account including any representations made by the registered representative, and the history of their dealings with the firm. 24/ Unless a customer

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24/ For a discussion of the importance of customer complaints as investigatory leads, see Report of Special Study of the Securities Markets, H.R. Doc. 95, Pt. I, 88th Cong, 1st Sess., pp. 269-272 (1963) (hereinafter "Special Study Report").

complains directly to an SRO, however, SRO enforcement personnel very rarely communicate with investors. Most SROs have a general policy that a customer will not be contacted without prior permission from the firm. One exchange senior staff member referred to this restriction as the "unspoken rule." On the other hand, a senior staff official of the NYSE has recently advised the Options Study that the exchange's examiners are now contacting customers of NYSE member firms when there is cause to do so.

Where SRO staffs do not contact customers they do not have ready access to a very important source of regulatory information which has resulted in less effective sales practice examinations and cause examinations. In conversations with the Options Study, SRO staff members attribute their reluctance to contact public customers to a number of reasons. First, SRO staff members are concerned about maintaining good relationships with member firms. They fear that such contacts might encourage customer complaints against a member firm, or could result in a member firm's losing a customer's account, or being subjected to litigation. They are also concerned that, in the event a customer does leave the firm or sue a member following an interview with an SRO staff member, the SRO may be sued by the firm for tortious interference with the business or contractual relationship between the member and its client.

The Options Study identified numerous SRO routine and cause examinations involving customer accounts in which issues of fact relating to possible violations were left unresolved or were resolved informally in

favor of a firm or salesperson without the SRO contacting the firm's customers. In some instances, the Options Study discovered that, had the SRO contacted the customer, the customer could have provided information which would have been relevant in resolving those issues of fact.

Illustrative of such a case was an SRO's investigation of a customer complaint received by the SRO against a large retail firm. The customer complained that he had not been advised of the risks of options trading, had not executed a customer account agreement and that unsuitable trades had been made in his account. The SRO's investigative report concluded that "documentation supplied by the firm substantiates the complainant's contention that the firm did not obtain signed options or customer agreements until well after the initial options transactions . . . ." The report also noted, however, that no determination of unsuitability could be made because "no written investment objective was provided" by the customer when the account was opened. The matter was closed without the SRO's interviewing the customer to determine, among other things, whether the firm had inquired as to his "investment objective," or executed transactions which were inconsistent with that objective and without the SRO even cautioning the firm for the established violation of permitting the customer to trade options before his account was properly approved.

In another case, an SRO conducted an investigation of apparent excessive trading in the account of a school teacher. Although the level of trading in the account was extraordinary, the SRO determined not to take disciplinary action. In reaching this decision, the SRO dismissed allegations that the trading had been induced by the misleading statements of the registered representative, noting simply that the teacher had been advised of the activity in the account. The Commission's staff, on the other hand, contacted other customers of this registered representative and learned of similar complaints from at least eleven other customers. The Commission's investigation is still pending.

Some SROs also consider only written submissions to be "complaints." Oral grievances, conveyed in person or over the telephone, to these SROs are usually classified as "inquiries" and, until reduced to writing, are not investigated or taken into consideration by SROs in their conduct of an examination. At one SRO, a senior staff member told the Options Study, for example, that an investor made a personal visit to the SRO and complained that his account had been mishandled. The customer was requested to make a written complaint. When the SRO did not receive one, no action was taken even though the staff member said that he knew the salesman involved had been the subject of prior customer complaints. The staff member also admitted that he did not take any notes of the

visit and did not even refer the matter to the SRO's examiners for possible use in the next examination of the firm.

