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Report to Congressional Requesters

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SECURITIES MARKETS

Actions Needed to Better Protect Investors Against Unscrupulous Brokers

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The Honorable John D. Dingell
Chairman, Subcommittee on Oversight
and Investigations
Committee on Energy and Commerce
House of Representatives

The Honorable Edward J. Markey
Chairman, Subcommittee on Telecommunications
and Finance
Committee on Energy and Commerce
House of Representatives

This report responds to your requests that we review the oversight and disciplinary actions of the Securities and Exchange Commission (SEC) and several of the securities industry's self regulatory organizations (SRO) against unscrupulous brokers—individuals licensed to sell securities who have committed a significant breach of sales practice rules or have a history of repeated sales practice violations.[1] The activities of such brokers can cause serious financial harm to investors and erode public confidence in the securities markets. Because recent press reports have alleged that unscrupulous brokers move from one firm to another and continue to commit sales practice violations, you were concerned that SEC and the securities industry may not be adequately protecting investors from unscrupulous brokers.

As agreed with the Subcommittees, this report discusses (1) the extent to which unscrupulous brokers are active in the securities industry, (2) regulatory and industry efforts to discipline unscrupulous brokers, and (3) the capability of the industry to identify unscrupulous brokers through its database of broker disciplinary histories.

Background

Oversight of the U.S. securities industry is primarily based on the concept of self-regulation, a process by which the industry regulates itself with oversight from SEC and state regulators.[2] This process is accomplished through a framework of (1) supervisory and compliance systems at securities firms; (2) oversight and discipline by SROs, state securities

[1]Sales practice abuse activities, which generate commissions for the broker but can jeopardize investor funds, include unsuitability (selling of securities that are inappropriate on the basis of the investor's source and amount of income), unauthorized trading (buying or selling securities without the consent or knowledge of the investor), and churning (excessive trading in the investor's account).

[2]To conduct business within a state, brokers generally must be licensed by the state.

regulators, and SEC; and (3) SEC's approval of SROs' rules and regulations and review of examination and disciplinary programs. SROs, such as the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE), establish rules of conduct for their member securities firms and perform examinations (on a routine basis or in response to an event) to detect violations of those rules and federal/state securities laws and regulations.

Brokers who violate federal or state securities laws and regulations, or SRO or firm rules, are subject to various disciplinary actions by SEC, state regulators, SROs, courts, and their employers. Available disciplinary actions vary in severity, reflecting the differing degrees and circumstances of wrongdoing they address. Relatively minor violations can result in informal disciplinary actions, such as a letter of caution, which is a warning letter, or a compliance conference, which is a conference between SRO staff, the firm, and the individual broker to address corrective actions for the securities violation. More serious violations can be addressed by formal disciplinary actions, including the imposition of monetary fines, censures, restitution orders, suspensions of varying lengths, and bars from certain or all securities-related functions.

Sales practice abuse can be detected through a variety of means, including investors' complaints, a firm's supervisory and compliance systems, SRO examinations, and self-reporting by brokers. The Securities Exchange Act of 1934, as amended, and SRO rules require brokers to disclose specific information when applying for a state license and when registering with SEC and SROs. Brokers and firms must disclose information relating to criminal convictions, civil litigation, and administrative proceedings, if applicable.

NASD and state regulators maintain the Central Registration Depository (CRD), a database containing information regarding the disciplinary history of member firms and individual brokers. Originally established as a centralized broker licensing and SRO registration system, CRD is now used by regulators and the industry to help oversee brokers' activities. Individual brokers and firms are required to report to CRD formal disciplinary actions taken against brokers by SEC, state regulators, SROs, courts, or employing firms for violations related to the securities business

and certain customer complaint[3] and arbitration[4] information. In addition to formal disciplinary actions, member firms are required to provide CRD with written notice of employment terminations. Data generally are to be reported within 30 days of the action's occurrence. SRO staff can use CRD information to help determine whether the firm or the broker has violated securities laws or rules.

Results in Brief

We do not know the exact extent to which unscrupulous brokers are active in the securities industry because (1) sales practice abuse is often difficult to detect, (2) CRD does not contain data on informal disciplinary actions, and (3) CRD is not designed to provide summary data by type of violation for the disciplinary histories it maintains. Although we could not determine the exact extent to which unscrupulous brokers are active in the securities industry, we were able to obtain CRD data showing the number of brokers with disciplinary histories. Of the almost 470,000 active brokers listed in CRD as of November 30, 1993, about 10,000 had at least 1 formal disciplinary action against them for a variety of violations, including sales practice abuse violations and such criminal acts as driving while intoxicated, and 816 had 3 or more disciplinary actions.

In our opinion, even a few unscrupulous brokers can cause serious financial harm to investors and have the potential to damage public confidence in the securities industry. Consequently, SEC and industry efforts to ensure effective oversight of brokers and discipline of those who violate laws and regulations need to be as effective as possible. Available evidence, however, points to shortcomings in the detection and discipline of unscrupulous brokers. In particular, according to SEC's 1994 staff report involving 9 U.S. broker-dealer firms, 25 percent of 161 branch offices SEC examined for sales practice abuse had weaknesses in broker hiring and supervision practices.[5] Further, 40 cases were referred for investigation and possible enforcement action to SEC enforcement staff. The report acknowledged that although it was not possible to generalize its findings because of the small number of firms examined, the disproportionate number of referrals for investigation and enforcement consideration suggested that (1) supervisory and compliance systems needed

[3]Any complaint that alleges (1) damages of $10,000 or more, (2) fraud, (3) the wrongful taking of property, or that is settled for $5,000 or more is to be reported by the broker to CRD.

[4]Arbitration, the most frequently used method to resolve securities complaints and disputes between investors and broker-dealer firms, is a process in which decisions are rendered by arbitrators. Arbitration was designed by the industry to be faster and less expensive than litigation.

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

improvement and (2) existing sanctions for sales practice violations at the SROs and SEC needed to be strengthened.

Furthermore, we found that certain practices contribute to a perception that SEC and industry disciplinary actions are lenient. Such actions allowed the imposition of retroactive bars and brokers who were permanently barred to reenter the industry. We also noted the potential for brokers barred from the securities industry to migrate to other financial services industries, such as banking and insurance.

SEC, state regulators, and SROs need effective broker surveillance monitoring systems that can help them identify brokers with a history of sales practice abuse and firms with questionable sales practices. CRD, the only centralized source of information about brokers' employment and disciplinary histories, is used by regulators and SROs as a regulatory surveillance tool to perform this function. However, because CRD was originally designed to be a state licensing and SRO registration system, it does not contain certain data that would be useful for regulatory surveillance and has limited capability to efficiently search, retrieve, and summarize data on brokers' disciplinary histories. NASD is in the process of a multimillion dollar redesign of CRD to address its limitations. While the redesign appears to address major regulators' needs, additional enhancements would improve CRD's capability to serve as a regulatory surveillance tool.

Objectives, Scope, and Methodology

The objectives of our review were to (1) determine the extent to which unscrupulous brokers are active in the securities industry, (2) assess regulatory and industry efforts to discipline unscrupulous brokers, and (3) assess the capability of CRD as a regulatory surveillance tool.

To determine the extent to which unscrupulous brokers are active in the industry, we identified the types and sources of information reported to CRD. We requested that NASD develop a computer program to identify any active broker listed in CRD with a formal disciplinary action. A formal action by a federal/state regulator or SRO or an indictment or conviction by a court constituted a formal disciplinary action. We wrote a computer program to compile the number of formal disciplinary actions against individual brokers and identify which regulatory agencies took the actions. We did not attempt to verify the accuracy of the data in CRD.

To assess industry efforts to discipline unscrupulous brokers, we met with officials responsible for examination and enforcement at SEC, NYSE, and NASD. We also discussed these issues with officials of the North American Securities Administrators Association (NASAA) and senior executives at two major broker-dealers. To assess these efforts, we (1) reviewed all 39 SEC inspection reports on SRO examination and disciplinary activities conducted from 1983 through 1993, (2) compiled information on the number of formal disciplinary actions taken by NASD and NYSE from 1990 through 1993 in response to customer complaints, and (3) analyzed SEC, NASD, and NYSE guidelines for sales practice examinations. To solicit views on licensing, monitoring, and disciplinary procedures, we sent a questionnaire to 51 state securities regulators,[6] 44 of whom responded. In addition, we reviewed the results of the May 1994 SEC staff study on the hiring, retention, and supervisory practices at nine major U.S. broker-dealers.

