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

DIVISION OF
MARKET REGULATION

The Honorable John D. Dingell
Chairman
Committee on Energy and Commerce
2125 Rayburn House Office Building
Washington, D.C. 20515

Dear Chairman Dingell:

This responds to your letter of November 14, 1986 on behalf of Ms. Joan Hunt Smith, which reflected Ms. Smith's dissatisfaction with the original report on this subject by the staff of the Division of Market Regulation. Our review did not indicate that the procedures employed or the decision rendered by the arbitration panel were either unfair or arbitrary. This, however, should not be read as the Division indicating a position on the correctness of the decision. As you know, the Commission has no authority to reverse securities arbitration decisions. We also do not object to the conclusion of the recently completed review by the New York Stock Exchange that in light of the evidence that Ms. Smith was aware of and acceeded to the activity in her account, no further investigation is warranted. In order to respond to the observations in both your letter and Ms. Smith's letter, I have reviewed the written file assembled by my staff and report the following information.

(1) The staff's statement at paragraph three of its report that "Smith appeared in that hearing, with counsel ..." should have read "through counsel." In any event, the purpose of the statement was, and remains, simply that her interests in the confirmation proceeding were represented by counsel.

(2) Account Opening Procedures. You have commented in your letter that the staff's "report does not comment on the fraud aspects, e.g., the illegally altered financial statements." My review of the file shows that, in fact, the staff thoroughly reviewed all of the allegations made by Ms. Smith in order to conclude, as expressed in the report, that "testimony at the [arbitration] hearing could reasonably support a decision adverse to the claimants."

The staff analyzed the account opening procedures involved, and noted that the record indicates that Smith's account was approved for trading on the basis of information contained on two in-house Shearson forms: a new account form and an options approval form. 1/ These forms are used by the firm to provide background information on clients, including both personal and financial data. The forms were represented to have been filled out by the registered representative and were not signed by the client.

The Division staff's file shows that the first time the form was completed, it showed Smith's annual income as $30,000, liquid net worth as $550,000 and total net worth as $750,000. The form was reviewed in Shearson's New York compliance office and approved only for covered options trading. Smith's registered representative, Herbert Mayer, then complained to his branch manager that his client, Smith, was familiar with and suitable for uncovered options trading. He allegedly then presented the second form, the "option suitability" form, for his manager's signature. 2/ This second form recorded Smith's annual income as $80,000, liquid net worth as $1,000,000 and total net worth as $1,500,000. The account was then approved for uncovered options trading. In addition, Shearson's compliance department sent "negative consent letters" to Smith in order to verify the figures on both of the forms. The second negative consent letter contained a mix of information from each of the forms. Smith testified that she had questioned Mayer about the higher income figure on the second letter, but that she accepted his explanation that a clerical error had been made, confusing an "8" and a "3".

Shearson's testimony was that the higher financial figures on the second form had nothing to do with the account approval. The firm's testimony was that Smith had originally been limited

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1/ Actually, the staff observed that the "two" forms are identical. Testimony established that if one box on the form were checked it served the "new account" function and if the other were checked, it served the "options suitability" function.

2/ The staff file shows that the branch manager testified that he did not sign the first form, another supervisory employee signed that form. The branch manager also testified that he had not seen the first form prior to the arbitration hearing.

to selling covered calls because she was "a divorced woman with no experience in option dealing before." Shearson's representatives testified that the firm's internal monetary guidelines for trading uncovered options were that a customer had to have an annual income of $25,000, liquid net worth of $50,000 and total net worth of $100,000. Both Smith's original financial statement and the allegedly fraudulent financial statement have figures that exceed these amounts. 3/ In conclusion, it appears that Smith's account qualified for uncovered options trading under either set of financial figures.

(3) Trading Activity. With respect to the trading activity in the accounts, the staff noted that the testimony, even allowing for differences between claimants and respondents testimony, indicates that during the complained of time period: (a) Smith was in contact with her registered representative, Herbert Mayer, almost daily; (b) George Hybert, the holder of one of the other complaining accounts, was in Mayer's office three to four times a week; (c) Hybert stated that he had given Mayer permission to execute every transaction except for three or four trades; (d) Smith read, at least partially, weekly account summaries; (e) both Smith and Hybert signed "Activity Letters" indicating they knew the extent of trading in their accounts; and (f) both Smith and Hybert received confirmation slips on all trades. The record also indicates that the claimants' expert witnesses supported their churning claims with an analysis based on studies of trading in stocks and covered options, rather than on uncovered options, which were traded in these accounts.

In addition, without attempting to minimize the dramatic swings of net value within the accounts, and without offering any views as to what appropriate damages might have been found had the claimants successfully established their claims of churning and unsuitability, the staff noted that the record did not support claimants' allegations of losses in excess of $500,000. 4/

3/ Smith's testimony never exactly established what the correct figures would have been.

4/ The staff also noted that the record showed that Smith had the terms of the trust governing the third complaining account, the account she held in trust for her daughter, altered so that it could engage in naked options trading. This change was made in response to Shearson's refusal to allow such trading in the account otherwise.