The Options Study believes that the failure of an SRO to contact public customers to ascertain facts necessary to determine whether there may have been a violation of the federal securities laws or SRO rules, to resolve disputed issues of fact, or to verify information obtained from other sources and to follow-up on oral complaints are major flaws in the SRO's compliance programs. The Options Study has voiced its concern to the SROs, individually and collectively, but they have not as yet abandoned their respective internal policies which inhibit or restrict communications with public customers. They have agreed, however, to study the issue and to determine if there are any "legal impediments" to such communications. The Options Study concurs with the recommendations made by the Special Study of the Securities Markets in 1963 that, in order to enforce their rules effectively, SROs should contact public customers. 25/ Accordingly, the Options Study recommends:

> SROs SHOULD INTERVIEW PUBLIC CUSTOMERS, IN APPROPRIATE CASES, AS PART OF ROUTINE OR CAUSE SALES PRACTICE EXAMINATIONS TO RESOLVE FACTUAL DISPUTES AND TO ASCERTAIN FACTS NECESSARY TO DETERMINE WHETHER THERE HAS BEEN A PROBABLE VIOLATION OF AN SRO RULE OR FEDERAL LAW.
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> SROs SHOULD MAKE AND RETAIN WRITTEN RECORDS OF ORAL COMPLAINTS, EVALUATE THEM CAREFULLY, AND, WHERE APPROPRIATE, CONDUCT A CAUSE EXAMINATION INTO THEM AND TAKE THEM INTO CONSIDERATION IN PLANNING ROUTINE AND CAUSE EXAMINATIONS.

25/ See Special Study Report, Pt. I, p. 328.

B. SROs

1. Sharing of information: Each SRO maintains substantial information about its members and their associated persons. This information includes: (1) records of routine and cause examinations, and disciplinary actions; (2) financial and operational filings made by firms for which the SRO is the designated examining authority; (3) customer complaints; (4) registration files for the firm and its associated persons; and (5) correspondence between the SRO and member firms.

Much of this data could be useful to other SROs, but is not shared on a routine basis among the SROs. For example, SROs do not share information about routine sales practice examinations. 26/ Between 1973 and 1977, the NYSE conducted approximately 1,500 options related sales practice or capital/sales practice examinations, but did not disclose routinely the results of these examinations to the options exchanges, as they pertained to firms which were common members. The options exchanges also conducted about 1,500 sales practice examinations, about 75% of which involved retail firms that were members of the NYSE and the NASD, but did not disclose routinely the results of these examinations to the NASD or NYSE. The same lack of interchange exists concerning cause examinations and the imposition of informal disciplinary sanctions on

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26/ The options exchanges represent that they forward to one another a copy of any letter sent to a common member firm noting deficiencies found in routine examinations. The Options Study found, however, that letters of comment may not reflect all of the violations found during an examination, and, thus, to rely exclusively upon a review of such correspondence to prepare for a routine or cause examination may be inadequate and misleading. See n. 19, *infra*.

member firms and information concerning Regulation T extensions. In addition, there are no established procedures among the SROs for the interchange of customer complaints. These complaints may be valuable because they can be used to detect potentially troublesome sales practice activities at a firm. 27/ The Options Study has found instances in which an SRO has investigated a customer complaint against a salesperson in ignorance that other customers had complained to other SROs about the same salesperson. 28/ The number of complaining customers frequently is an important measure of the magnitude of a suspected problem.

The failure of the SROs routinely to share data is a serious shortcoming in their compliance programs. The consequences are illustrated by the following case history:

Between 1974 and 1978, a major retail firm was the subject of eight different routine sales practice examinations by three different SROs. Collectively, these SROs sent the firm five letters of caution and one letter of "education." In addition, formal charges were filed against the firm in 1976, which were settled when the firm agreed to pay a $4,000 fine. The results of these examinations and the related informal disciplinary actions were not shared among these SROs. A summary of these examinations and the action taken on them appears in the following table.

27/ *See* n. 24 and accompanying text, *supra*.

28/ A summarized history of the findings and dispositions of SROs routine and cause examinations of one such firm appears at Appendix D.