To obtain additional insight into the nature of the violations leading to disciplinary actions, and by whom the actions were taken, we categorized by type of formal disciplinary action the 9,799 brokers who had some formal disciplinary history. Because CRD has limited capability to provide aggregate information and can only provide summary information on individual broker disciplinary histories, we took a judgmental sample of 100 brokers to obtain information on the violations leading to the disciplinary actions. We selected brokers from 3 types of formal disciplinary actions identified in the CRD—50 with bars, 32 with formal disciplinary actions other than bars, and 18 with court actions. The 50 bars, imposed by an SRO, a state securities regulator, or SEC, limited or prohibited a broker's participation in securities activities. The sampled number of these actions does not necessarily represent the proportions in which they occurred in the total population of 9,799 brokers. We selected a larger number of bars because we wanted to obtain a greater understanding of the violations for which a bar was imposed.

We reviewed the disciplinary histories of 29 brokers who were subject to a statutory disqualification[7] because of a bar imposed by SEC or an SRO and whose employment status required regulatory review from October 1991 through December 1993. We also attempted to gauge the extent to which

[6]Includes the securities regulator for the District of Columbia.

[7]The definition of statutory disqualification, contained in section 3(a)(39) of the Securities Exchange Act of 1934 generally includes individuals who have been barred by SEC or an SRO; convicted of any felony or certain misdemeanors, such as bribery and forgery, within the last 10 years; or have been enjoined temporarily or permanently from violating securities laws by a court.

unscrupulous brokers migrated to other sectors of the financial services industry by determining the current employment of 96 potentially unscrupulous brokers who SEC identified in its May 1994 staff study as having left the securities industry.

To assess the capability of CRD as a regulatory surveillance tool, we reviewed CRD data and how these data could be used to identify unscrupulous brokers. We also discussed with senior NASD and NASAA officials CRD's redesign and how planned changes are expected to improve the industry's capability to monitor unscrupulous brokers.

Our work was performed in New York, NY, and Washington, D.C., between September 1993 and May 1994 in accordance with generally accepted government auditing standards.

We provided a draft of this report to SEC, Treasury, NASD, and NYSE for review and comment. Their comments and our evaluation are presented at the end of this letter. SEC's written comments and our additional comments are presented in appendix III.

Extent to Which Unscrupulous Brokers Are Active in Industry Is Unknown

Although regulators and industry representatives acknowledge that there are unscrupulous brokers active in the securities industry, it is not known to what extent unscrupulous brokers are active in the industry. Several major reasons are as follows:

- Unscrupulous activity is often difficult to detect. Allegations of sales practice abuse are often difficult to substantiate because there is often little evidence other than the word of the broker against that of the investor. Further, sales practice abuse violations often surface long after they have occurred, even after the broker has moved to another firm. SEC staff recommended in its May 1994 staff study that SEC and SROs develop better means of identifying sales practice problems at an earlier stage.
- Informal actions are not required to be reported. SRO rules require that only formal disciplinary actions be reported to CRD, not informal actions. Therefore, informal actions such as letters of caution or compliance conferences taken to address sales practice complaints are not reported to CRD.
- CRD is not designed to identify and provide summary information on brokers by particular types of violations. CRD, the only centralized source of information about brokers' employment and disciplinary histories, was originally designed to facilitate state licensing and registration of

individual brokers, not to perform a regulatory surveillance function. Over time, extensive narrative information on disciplinary actions for violations of securities and nonsecurities-related laws has been added to the system. However, the system has not been changed to meet its new role as a surveillance tool. Consequently, it cannot generate, without extensive manual effort, data on the number of brokers who have been disciplined for sales practice violations, financial/operational violations,[8] or nonsecurities criminal acts such as robbery.

- The extent of nonreporting and erroneous reporting to CRD is unknown. Regulators and industry representatives we spoke with were concerned that employing firms are less than candid in disclosing to CRD the reasons for terminating brokers' employment. Also, in a recent staff study, SEC found that one major firm did not file reportable information on employment terminations to CRD in a timely manner. SEC regards these disclosures as valuable red flags to address possible sales practice abuse in a timely manner.

Although we could not determine the extent to which unscrupulous brokers are active in the industry, we were able to determine the number of active brokers in CRD with known formal disciplinary histories. Our analysis of CRD records disclosed that 9,799 (about 2 percent) of over 467,000 active brokers as of November 30, 1993, had at least one formal disciplinary action taken against them by SEC, an SRO, a state securities regulator, or a court.[9] Of these 9,799 brokers, 7,297 had 1 action taken against them, 1,686 had 2, and 816 had 3 or more. In our judgmental sample of 100 of these 9,799 disciplined brokers, disciplinary actions were imposed for a variety of violations of securities laws and regulations such as sales practice abuses and financial/operational infractions. The sample also included brokers who had actions imposed for nonsecurities-related infractions such as robbery or driving while intoxicated. A detailed breakdown of the 50 brokers identified in CRD with bars from some or all functions of the securities industry we sampled is contained in appendix I.

[8]Financial/operational violations generally involve activities related to the management of a firm, such as filing incomplete and inaccurate financial reports with regulators, or improperly offering securities for sale before properly registering them.

[9]These actions can include any charges and/or convictions for a felony or misdemeanor involving investments, bribery, fraud, forgery, false statements, counterfeiting, extortion, or other criminal acts.

Existing Disciplinary Policies and Practices May Not Adequately Ensure Investor Protection

The potential harm that even a few unscrupulous brokers can have on investors can be financially devastating to them and could erode investor confidence in the industry. Because of this potential harm, the industry's efforts to detect and discipline unscrupulous brokers should be as effective as possible. However, available evidence points to shortcomings in the detection and discipline of unscrupulous brokers. SEC's May 1994 staff study of the hiring, retention, and supervisory practices of nine large firms supports the need for improvements. Also, the most serious disciplinary measure, permanent bars from the industry, may not necessarily result in permanently removing unscrupulous brokers from the securities industry. Existing policies and practices may erode the effectiveness of disciplinary actions and do not prevent unscrupulous brokers from migrating to other sectors of the financial services industry.

SEC Staff Study Recommended Efforts to Better Detect and Discipline Unscrupulous Brokers

In July 1992, in cooperation with NASD and NYSE, SEC's Division of Market Regulation initiated an examination of the employment and supervisory practices at nine of the largest broker-dealers in the United States. SEC selected branch offices of these nine firms that it believed were most likely to have problems on the basis of customer complaint information. The impetus for this examination was concern by SEC and SROs about the frequency and severity of sales practice abuses. At the 9 firms, SEC analyzed the employment and disciplinary histories of 268 broker-dealers, each of whom had received from 3 to 89 customer complaints.

SEC's staff study on industry practices, issued in May 1994, reported problems with the hiring and supervision of brokers at 25 percent of the 161 branch offices reviewed and made 40 referrals of possible securities law or regulation violations to SEC enforcement staff. The report acknowledged that it was not possible to draw general conclusions regarding the securities industry as a whole because the project involved only a small sample of the total number of securities firms and, of the firms selected, only a small portion of the branch offices and brokers at those firms were examined. However, the report concluded that the disproportionate number of referrals for further investigation and enforcement consideration as compared with that expected from routine examinations suggested that (1) firms' supervisory and compliance systems needed improvement and (2) sanctions for sales practice violations at SROs and SEC needed to be strengthened.

Key principles of the SEC staff study recommendations to SEC were that problem brokers needed to be (1) identified at an early stage,

(2) scrutinized closely when hired and when making retention decisions, and (3) subjected to aggressive enforcement action when warranted. The Chairman has publicly concurred with the thrust of the recommendations and is considering how best to implement them.

Bars Do Not Ensure Removal of Unscrupulous Brokers From the Securities Industry

Serious violations of securities laws and regulations are addressed through formal disciplinary actions, with the most serious violations warranting a bar. In practice, a bar may restrict a broker's activities by function, length of time, or both. However, even a permanent bar allows brokers to seek reentry to the industry. These and other practices, such as NYSE's use of retroactive imposition of bars, which credits the violator with time spent outside the industry, may give investors the perception that violators are tolerated, thereby eroding public confidence in the disciplinary process employed by the securities industry.

SEC and SROs may impose three types of bars: (1) prohibiting work in a specified function, such as prohibiting an individual from working as a supervisor, while allowing the individual to remain in the securities industry; (2) allowing reentry to the securities industry after a specified period of time; and (3) prohibiting work in the industry in any position for an unspecified time period. States may impose similar types of bars that are only applicable to activities within the state imposing it. Brokers subject to a bar by SEC or an SRO, but not a state, are considered statutorily disqualified. In practice, such bars may not ensure permanent removal of a broker. This is because the statute allows a statutorily disqualified broker to return to the securities industry, subject to heightened regulatory scrutiny, if approved by SEC and an SRO. Once permitted to return, the broker must obtain SEC and SRO approval for every employment change within the securities industry. From October 1991 through December 1993, SEC approved the application for one permanently barred broker to reenter the securities industry. During the same time frame, SEC approved employment changes for five permanently barred brokers. SEC had permitted these brokers to reenter at an earlier time. In its May 1994 study, SEC staff recommended a number of measures to strengthen disciplinary actions, including allowing for permanent bars without the possibility of reentry.