(4) The staff's statement that it "would not recommend that the Commission take any action against either the CBOE or Shearson on the basis of Ms. Smith's complaint" should not be read as a determination prior to the completion of the NYSE investigation that no violations of the securities laws occurred. In order to efficiently employ SEC examination and enforcement resources, the staff as a general policy will refer to the relevant self-regulatory organization complaints relating to alleged securities law violations of a single registered representative where there is no indication of structural problems in the firm's compliance systems. The Division believes that this approach has permitted an efficient melding of SEC and SRO resources in addressing sales practices abuses.

(5) NYSE Investigation. The NYSE's final report on these complaints was received by the staff on December 29, 1986. The exchange had closed out its investigation on July 14, 1986, but failed to advise the staff of its action until the staff again asked for the results of its investigation in response to your November 14, 1986 letter.

A summary of the timing of the NYSE's investigation shows that the Commission requested that the exchange investigate Ms. Smith's complaint by letter dated October 31, 1985. Periodic telephone conversations between the staffs of the Commission and the NYSE produced assurances from the NYSE that the voluminous file in this matter was being reviewed. Finally, by letter dated April 18, 1986, the NYSE staff acknowledged its review in writing and stated that its examiners would soon visit the branch office of Shearson named in Ms. Smith's complaint. This was the first indication that the Commission's staff had that the NYSE was delaying its field work in this matter in order for it to coincide with its regular sales practices examination of the firm. Although there may be sufficient merit to warrant such an allocation of its resources, we have advised the NYSE staff that it should have advised us of its decision much earlier, in order that we could have advised your office of the course of the investigation on a more timely basis.

In mid June 1986, the Commission received two short reports dated June 3, 1986 and June 13, 1986 from the examination staff of the NYSE, discussing its review of Shearson's records. At that point, the NYSE's enforcement staff commenced its review of the record in order to determine whether to institute any action against Shearson on the basis of Ms. Smith's complaints. As stated in the attached report from the NYSE, it has concluded that no further action is warranted in this matter.

The Commission's staff has been informed by the NYSE's staff that its examination of Shearson included a review of the firm's new account documentation at the Shearson branch where Ms. Smith's account was held, as well as at other branches of the firm. This letter addresses only the accounts mentioned by Ms. Smith in her letters to you. Other findings by the NYSE are still under consideration, and, of course, are non-public.

In addition, I would add that while the staff does not disagree with the NYSE's conclusion that the evidence in this case would not warrant further action, our reasoning is not identical to that expressed by the exchange in its December 24, 1986 letter.

First, the NYSE's letter relies principally on testimony by Shearson's representatives that Ms. Smith and the other account holders were aware of the activity in the accounts. Our review of the file finds that Ms. Smith's own testimony at the hearing would equally support a conclusion that she was aware of and acceeded to the options activity in her account. In addition, we also looked to the evidence regarding Ms. Smith's financial position and securities investment experience in determining that the arbitration decision was not unreasonable. Finally, while we agree that in light of all the circumstances of this case the inaccurate new account and options suitability documentation would not support any enforcement action, we also believe that the extent of misinformation on all three clients' forms, if found widespread at that firm or any firm, would be unacceptable. We have advised the exchange of our views concerning this and have encouraged the NYSE to pursue this issue vigorously in its continuing sales practices reviews.

(6) CBOE Response. The staff attached a copy of the CBOE's response (without attachments) to its first report of its review of Ms. Smith's complaint. The staff had carefully reviewed the response at that time and concluded that the response was complete on its face and needed no further follow-up. I have enclosed with this letter the attachments to the CBOE's letter which may help you with your own analysis of Ms. Smith's allegations of bias at her arbitration hearing.

(7) Staff Investigation. You have asked that we explain the extent of the investigation conducted by the staff. The staff's investigation of this matter has been unusually exhaustive, especially in light of the work done by the Chicago Board Options Exchange and New York Stock Exchange. As noted above, the Commission has always relied in part on resources of securities industry self-regulatory organization in evaluating

investor complaints that do not appear to raise concerns regarding structural compliance deficiencies in the broker-dealer. My staff advises me, however, that they estimate that your requests that we review this matter have resulted in several full weeks of work by an attorney at the special counsel level, assisted by many hours of work by a legal intern, and additional hours of work by an Assistant Director. Additional time has, of course, been expended at higher levels of review up to and including Commissioner Cox, who responded to your initial letter. Every indication from our review of the arbitration files as well as the reviews of both the Chicago Board Options Exchange and the New York Stock Exchange indicates that an SEC enforcement action could not be supported under the facts of this case. Accordingly, I believe that any further review would be an unjustifiable use of staff resources.

We appreciate this opportunity to clarify our earlier response. Please contact me (272-3000) if you have further questions regarding this matter.

Sincerely yours,

Richard G. Ketchum

Richard G. Ketchum
Director

Attachments