Table II

Summary of SRO Examination and Disciplinary Action as to Firm XYZ

Examining SRO	Date of Exam	Options Related Violations Noted	Action Taken
NYSE	9/74	Inadequate or improper account documentation.	Letter of Education
CBOE	9/74	Inadequate or improper account documentation; missing or defective discretionary trading agreements; unsuitable recommendations; position limit violations; failure to file position reports.	Letter of Caution
NYSE	9/75	Inadequate or improper account documentation; failure to adhere to rules governing opening of accounts; false and misleading representations by a salesman; inadequate or unqualified supervisory personnel; check kiting by a customer.	Verbal Caution
PHLX	10/75	Inadequate or improper account documentation; failure to adhere to rules governing opening of accounts.	Letter of Caution
CBOE	4/76	Inadequate or improper account documentation; failure to adhere to rules governing opening of accounts; missing or defective discretionary trading agreements; failure to file position limit reports.	Statement of charges filed; firm settled proceedings by paying $4,000 fine.
NYSE	8/76	None	None
CBOE	8/77	Inadequate or improper account documentation; failure to adhere to the rules governing opening of accounts; improper extension of credit; defective confirmation notices.	Letter of Caution
NYSE	9/77	Inadequate or improper account documentation; failure to adhere to the rules governing opening of accounts; improper nominee account; failure to comply with the "know your customer" rule.	Letter of Caution

Several observations may be made concerning this example. 29/ First, sharing of examination data would have enabled each SRO to focus its routine examinations so that problem areas or individuals could have been better scrutinized. The NYSE's 1976 examination, for example, found no options related violations, although the CBOE's examination only four months earlier had found several potentially serious violations. If the NYSE had been aware of the CBOE's findings, its examiners could have conducted their review to ensure that they did not overlook similar violations or to verify that violations cited by the CBOE had been remedied. 30/

Second, the sharing of information about informal disciplinary actions (letters of caution, etc.) would have placed each SRO on notice that another SRO's previous attempt to resolve a problem by an informal sanction apparently was not effective. The failure of SRO sanctions to correct repeated violations became apparent to the Commission's staff as a result of a detailed examination in 1978 of certain of the firm's branch offices which had received substantial customer complaints or which had engaged in aggressive advertising campaigns. 31/ The staff found

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29/ Table II also illustrates the need for increased coordination of routine examinations among SROs. See pp. 30-32, infra.

30/ See also Appendix D.

31/ The Commission's staff examination included an analysis of more than 500 customer accounts and inspections of ten branch offices. The staff also took testimony from nine branch managers, 27 salesmen and four managers in the firm's options department. In addition, approximately 700 customers were questioned about their accounts either by personal contact or through questionnaires. For an overview of SRO examination techniques, see pp. 44-63 and Appendix G.

indications of a apparently serious violations of the federal securities laws, Commission rules, or SRO rules. Applicable SRO rules governing the opening of accounts apparently had been violated in approximately 65 percent of accounts reviewed for that purpose (113 of 171), and approximately 50 percent of the accounts reviewed for proper account documentation (62 of 123) did not appear to be properly documented. 32/ The examination also revealed that several registered representatives and supervisors may have engaged in false and misleading promotional campaigns and fraudulent trading practices in options accounts. 33/ The Commission's staff has recommended that an administrative proceeding be commenced naming as respondents the firm and 17 of its registered representatives and supervisors.

The Options Study undertook to ascertain what compliance information existed in the files of the SROs with respect to these 17 individuals and requested the NYSE, NASD, AMEX and CBOE to furnish such information concerning them. 34/ The following table summarizes the responses received by the Options Study.

32/ These accounts were selected for analysis because they were serviced by registered representatives who had high options commission income.

33/ One of the branch offices examined by the Commission's staff had been examined by the NYSE in June, 1977. The NYSE had found a high percentage of accounts without requisite documentation and had sent the firm a letter of caution which cited, among other things, these deficiencies. These problems had not been remedied by the time the Commission's staff inspected the office six months later.

34/ The MSE and PSE were not contacted because they do not register salespersons for their member firms and, thus, do not have any records. The PHLX was not contacted because the PHLX staff had previously informed the Options Study that the PHLX had never received a notice of a termination for cause and had not conducted any options sales practice cause examinations.