Some state regulators responding to our survey viewed SEC and SRO disciplinary actions as being too lenient. Of 44 state regulators responding to our survey, 14 believed that SEC disciplinary actions were too lenient, 24 viewed NASD actions as too lenient, and 11 viewed NYSE actions as too

lenient. Further information on these responses is contained in appendix II.

We observed some disciplinary practices that could contribute to the perception that some disciplinary actions are lenient. For example:

- A securities firm president was fined $10,000 in 1984 by NASD for numerous supervisory and record-keeping violations. Subsequently, his firm was expelled from NASD in 1992, and he was fined $60,000, suspended for 6 months, and permanently barred as a supervisor, principal, and manager of a firm. After the expiration of the 6-month suspension, this individual was permitted by NASD to work in another firm as a broker supervised by a former employee.
- A broker barred by SEC for fraudulent sales of securities was permitted to remain in the industry provided his activities were limited to the sale of mutual funds and annuities.
- Several brokers received bars for a specific amount of time, imposed partly on a retroactive basis. Enforcement officials at NYSE told us that retroactive bars are used to more readily obtain voluntary acceptance of the action; however, these officials did not favor the practice.

Potential Exists for Migration to Other Sectors of the Financial Services Industry

Our review of current laws and regulations indicated that regulatory gaps can exist in safeguarding investors from unscrupulous brokers. SEC's May 1994 study indicated that some potentially unscrupulous brokers had left the securities industry. However, we found, in following up on some of these brokers and the brokers in our sample, that some had migrated to other sectors of the financial services industry, such as banking and insurance.

Currently, SEC and the Commodities Futures Trading Commission (CFTC) are authorized by law to honor each other's bars and can choose to prevent barred individuals from migrating between the two regulators. However, no similar law or agreements are in force between SEC and other financial services regulators to limit the migration of unscrupulous brokers. Therefore, an unscrupulous broker with a disciplinary history of sales practice abuse can migrate to work in an industry that is not federally regulated, such as insurance, and sell certain financial products in that industry. Similarly, such a broker can work as a bank employee in a Federal Deposit Insurance Corporation-insured bank selling bank-sponsored mutual funds if he or she has a disciplinary history but has not been convicted of a crime.

We analyzed the records of 96 potentially unscrupulous brokers identified in SEC's May 1994 staff study who had left the securities industry and found that 3 of these brokers had migrated to the insurance industry. We were unable to determine the current employment of the remaining 93 brokers because data were not readily retrievable. We also found indications of migration from our sample of 100 brokers with formal disciplinary histories. For example, one broker, who was barred by an SRO for 9 months in 1989 for misrepresentations made during an insider trading investigation, migrated to a related financial services company and worked as a mortgage consultant. Another broker, who was suspended by an SRO for 18 months in all functions for unauthorized trading, worked at 4 savings and loan associations as a loan officer and a salesperson for certificates of deposits.

SEC, NASD, NYSE, and state officials expressed concern about the potential for brokers barred from the securities industry to migrate to other financial services industries. Some of these industries, such as banking and securities, are subject to federal regulation, while others, such as insurance, are not. We discussed this migration issue with Treasury and NASD officials. As a result of our discussions, Treasury officials told us that they have made initial contact with SEC, CFTC, and banking regulators to explore the issue of migration to the banking industry. Addressing the issue of migration to the insurance industry would be difficult for a federal agency because insurance is regulated only by individual state regulators.

Treasury officials said that they would pursue whether CRD information could be made available to all potential employers within the financial services industry, including those industries regulated by states. NASD officials said that they had held preliminary discussions with officials of four bank regulators to explore the possibility of maintaining employment data, including disciplinary histories, for bank employees engaged in securities-related sales activity. In our view, prospective employers of disciplined brokers in financial services-related industries would benefit by being informed of any disciplinary actions taken against the brokers. Banking and insurance regulators can access CRD information through a toll-free telephone number, as can securities investors.[10] However, the toll-free telephone number cannot provide certain CRD data, such as certain customer complaint information and reasons for employment

[10]As required by the Penny Stock Reform Act of 1990, P.L. 10-429, 104 Stat. 931 (1990), NASD in 1991 established a toll-free telephone number through which investors and other interested parties can obtain information on formal disciplinary actions taken against brokers. In July 1993, the information provided was expanded to include criminal and civil indictments, civil litigations, pending disciplinary actions, and available arbitration decisions.

termination, which are available only to SEC, SROs, state regulators, and the securities industry.

Improvements Needed in Broker Surveillance

To safeguard investors and maintain public confidence in the securities markets, SEC, state regulators, and SROs need effective broker surveillance monitoring systems to help them identify brokers with histories of sales practice abuse and questionable sales practices. SEC, state regulators, and the securities industry currently rely on CRD, the only centralized source of information on brokers' employment and disciplinary histories, as a regulatory surveillance tool. However, CRD is limited in its capability to support regulatory surveillance of unscrupulous brokers because of design limitations. Further, SROs generally do not require member firms to report information on disposition of customer complaints. Such information, if reported to SROs through CRD, would help regulators and SROs monitor questionable sales practice activities at member firms and industrywide.

Limitations that restrict regulatory and SRO broker surveillance capabilities include the following:

- CRD has limited industrywide surveillance capability. Although SEC, state regulators, and the securities industry use CRD to monitor brokers with disciplinary histories, it was not originally designed in 1981 to be a compliance-related regulatory tool. Currently, CRD users cannot easily use the system to perform certain functions desirable for industrywide regulatory surveillance, such as identifying brokers with particular attributes (i.e., the type or number of disciplinary actions). NASD is redesigning CRD to in part provide firms and regulators with the ability to identify and monitor brokers with specified disciplinary histories. Although we did not assess the redesign efforts, discussions with users and responses to our questionnaire indicated that the redesign may address CRD users' major needs for improved capability to provide numerical data on the type of violations against brokers as opposed to the current nonsummary narrative type information on individual brokers. NASD officials told us that improvements will be phased in starting in mid-1995.
- CFTC, SEC, American Stock Exchange (AMEX), and regional stock exchanges are not directly reporting to CRD. Currently, disciplinary actions taken by the CFTC, SEC, AMEX, and regional stock exchanges are not reported directly to CRD. Instead, CRD personnel must obtain information on disciplinary actions imposed by these entities from publicly disclosed sources and enter the information into CRD. Direct reporting to CRD by these regulators

and exchanges would be more efficient and provide control over reliability of the data. We noted that one broker who, despite a bar in 1988 by CFTC for fraud, continued to work as a trader at NYSE. He was able to do so because he apparently did not report his disciplinary history to either CRD or NYSE. When the bar was discovered, he sought approval for and was accepted to reenter the securities industry in 1993.

- SROs generally do not collect and report information on customer complaints from individual firms to CRD. Since 1988, NYSE has required member firms to report to NYSE quarterly all customer complaints received, including the name of the broker, the branch where the broker works, and the type of complaint.[11] However, NYSE does not report this information to CRD. Although most complaints do not result in disciplinary action, complaint information is useful to SROs for determining how best to allocate examination resources, according to SEC, NASD, and NYSE officials. NASD officials told us that imposing a requirement on its members similar to that of NYSE will be on the agenda of its September 1994 board of governors meeting. Customer complaint data have proven useful for regulatory surveillance, as indicated by SEC's use of the NYSE customer complaint data for its recent staff study. Reporting of customer complaints to CRD by SROs would increase the usefulness of this information for regulatory surveillance. We found also that some state securities regulators will disclose all information in the CRD to inquiring investors. We recognize that public disclosure of complaints may be controversial because they may not always be indicative of wrongdoing by the broker. Therefore, it may be necessary to maintain separate data bases, one for regulatory surveillance and one for public disclosure.
- SROs do not report information on customer complaint disposition to CRD. SROs generally did not gather information on the disposition of customer complaints from member firms and, therefore, could not provide these data to CRD. By collecting customer complaint disposition data, SROs potentially could better assess and monitor possible sales practice abuse at member firms and identify sales abuse trends at a firm. For instance, if a firm has a pattern of settling customer complaints involving sales abuse in favor of the customer, this may indicate that the firm needs to better monitor and discipline its brokers. Requiring firms to report customer complaint disposition data to CRD would also provide additional information that could assist SEC, SROs, and state regulators, in better monitoring brokers industrywide for possible sales practice abuse. Once again, public disclosure of data about complaint disposition may be controversial because complaints may be settled in favor of the investor

[11]NYSE member firms are required by NYSE Rule 351 to collect and report to NYSE data on customer complaints. Since 1989, an average of over 11,000 sales practice complaints have been reported annually to the NYSE by member firms.

for reasons other than wrongdoing on the part of the broker or firm. Therefore, in this case, it may also be necessary to maintain separate databases, one for regulatory surveillance and one for public disclosure.

Conclusions

The financial health and soundness of our nation's securities markets depend partly on public confidence that these markets operate fairly and honestly. A key factor in public confidence is the level of trust between investors and their brokers. SEC, state regulators, and the industry all have a role in protecting investors from unscrupulous brokers. Although regulators and the industry acknowledge the existence of unscrupulous brokers, the extent to which unscrupulous brokers are active in the industry could not be determined. However, we were able to determine that almost 10,000 brokers active in the industry have formal disciplinary histories. Given that even a few unscrupulous brokers can do serious harm to investors, surveillance and disciplinary policies and practices need to be as effective as possible. We found evidence that improvements could be made in the detection and discipline of unscrupulous brokers. For example, a recent SEC staff study concluded that improvements should be made to industry hiring and surveillance processes and SEC industry disciplinary practices. We also found brokers who had been permanently barred from the industry but later were allowed to reenter the industry and other disciplined brokers had migrated to other sectors of the financial services industry. Finally, broker surveillance systems could be improved by enhancing the reporting of disciplinary actions and information on customer complaints to CRD.

Recommendations to the Chairman of SEC

To help maintain investor confidence in the securities markets, we recommend that the Chairman of SEC

- implement the recommendations of the SEC staff study to strengthen existing disciplinary standards, including the imposition of a permanent bar with no opportunity for reentry, when warranted.
- monitor CRD's redesign to ensure that it provides the capability to allow regulators to more easily identify and monitor brokers with disciplinary histories.
- direct SROs to enhance and increase the reporting of information to CRD. Specifically, we recommend that SEC direct that (1) SRO formal and informal disciplinary actions be reported directly to CRD and (2) information on customer complaints and their dispositions be collected, monitored, and reported to CRD. We also recommend that SEC

work with NASD to develop procedures to balance regulatory surveillance and public disclosure interests pertaining to disclosure of customer complaint and complaint disposition information to regulators and investors.

- work with NASD, NASAA, and the Department of the Treasury to increase disclosure of CRD data pertinent to the detection of unscrupulous brokers that migrate from the securities industry to other segments of the financial services industry.

Recommendation to the Secretary of the Treasury

Recognizing the potential for unscrupulous brokers to migrate freely from securities to other sectors of the financial services industry and related industries, we recommend that the Secretary of the Treasury work with SEC and other financial regulators to

- increase disclosure of CRD information available to regulators and employers among the financial services industry and related industries so that regulators may be aware of and give consideration to a broker's disciplinary history in allocating examination resources and so that employers can use the information in making a hiring decision, and
- determine whether legislation or additional reciprocal agreements between SEC and other financial regulators are necessary to prevent the migration of unscrupulous brokers to other financial services industries.

Agency Comments and Our Evaluation

We provided a draft of this report to SEC, Treasury, NASD, and NYSE for review and comment. We obtained written comments from SEC (see app. III). We obtained oral comments from Treasury in a meeting with the Director, Office of Financial Institutions Policy on August 26, 1994. We obtained oral comments from NYSE in a meeting on August 30, 1994, with NYSE's Senior Vice President, Government Relations and the Senior Vice President, Compliance. We obtained oral comments from NASD in meetings on August 30 and 31, 1994, with NASD's Executive Vice President for Regulation and the Director of Regulatory Policy. Treasury, NYSE, and NASD generally agreed with the information provided and, with the exception noted below, our conclusions and recommendations. They offered some technical clarifications that we incorporated in the report where appropriate.

SEC strongly agreed with our basic finding that efforts to ensure oversight of brokers and discipline of those who violate laws and regulations need to be as effective as possible. However, SEC advised that care should be

exercised in drawing conclusions that shortcomings exist in the detection and discipline of unscrupulous brokers based on CRD's universe of disciplined brokers or our sample, which was drawn from CRD. SEC commented that a sample drawn from CRD would include not only sales practice violations but violations that do not affect an individual's ability to act in a fiduciary capacity as broker, such as driving while intoxicated.

SEC's comments infer concern that readers might use the numbers taken from CRD to reach erroneous conclusions about the extent to which unscrupulous activity exists in the securities industry. We agree that the available data cannot be used to project the extent of unscrupulous activity across the universe of brokers and we state this explicitly in the report. Indeed, it is our concern with the limitations of currently available data that formed the basis of our recommendations for improving CRD. However, it is also important to note that we did not base our overall conclusions solely on our sample. We also considered the results of our analysis of applicable laws, regulations, and policies; our survey of state regulators; our analysis of CRD and CRD data; and the findings of SEC's Staff Study.

Concerning our recommendation that SEC implement the recommendations in its staff study, SEC noted that it, in conjunction with the SROs, has begun implementing a number of the recommendations from the 1994 staff study. SEC also said that it has recommended SROs review their rules and by-laws with a view toward enhancing disciplinary actions, and plans to make public its policy on reentry to the industry of previously barred brokers. We believe that these will be positive steps toward addressing a perception that disciplinary actions may be lenient.

Regarding our recommendation that SEC monitor the redesign of CRD, SEC expressed the belief that CRD's redesign will greatly assist regulators to identify and monitor brokers with disciplinary histories, and said it will continue to work closely with NASD and NASAA on enhancements to CRD.

While SEC agreed that it was important to enter all relevant disciplinary information into CRD, it disagreed with our recommendation that informal actions, customer complaints, and customer complaint disposition be reported to CRD. SEC contended that such reporting would clutter and create disorder in the system. SEC questioned the value of collecting information on informal disciplinary actions based on its understanding that few sales practice abuse violations result in informal actions. While both SEC and NASD commented that it may be valuable to collect and

monitor information regarding customer complaints and their disposition, both were concerned that the reporting to investors of unsubstantiated complaints would raise due process and privacy concerns. NASD commented that customer complaint and disposition data should be used for regulatory surveillance and not be publicly disclosed. NASD noted, however, that some states consider all CRD information available for public disclosure.

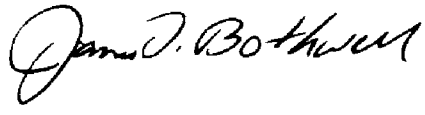
We believe information on informal disciplinary actions and customer complaints is useful for regulatory surveillance and can help regulators and SROs identify brokers with a pattern of sales practice abuse activity. In the text of the report, we recognized possible due process and privacy conerns related to the reporting of customer complaints and disposition. Although SEC said that they understood few sales practice abuse violations result in informal actions, empirical data are unavailable to document this. We believe that if CRD is effectively redesigned, useful information on disciplinary actions and customer complaints and their disposition should be generated and processed without disorder to the system. In sum, we believe that SEC's concerns could be effectively addressed by SEC, SROs, and state regulators working together to (1) define parameters for collecting such data and (2) ensure that disclosure of such data to investors would incorporate adequate safeguards and due process protections.

Regarding the issue of direct reporting of SEC disciplinary actions to CRD, SEC said that it is not prepared to change its longstanding arrangement, whereby Commission disciplinary actions, as announced in SEC's Daily News Digest, are reported to CRD by NASD staff. While this arrangement may have worked well in the past, the redesign of CRD may provide SEC with the opportunity to directly report disciplinary actions to CRD. This would better ensure that all disciplinary actions are reported.

Concerning our recommendations on providing information on unscrupulous brokers to other sectors of the financial services industry, both SEC and Treasury agreed that prospective employers of disciplined brokers in related financial industries would benefit by being informed of any regulatory or disciplinary actions taken against brokers. SEC said that its staff will work with other regulators to make CRD information available throughout the financial services industry. Treasury officials said that they would pursue whether CRD information could be made available to all potential employers within the financial services industry, including the state regulated insurance industry.

We are sending copies of this report to SEC, the Department of the Treasury, and other interested parties. We will also make copies available to others on request.

This report was prepared under the direction of Bernard D. Rashes, Assistant Director, Financial Institutions and Markets Issues. Other major contributors to this report are listed in appendix IV. Please contact either Mr. Rashes on (212) 264-0737 or me on (202) 512-8678 if you have any questions about this report.



James L. Bothwell
Director, Financial Institutions
and Markets Issues

Contents

Abbreviations

AMEX	American Stock Exchange
CFTC	Commodities Futures Trading Commission
CRD	Central Registration Depository
NASAA	North American Securities Administrators Association
NASD	National Association of Securities Dealers
NYSE	New York Stock Exchange
SEC	Securities and Exchange Commission
SRO	self-regulatory organization

Formal Disciplinary Histories for 50 Brokers With a Bar Active in the Securities Industry as of November 30, 1993

Broker number	Year bar imposed	Regulator imposing bar	Activity leading to bar	Function from which barred	Length of bar	Formal disciplinary actions after last bar?
1	1969	SEC	Financial/ operational	All	60 days	
	1969	SEC	Sales practice	All	60 days	
	1976	NASD	Sales practice, financial/ operational	Principal/ supervisor	Permanent	No
2	1970	NASD	[a]	All	30 days	
	1976	NASD	Financial/ operational	a. All	a. 1 year	
		[b]		b. Principal/ supervisor	b. Permanent	
	1993	NASD	Financial/ operational	All	15 days	No
3	1981	Minnesota	Sales practice	All	3.5 years	
	1981	Wisconsin	Financial/ operational	All	120 days	
	1982	NASD	Sales practice	All	Permanent	Yes
4	1992	Vermont	Sales practice	All	Permanent[c]	
	1993	California	Sales practice	All	4 years	
	1993	Minnesota	Sales practice	All	5 years	No
5	1983	Oklahoma	Sales practice, financial/ operational, failure to supervise	Principal	6 months	
	1984	Alabama	Financial/ operational	All	Permanent	
	1992	NASD	Sales practice, failure to supervise, financial/ operational	a. All	a. 6 months	
				b. Supervisor/ principal	b. Permanent	No
6	1974	NASD	Sales practice	All	Permanent	
	1975	SEC	Sales practice	All	Permanent	No
7	1958	NYSE	[a]	All	Permanent	
	1958	SEC	Financial/ operational	All	Permanent	No
8	1992	NYSE	Failure to supervise	Supervisor	1 year	

(continued)

Broker number	Year bar imposed	Regulator imposing bar	Activity leading to bar	Function from which barred	Length of bar	Formal disciplinary actions after last bar?
	1993	SEC	Failure to supervise	Supervisor	3 years	No
9	1988	Massachusetts	Financial/ operational	All	1 year	
	1991	Chicago Board Options Exchange	Sales practice	All	1 month	No
10	1971	NASD	Financial/ operational	a. All	a. 6 months	
				b. Principal	b. Permanent	
	1972	SEC	Financial/ operational	All	Permanent[c]	No
11	1983	SEC	Sales practice, financial/ operational	a. All	a. 9 months	
				b. Principal/ supervisor	b. Permanent	
	1983	Iowa	Sales practice, financial/ operational	a. All	a. 9 months	
				b. Principal/ supervisor	b. Permanent	No
12	1989	NASD	Sales practice, financial/ operational	All	3 months	
	1990	Pennsylvania	Sales practice, failure to supervise	a. All	a. 60 days	
				b. Principal/ supervisor	b. 180 days	No
13	1982	SEC	Failure to supervise	Supervisor	30 days	
	1992	AMEX	Failure to supervise	Supervisor	3 years	No
14	1981	Minnesota	Failure to supervise, sales practice	Supervisor	3 years and 30 days	
	1983	NASD	Financial/ operational	Principal	Permanent	No
15	1978	NASD	Sales practice	Principal	3 years	
	1978	SEC	Sales practice	a. All	a. 30 days	
				b. Supervisor	b. Permanent[c]	No
16	1975	NASD	[a]	All	10 days	

(continued)

Broker number	Year bar imposed	Regulator imposing bar	Activity leading to bar	Function from which barred	Length of bar	Formal disciplinary actions after last bar?
	1976	NASD	[a]	Principal	Permanent	No
17	1988	NASD	Sales practice	All	1 year	
	1992	Arizona	Sales practice	All	Permanent	No
18	1982	NYSE	Financial/ operational	All	18 months[b]	Yes
19	1980	NYSE	Sales practice	All	18 months[b]	No
20	1988	NYSE	Sales practice	All	2 years	No
21	1991	NYSE	Sales practice	All	3 months	No
22	1977	SEC	Sales practice	a. All	30 days	
				b. Supervisor	2 years	No
23	1983	Pennsylvania	Financial/ operational	All	4 years	Yes
24	1975	SEC	Sales practice, failure to supervise	All	Permanent[c]	No
25	1993	NYSE	Sales practice	All	10 years[b]	No
26	1979	NASD	Financial operational	a. All	a. 3 months	
				b. Financial principal	b. Permanent	No
27	1989	NYSE	Sales practice	All	3 months[b]	No
28	1993	NASD	Financial/ operational	All	Permanent	No
29	1989	AMEX	Sales practice	All	9 months	No
30	1989	Pennsylvania	Financial/ operational	All	3 years	No
31	1990	Pennsylvania	Sales practice, financial/ operational	All	2 years	No
32	1991	NASD	Sales practice	All	Permanent	No
33	1978	SEC	Sales practice, financial/ operational	All	Permanent[c]	No
34	1987	AMEX	Failure to supervise	Supervisor	3 years	No
35	1991	NASD	Financial/ operational	Principal	Permanent	No
36	1980	SEC	[a]	a. All	a. 1 year	
				b. Principal/ supervisor	b. Permanent[c]	No
37	1993	AMEX	Failure to supervise	Supervisor	2 years[b]	No

(continued)

Broker number	Year bar imposed	Regulator imposing bar	Activity leading to bar	Function from which barred	Length of bar	Formal disciplinary actions after last bar?
38	1976	NASD	[a]	All	Permanent	No
39	1971	NASD	Sales practice, failure to supervise	Principal	Permanent	No
40	1974	Pennsylvania	[a]	All	Permanent[c]	No
41	1970	SEC	Sales practice, failure to supervise	a. All	a. 30 days	
				b. Principal/ supervisor	b. Permanent[c]	No
42	1977	SEC	Financial/ operational	a. All	a. 60 days	
				b. Supervisor/ principal	b. Permanent	No
43	1979	NASD	[a]	Principal/ supervisor	Permanent	Yes
44	1978	SEC	Failure to supervise	Supervisor	Permanent	No
45	1978	NASD	Sales practice	a. All	a. 60 days	
				b. Principal/ supervisor	b.Permanent	No
46	1986	NASD	Sales practice, financial/ operational	a. All	a. 30 days	
				b. Principal	b. Permanent[c]	No
47	1978	NYSE	[a]	Supervisor	2 years[b]	No
48	1976	SEC	Sales practice	a. All	a. 60 days	
				b. Supervisor/owner	b. 18 months	No
49	1988	AMEX	Sales practice	Option trading	6 months	No
50	1983	SEC	Sales practice, failure to supervise	a. All	a. 60 days	
				b. Principal/ supervisor	b. Permanent[c]	No

Note: These brokers were active in the industry because (1) their bars expired, (2) they continued to work in a state or function other than that from which they were barred, (3) approval for reentry was obtained, or (4) their bar was being appealed.

[a]CRD did not contain data on the nature of the activity.

[b]Actual length of bar reduced because of retroactive imposition.

[c]While noted as permanent, these bars provided for the right to apply for reentry to the industry within a specific time frame, either in all or specified capacities.

Source: GAO analysis of CRD data.

Questionnaire Sent to State Securities Regulators

United States General Accounting Office

Survey of State Securities Regulators on Oversight of Registered Representatives

INSTRUCTIONS

At the request of Congressmen Edward J. Markey, Chairman, House Committee on Energy and Commerce, Subcommittee on Telecommunications and Finance, and John D. Dingell, Chairman, Subcommittee on Oversight and Investigations, GAO is currently evaluating the effectiveness of the disciplinary process used by the securities industry to identify, sanction and, when appropriate, bar registered representatives.

The purpose of this questionnaire is to (1) assist us in determining the processes utilized by state securities regulators to register, monitor, discipline and bar individuals from practicing within the industry as registered representatives, and (2) obtain comments as to whether any changes are needed at the federal level to facilitate these processes.

This survey should be completed by this state's chief securities administrator, or by someone else designated by that person. Most of the questions can easily be answered by checking boxes or filling in blanks. Space is provided for any additional comments at the end of the questionnaire.

Please return the completed questionnaire in the enclosed preaddressed envelope within 10 days of receipt. In the event the envelope is misplaced, please mail the completed questionnaire to:

U.S. General Accounting Office
Attn: Mr. Jack Harrison
7 World Trade Center
Floor 25
New York, NY 10048

If you anticipate any difficulty in returning the questionnaire promptly or if you have any questions, please call Mr. Jack Harrison at (212) 264-8102.

BACKGROUND

Please provide the following information so that we can contact you if we need to clarify an answer.

Name: _____

Title: _____

Agency: _____

Phone: ( ) _____

I. Approval of Registered Representatives

1) How many individuals are currently authorized by your agency as securities industry registered representatives to offer securities for purchase or sale within your state? *(Check only one box.)*

1. ☐ None
2. ☐ 1 - 25,000
3. ☐ 25,001 - 50,000
4. ☐ 50,001 - 100,000
5. ☐ Over 100,000

2) Must an individual be registered by either the National Association of Securities Dealers (NASD), the New York Stock Exchange (NYSE), the American Stock Exchange (AMEX), or a regional exchange to apply for registration within your state? *(Check only one box.)*

1. ☐ Yes 8
2. ☐ No 36
3. ☐ Do not know

1

3) Which of the following procedures best describes the process your agency uses to approve an individual's application for license within your state when the individual is already registered with an SRO, but IS NOT presently approved by any other state?

(Check only the ONE box most closely describing your process.)

Is approval:

1. ☐ Automatically given, provided all application requirements have been satisfied?

2. ☐ Given after a review of the application and the Central Registration Depository (CRD)? 1

3. ☐ Given after application and CRD review, and an investigation of disciplinary items disclosed on the CRD, if any exist? 38

4. ☐ Other procedure? *(Please specify)* 5

_____

_____

_____

_____

4) Does your agency follow different procedures from those you described in question 3 above if the individual representative IS currently licensed in another state? *(Check one box, and explain if necessary.)*

1. ☐ No 44

2. ☐ Yes ——> How do the procedures differ?

_____

_____

_____

_____

5) Does your agency follow different procedures from those described in question 3 above if the individual representative is switching employers within your state? *(Check one box, and explain if necessary.)*

1. ☐ No 36

2. ☐ Yes ——> How do the procedures differ? 6

_____

_____

_____

_____

_____

2

6) To what extent do each of the following factors influence the decision to approve or disapprove applications for initial licensing to operate as a registered representative in this state?
(Check one box for each of the following rows.)

	Very great extent	Great extent	Moderate extent	Some extent	Little or no extent	Do not know
a. Presence of a civil conviction 42	4	16	15	2	3	2
b. Criminal conviction 42	37	3			2	
c. SEC/CFTC sanction 42	16	19	5		2	
d. SRO disciplinary action, other than suspension 42	9	13	15	4	1	
e. SRO suspension 42	23	14	3	1	1	
f. Denial of registration by another state 42	36	5	5		1	
g. Revocation of registration by other state 42	32	6	3		1	
h. Disciplinary action by firm 42	2	8	20	9	3	
i. Arbitration proceeding 41	2	2	17	14	6	
j. Arbitration award 41	4	9	16	8	4	
k. Customer complaint 42	2	5	18	15	2	
l. Frequency of switching employer 41	1	3	6	14	17	
m. Type/size of employer 41		1	7	12	21	
n. Other *(Please specify)* 15	5	8	1	1		
o. Other *(Please specify)* 6	3	1	2			

3

7) Do you utilize any quantitative thresholds for any of the criteria listed in Question 6 as a basis for automatic disapproval of an application? (For example, thresholds of two disciplinary actions or four customer complaints within a certain time period.) *(Check one box.)*

1. ☐ No *(Skip to question 9.)* 37

2. ☐ Yes *(Continue with the next question.)* 7

8) For each of the following factors which you might consider in granting a license to an applicant, are there any quantitative thresholds that your agency sets for automatic disapproval of an application, or any thresholds that would at least trigger further review before approval? If so, please define those thresholds and describe how they are measured. *(Describe numeric thresholds in each applicable block, or leave blank if there is no quantitative threshold.)*

	Quantitative threshold for disapproval	Quantitative Threshold for review
a. Presence of a Civil conviction		
b. Criminal conviction		
c. SEC/CFTC sanction		
d. SRO disciplinary action, other than suspension		
e. SRO suspension		
f. Denial of registration by another state		
g. Revocation of registration by another state		
h. Firm disciplinary action		
i. Arbitration proceeding		
j. Arbitration award		
k. Customer complaint		
l. Frequency of switching employer		
m. Type/size of employer		
n. Other *(Please specify)*		

4

9) How many applications received in the last four years for (1) initial license to offer securities for purchase or sale within your state, and (2) transfer among employers has your agency approved, denied and had withdrawn by the applicant?
(Enter actual numbers of applications disposed of in the following ways, or provide your best estimate and identify as such.)

	Disposition of applications					
	Initial Authorization Application			Transfer Application		
	Approved	Denied	Withdrawn	Approved	Denied	Withdrawn
1990						
1991						
1992						
1993						

10) In each of the last four years, how many registrations has your agency revoked on the basis of disciplinary history? And how many of those representatives, to your knowledge, continue to be registered by an SRO today?
(Enter actual numbers of revocations meeting these two conditions, or provide your best estimate and identify as such.)

Year	Number Revoked by your Agency	Number still SRO registered
1990		
1991		
1992		
1993		

11) In each of the last four years, how many representatives in this state have surrendered or withdrawn their licenses in response to state regulatory scrutiny?
(Enter actual numbers of licenses surrendered or withdrawn, or provide your best estimate and identify as such.)

Year	Surrendered or Withdrawn
1990	
1991	
1992	
1993	

5

II. Routine Monitoring

12) Which of the following best describes how often, if at all, your agency reviews individual registered representatives' records to assess whether their registration to operate within your state should be reconsidered?
(Check only the one box most closely describing how the majority of reviews are handled.)

1. ☐ All representative records are assessed on a fixed schedule *(Continue with next question.)*
2. ☐ No fixed schedule, but in response to certain events *(Skip to Question 14.)* **38**
3. ☐ No fixed schedule, but based upon representative's profile *(Skip to Question 14.)* **2**
4. ☐ No periodic reviews *(Skip to Question 16.)* **1**
5. ☐ Other procedure/combination *(Please describe below, and continue with next question.)* **3**

_____

_____

_____

13) IF A FIXED SCHEDULE IS FOLLOWED:
How frequently does your agency conduct most of these reviews of representative records?
(Check the one box that best represents your agency's practice.)

1. ☐ Every 1 to 6 months
2. ☐ Every 7 to 12 months
3. ☐ Every 13 months to 2 years
4. ☐ Less often than once every 2 years

_____

5. ☐ Do not know

14) IF REVIEWS BASED ON EVENTS/PROFILES:
If your agency reviews representatives' records in response to an event, which of the following types of events will usually trigger such a review?
(Check all that apply.)

1. ☐ Civil conviction **26**
2. ☐ Criminal conviction **38**
3. ☐ SEC/CFTC sanction **37**
4. ☐ SRO disciplinary action (not suspension) **29**
5. ☐ SRO suspension **36**
6. ☐ Denial of registration by another state **35**
7. ☐ Revocation of registration by another state **38**
8. ☐ Disciplinary action by firm **19**
9. ☐ Arbitration proceeding **14**
10. ☐ Arbitration award **20**
11. ☐ Customer complaint **32**
12. ☐ Frequency of change of employer **8**
13. ☐ Amended U-4 submission **24**
14. ☐ Others *(Please specify)* **25**

_____

_____

_____

6

15) IF REVIEWS BASED ON EVENTS/PROFILES: Through which of the following ways does your agency usually become aware of any of the events you identified in the previous question? *(Check all that apply.)*

1. ☐ Form U-4 filing 18
2. ☐ Form U-5 filing 16
3. ☐ Form U-6 filing 16
4. ☐ SEC publication 15
5. ☐ SRO notification 21
6. ☐ State contact 19
7. ☐ Customer complaint 21
8. ☐ Review of the CRD 23
9. ☐ All of the above 24
10. ☐ Other *(Please specify)* 4

_____
_____
_____
_____

16) Are you aware of any firms operating in your state which require their compliance departments to approve the hiring of registered representatives? *(Check only one box.)*

1. ☐ Yes 22
2. ☐ No *(Skip to question 18)* 22

17) In approximately what proportion of the firms operating in your state do you believe compliance departments are required to approve the hiring of registered representatives? *(Check one box.)*

1. ☐ All or almost all (90-100%) 2
2. ☐ Most (about 75%) 3
3. ☐ Some (about 50%) 1
4. ☐ Few (about 25%) 1
5. ☐ Very few or none (0-10%) 2
6. ☐ Do not know 12

7

III. Use of the Central Registration Depository (CRD)

18) To what extent, if at all, do you find the CRD, in its present form, useful as a regulatory tool? *(Check only one.)*

1. ☐ Very great extent 15
2. ☐ Great extent 22
3. ☐ Moderate extent 6
4. ☐ Some extent 1
5. ☐ Little or no extent
6. ☐ No basis to judge

19) To what extent, if at all, does your agency use the CRD to perform the following functions? *(Check one box in each row. Leave row blank if function not applicable.)*

	Very great extent	Great extent	Moderate extent	Some extent	Little or no extent	Do not know
Approval of initial applications 43	40	2		1		
Approval of transfer applications 43	37	2	1	1	1	1
Periodic monitoring 41	15	13	5	4	4	
Publicizing agency actions 44	16	15	8	2	3	
Other function *(please specify)* 38	21	13	4			
Other function *(please specify)* 30	14	11	5			

8

20) To what extent, if at all, do you believe the usefulness of the CRD as a regulatory tool is hampered by the following: *(Check one box in each row.)*

	Very great extent	Great extent	Moderate extent	Some extent	Little or no extent	Do not know
Nonreporting of data by SEC 42	5	7	7	7	8	8
Nonreporting of data by SRO's 42	6	7	6	8	7	8
Nonreporting of data by states 42	6	7	7	9	5	8
Nonreporting of data by firms 42	12	12	10	4		4
Nonreporting of data by representatives 42	11	14	10	4		3
Delayed reporting of data by SEC 42	4	7	11	7	5	8
Delayed reporting of data by SRO's 42	4	10	10	8	4	6
Delayed reporting of data by states 43	5	8	8	11	4	7
Delayed reporting of data by firms 43	7	12	14	5	1	4
Delayed reporting of data by representatives 43	9	14	12	5		3
Data retrieval problems 41	10	8	7	6	6	4
Other limitation *(Please specify)* 22	9	6	6	1		
Other limitation *(Please specify)* 11	5	3	3			

21) How frequently or infrequently is a Form U-5 not filed by the time your agency must act on an application for initial registration, or on an application for reregistration as a result of a change of employer? *(Check only one box.)*

1. ☐ Very frequently 4
2. ☐ Frequently 12
3. ☐ Neither frequently nor infrequently 7
4. ☐ Infrequently 8
5. ☐ Very infrequently 4
6. ☐ No basis to judge 9

9

22) Which of the following actions, if any, would you recommend as a means of reducing the number of late Form U-5 filings? *(Check all that apply.)*

1. ☐ No actions necessary 2
2. ☐ Increase the NASD nonfiling penalty 34
3. ☐ Increase the state nonfiling penalty 16
4. ☐ Impose an SEC nonfiling penalty 17
5. ☐ Allow suspension of the applicant's license 13
6. ☐ Impose other NASD disciplinary sanctions *(Please specify)* 8

_____

7. ☐ Impose other state disciplinary sanctions *(Please specify)* 1

_____

8. ☐ Other action *(Please specify)*

_____

_____

_____

23) In general, how accurate or inaccurate is the information provided on Forms U-4 and U-5? *(Check one box in each row.)*

	Very accurate	Accurate	Neither accurate nor inaccurate	Inaccurate	Very inaccurate	Do not know
Information on Forms U-4 44	1	26	10	3		4
Information on Forms U-5 44		19	13	6		6

24) In which of the following ways, if any, has your agency provided input to the CRD redesign efforts? *(Check all that apply.)*

1. ☐ Participation in NASD/NASAA meetings on redesign 34
2. ☐ Provided written comments in response to a solicitation 18
3. ☐ Provided written comments without being solicite 8
4. ☐ Was solicited, but declined to provide input 1
5. ☐ Was not solicited, did not provide input 2
6. ☐ Do not know

10

25) What would you consider to be the two most significant changes, if there are any, that should be made to the CRD as part of its redesign to increase its effectiveness as a regulatory tool?

1. _____

_____

_____

2. _____

_____

_____

IV. Discipline of Registered Representatives

26) Thinking about the disciplinary actions imposed by the following regulators against registered representatives for violative behavior, how appropriate do these actions seem for the behavior involved? *(Check one box in each row.)*

		Much too severe	Too severe	Appropriate	Too lenient	Much too lenient	Do not know
SEC	44			28	11	3	2
NASD	44			18	18	6	2
NYSE	43			24	6	5	8
AMEX	44			15	8	5	16
Regional Exchanges	44			10	8	3	23
States	44			29	11		4

27) Which of the following actions, if any, would you recommend to make the SRO disciplinary process more effective? *(Check all that apply.)*

1. ☐ More aggressive investigation of customer complaints 29
2. ☐ Progressively more severe sanctions for repeat violations 38
3. ☐ More frequent use of suspension 23
4. ☐ More frequent use of bar 24
5. ☐ More widely publicize disciplinary actions 22
6. ☐ More frequent discipline of violative representative's supervisors 30
7. ☐ More frequent sanctions against the violative representative's firm 36
8. ☐ Other action *(Please specify)* 12

_____

_____

_____

11

28) To what extent, if at all, do you believe that a bar from the industry is used appropriately as a disciplinary action by each of the following parties? *(Check only one box in each row.)*

	Very great extent	Great extent	Moderate extent	Some extent	Little or no extent	Do not know
Bar by SEC 43	3	1	19	9	3	8
Bar by the SRO's 43	4	2	15	13	3	6

29) To what extent, if at all, do you believe that a bar from the industry by the following parties represents an effective disciplinary action that will prevent recurrence of violations by permanently keeping serious violators out of the industry? *(Check only one box row.)*

	Very great extent	Great extent	Moderate extent	Some extent	Little or no extent	Do not know
Bar by SEC 44	12	17	6	5	1	3
Bar by the SRO's 44	11	17	8	4	1	3

30) For what reasons, if any, do you believe that bar from the industry is not as effective as it could be? *(Please list reasons below, or write "none" if sufficiently effective.)*

_____

_____

_____

31) To what extent do you believe that registered representatives with a history of frequent or egregious complaints of sales practice violations continue in business without appropriate discipline action being taken by the SRO's? *(Check one box in each row.)*

	Very great extent	Great extent	Moderate extent	Some extent	Little or no extent	Do not know
Representatives with numerous complaints 44	7	25	8	3		1
Representatives with particularly egregious complaints 44	2	16	15	10		1

12

32) To what extent, if at all, do you believe that registered representatives with a history of disciplinary action for sales practice violations are permitted to continue in business? *(Check only one box in each row.)*

	Very great extent	Great extent	Moderate extent	Some extent	Little or no extent	Do not know
Representatives with numerous disciplinary actions 44	11	20	8	4		1
Representatives with disciplinary action for particularly egregious violations 44	2	18	13	9	1	1

33) To what extent, if at all, do you believe that registered representatives with a history of frequent complaints and or disciplinary action for sales practice violations move from firm to firm within the industry today? *(Check only one box in each row.)*

	Very great extent	Great extent	Moderate extent	Some extent	Little or no extent	Do not know
Representatives with numerous complaints 44	13	22	6	2		1
Representatives with multiple disciplinary action 44	7	23	10	2	1	1

34) Would you favor or oppose permanently barring registered representatives who accumulate a certain number of the following types of incidents? *(Check one box in each row. If you favor a bar based on a particular incident, please describe the threshold you would set for triggering a permanent bar in the last box of that row.)*

	Favor a bar	Oppose a bar	Do not know	IF FAVOR -- Describe threshold for bar:
Criminal convictions 43	40	2	1	
Civil convictions 41	23	5	13	
Federal/state regulator sanctions 41	28	4	9	
SRO sanctions 39	24	5	10	
Arbitration filings 39	5	23	11	
Arbitration judgments 39	16	9	14	
Customer complaints 39	7	18	14	
Other (please specify)				

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35) Do you provide information about registered representatives to inquiring investors? *(Check only one box.)*

1. ☐ Yes *(Continue with next question.)* 44
2. ☐ No *(Skip to question 37.)*

36) IF PROVIDE INFORMATION: Which of the following types of information about registered representatives will you provide to inquiring investors? *(Check all that apply.)*

1. ☐ Employment history 40
2. ☐ Criminal convictions 36
3. ☐ Civil convictions 37
4. ☐ SEC or SRO disciplinary action 39
5. ☐ Arbitration awards 38
6. ☐ Pending SEC or SRO disciplinary action 34
7. ☐ Pending arbitrations 33
8. ☐ Customer complaints, whether or not resulting in a disciplinary action 31
9. ☐ Firm disciplinary action 32
10. ☐ Other: *(Please specify)* 19

_____
_____
_____

37) Some states are reported to use confidentiality agreements, or similar arrangements, by which a proposed disciplinary action is not publicly reported in exchange for a promise by the registered representative not to contest the action. Does your agency ever utilize such confidentiality agreements or similar arrangements? *(Check only one box.)*

1. ☐ Yes 8 ---> *(Continue with next question.)*
2. ☐ No 36 ---> *(Skip to question 40.)*

38) IF UTILIZE AGREEMENTS: For which of the following violative activities, if any, do you utilize such arrangements? *(Check all that apply.)*

1. ☐ Administrative violations 5
2. ☐ Financial/operational violations 3
3. ☐ Sales practice abuses 3
4. ☐ Other *(Please specify)* 5

_____
_____
_____

39) IF UTILIZE AGREEMENTS: How many such agreements have you entered into in each of the last four years? *(Enter actual numbers in each box, or provide best estimate and identify as such.)*

Year	Number of agreements
1990	
1991	
1992	
1993	

14

V. Comments

40. If you have any additional explanations of the answers you have provided, or any comments concerning this questionnaire, please use the space provided below, and attach additional sheets if necessary.

Thank you for your time and care in filling out this questionnaire.
Please return it in the envelope provided, or to the address listed on the front.

GOD/CR/1-94/231415

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Comments From SEC

Note: Comments supplementing those in the report text appear at the end of this appendix.

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

DIVISION OF
MARKET REGULATION

September 2, 1994

VIA FACSIMILE

James L. Bothwell
Director, Financial Institutions
and Markets Issues
General Government Division
General Accounting Office
Washington, D.C. 20548

Re: **Comments on Draft Report Entitled SECURITIES MARKETS: Actions Needed to Better Protect Investors Against Unscrupulous Brokers**

Dear Mr. Bothwell:

The Division appreciates the opportunity to comment on the General Accounting Office's ("GAO") draft report entitled SECURITIES MARKETS: Actions Needed to Better Protect Investors Against Unscrupulous Brokers. The draft report concludes that, although GAO was unable to determine the exact extent to which unscrupulous brokers are active in the securities industry, even a few unscrupulous brokers can cause serious harm to investors, and have the potential to damage public confidence in the securities industry. The Division shares this concern and is committed to combatting sales practice abuses and ensuring that public customers are protected from unscrupulous brokers. As you are aware, in May 1994, the Commission announced the findings of a staff review of the hiring, retention and supervisory practices of nine of the largest domestic broker-dealers ("1994 staff study").[1] The staff found that, while sales practice abuses are not a systemic problem, efforts to detect and prosecute brokers who engage in such misconduct need to be strengthened. Accordingly, the Division, in conjunction with the self-regulatory organizations ("SROs"), has begun implementing a number of recommendations resulting from the 1994 study.

Before addressing the specific recommendations, I would like to comment on the methodology of the GAO study as well as the basis for the conclusion in the draft report that shortcomings exist in the detection and discipline of unscrupulous brokers. The draft report indicates that in selecting its sample, GAO obtained from the Central Registration Depository ("CRD") an initial universe of

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

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active brokers with "formal disciplinary histories." It is important to recognize that the actions CRD captures in this category are not limited to sales practice violations or even securities law violations, but also include disclosures relating to personal bankruptcies and liens on personal accounts. In addition, disclosures in this category also include indictments and convictions for offenses unrelated to the securities industry, such as driving while intoxicated. Moreover, as the draft report acknowledges, of the almost 470,000 active brokers, only 9,799 (i.e., two percent) had at least one "formal disciplinary action" recorded. From this universe, GAO selected a judgmental sample of 100 brokers to obtain information on the violations leading to the actions. Both the initial universe and the judgmental sample of 100, therefore, included individuals disciplined for violations involving not only sales practice abuses, financial/operational violations, and criminal infractions such as robbery, but also those types of actions that arguably do not affect an individual's ability to act in a fiduciary capacity as a broker. In light of these factors, I believe that care should be exercised in drawing conclusions based on GAO's universe or sample.

Additionally, the draft report states that 25 percent of the 161 branch offices examined in connection with the 1994 staff study had weaknesses in their broker hiring and supervision practices. I believe this overstates the problem and does not accurately portray the staff's findings. While the staff did make 40 referrals of possible securities law violations to SEC enforcement staff, that number must be put into perspective. Specifically, in planning the examination sweep, the staff selected those branch offices most likely to have problems based on customer complaint information in an attempt to maximize its enforcement opportunities. Although the large number of referrals was disturbing, it was not wholly unanticipated given the deliberately selective sample. Accordingly, while I do not believe that this is indicative of a systemic problem, I, along with the Director of the Division of Enforcement, recently wrote to the SROs requesting a report on the actions that they have taken, or plan to take, to implement the recommendations in the 1994 staff study.

See comment 1.

Finally, the draft report raises concerns about a perception that SEC and industry disciplinary actions are lenient based in part on the ability of individuals subject to bars to remain in or re-enter the industry. The draft report does not, however, fully discuss the distinctions among bars or the policies of the SROs and the Commission regarding the possibility of re-entry notwithstanding a bar. The differences in the types of bars and the policies regarding possible re-entry are important to a fair and accurate representation of the process by which applications for re-entry are considered. For example, the Commission imposes bars that: (1) prohibit association in specified capacities (e.g., a supervisory or proprietary capacity) while allowing an individual

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to remain in the securities industry; (2) include a proviso allowing for application to re-enter after a specified period of time; and (3) do not include any proviso allowing the barred individual to apply for re-entry after a specified period of time (i.e., unqualified bars). The imposition of any bar is a serious sanction; the imposition of an unqualified bar is viewed as particularly severe and is reserved for egregious cases. Nevertheless, the statutory scheme contemplates the opportunity to apply to re-enter the securities industry notwithstanding a bar and I believe that the Division has been responsible in making determinations on applications to re-enter. In this regard, the draft report indicates that, between October 1991 and December 1993, the Commission permitted the re-entry of only one person who was subject to an unqualified bar. That individual had been out of the securities industry for 12 years and was allowed to re-enter only in a limited capacity (i.e., in addition to being subject to heightened supervision, the individual was permitted to sell only investment company products and variable annuities).

See comment 2.
Now on p. 9.

The draft report makes four recommendations designed to help maintain investor confidence in the securities markets. These recommendations are addressed below.

1. **That the SEC implement the recommendations of the SEC staff study to strengthen existing disciplinary standards, including the imposition of a permanent bar with no opportunity for re-entry when warranted.**

The staff has recommended that SROs review their rules and by-laws with a view toward enhancing sanctions against registered representatives and broker-dealers who commit sales practice violations. The staff also plans to disseminate publicly the Commission's policy regarding the re-entry of persons subject to unqualified bar orders imposed by the Commission.

2. **That the SEC monitor the CRD redesign to ensure that it provides the capability to allow regulators to more easily identify and monitor brokers with disciplinary histories.**

The Division continues to work closely with both the National Association of Securities Dealers, Inc. ("NASD") and the North American Securities Administrators Association ("NASAA") on enhancements to the CRD that will improve its usefulness as a regulatory surveillance tool. The redesign of the CRD is well underway and the Division is confident that it will assist greatly the ability of regulators to identify and monitor brokers with disciplinary histories.

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3. **That the SEC direct the SROs to enhance and increase the reporting of information to CRD. Specifically, the SEC should direct that (1) SRO disciplinary actions be reported directly to CRD, and (2) information on customer complaints and their disposition be collected, monitored, and reported to CRD.**

The Division agrees that it is important to enter all relevant disciplinary information into the CRD system; the Division does not, however, agree with the recommendation that informal actions such as staff interviews or letters of caution be reported to CRD. The Division understands that very few sales practice violations result in informal disciplinary actions. Moreover, such actions are not probative of serious problems and would only serve to clutter the system. In the discussion of the reporting of disciplinary information to the CRD, the draft report correctly states that the SEC is not directly reporting to the CRD. Nevertheless, the Division wishes to point out that this is in accordance with a longstanding arrangement, whereby Commission disciplinary actions, as announced in the SEC's Daily News Digest, are reported to the CRD by NASD staff. Absent some evidence that this informal arrangement is not working, and the draft report does not cite any, the Division is not prepared to change the current arrangement.

While the Division agrees that it may be valuable to collect and monitor information regarding customer complaints and their disposition, the inclusion of this information in CRD may lend unnecessary disorder to the system and, for unsubstantiated complaints, would raise due process and privacy issues.

4. **That the SEC work with the NASD, NASAA and the Department of the Treasury to increase disclosure of CRD data pertinent to the detection of unscrupulous brokers that migrate from the securities industry to other segments of the financial services industry.**

The Division agrees that prospective employers of disciplined brokers in related financial industries would benefit by being informed of any regulatory or disciplinary actions taken against the brokers. Consequently, the staff will endeavor to work with other regulators to make CRD information available throughout the financial services industry.

The Division appreciates the opportunity to comment on the draft report. I wish to thank the GAO staff for their efforts to address and integrate oral comments made by the Division's staff during the past week. The Division strongly agrees with the GAO's basic finding that efforts to ensure oversight of brokers and discipline of those who violate laws and regulations need to be as effective as possible. The Division is committed to protecting investors from unscrupulous brokers and has undertaken a number of

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investors from unscrupulous brokers and has undertaken a number of initiatives in addition to those discussed above designed to detect and prevent sales practice abuses in the securities industry. I respectfully request that this letter be appended to the final report delivered to Congress.

Sincerely,

Brandon Becker

Brandon Becker
Director

The following are GAO's comments on SEC's September 2, 1994, letter.

GAO Comments

1. It is not our intention to suggest that the large number of problems found by SEC in its staff study of nine large firms and their branch offices is systemic of the number that exists in all branch offices. We believe that the SEC findings in this unique study, along with the other concerns we raise in this report, indicated that some shortcomings do exist in the detection and discipline of unscrupulous brokers. We have modified the text to more fully explain SEC's criteria for selecting the branch offices to review.

2. We have modified the text to more fully explain the distinction among the types of bars imposed, and SEC and SRO policies regarding reentry to the securities industry.

Major Contributors to This Report

General Government Division, Washington, D.C.	Helen H. Hsing, Associate Director Bernard D. Rashes, Assistant Director Carl M. Ramirez, Social Science Analyst
Seattle Regional Office	Desiree W. Whipple, Reports Analyst
New York Regional Office	John P. Harrison, Evaluator-in-Charge John D. Carrera, Senior Evaluator Richard D. Burger, Evaluator Rita L. Chambers, Evaluator Assistant
Office of the General Counsel, Washington, D.C.	Lorna MacLeod, Attorney

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