ADMINISTRATIVE PROCEEDING
FILE NO. 3-6222

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of	:
CHARLES SCHWAB & CO., INC.	:
	:

INITIAL DECISION

December 28, 1983
Washington, D.C.

David J. Markun
Administrative Law Judge

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APPEARANCES: Beverly K. Kennedy and Rosalind R. Tyson, Esqs., Los Angeles, California, for the Division of Enforcement. Also appearing on the briefs, Michael J. Stewart, Los Angeles Regional Administrator, and law clerks Phyllis Meadows and Jonathan Golden.

Patrick J. Mahoney and Daniel Alexander, Esqs., of Cooley, Godward, Castro, Huddleston & Tatum, Palo Alto, California, for the Respondent. Also appearing on the briefs, Robert E. Gooding, Jr. and Steven E. Schon, Esqs., of Howard, Rice, Nemerovski, Canady, Robertson & Falk, San Francisco, California.

BEFORE: David J. Markun, Administrative Law Judge.

I. THE PROCEEDING

This public administrative proceeding was instituted by an order of the Commission dated March 9, 1983 ("Order") pursuant to Sections 15(b) and 19(h)[1/] of the Securities Exchange Act of 1934 ("Exchange Act") to determine whether Respondent Charles Schwab & Co., Inc. ("Respondent" or "Schwab"), as alleged in Section II of the Order by the Division, failed reasonably to supervise, within the meaning of Section 15(b)(4)(E)[2/] of the Exchange Act, Marion Albert Arture ("Arture"), a person alleged to be subject to Schwab's supervision, with a view to preventing various antifraud violations of the securities laws alleged to have been committed by Arture, and to determine what, if any, remedial action is appropriate in the public interest.

An eight-day evidentiary hearing was held in June, 1983, in Los Angeles, California. The parties have filed proposed findings of fact and conclusions of law and supporting briefs pursuant to the Commission's Rules of Practice.[3/]

The findings and conclusions herein are based upon the record and upon the demeanor of the various witnesses. The

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1/ 15 U.S.C. §§78o(b), 78s(h).

2/ 15 U.S.C. §78o(b)(4)(E).

3/ 17 CFR §201.16.

standard of proof applied is that requiring proof by a preponderance of the evidence. 4/

II. FINDINGS OF FACT AND LAW

A. The Respondent.

Respondent Schwab has been a registered broker-dealer continuously since 1971. During the period within which the failure to supervise is alleged to have occurred, i.e. September 1979 through October 8, 1980 (the "relevant period"), Schwab was the nation's largest discount broker. At the beginning of 1980 it had 16 branch offices. During 1980 it opened 7 new offices in as many different states. As of September 22, 1983, Respondent had 53 offices. Its home office was and is in San Francisco, California. In January, 1983, Schwab was acquired by the Bank of America.

During the relevant period Schwab was a member of the Philadelphia Stock Exchange ("PHLX") and the National Association of Securities Dealers ("NASD") and applied to the New York Stock Exchange ("NYSE") for membership.

B. The Fraud Committed by an Employee of Schwab.

Respondent Schwab concedes that within the relevant

4/ Steadman v. S.E.C., 450 U.S. 91, 101 S. Ct. 999 (1981).

period one of its employees, Marion Albert Arture ("Arture"), while employed in its Newport Beach Branch Office ("NBBO") in Orange County, California, carried out a fraudulent scheme involving purportedly "discounted securities" in wilful violation of Section 17(a) [5/] of the Securities Act of 1933 ("Securities Act") and Section 10(b) [6/] of the Exchange Act and Rule 10b-5 [7/] thereunder. Schwab denies, however, that the fraud occurred under circumstances that would render it subject to sanction for a failure reasonably to supervise in accordance with Section 15(b)(4)(E) of the Exchange Act.

Arture's scheme extracted about $845,000 from some 31 victims of his fraud ("investors"). [8/] In carrying out his scheme, Arture told potential investors, directly or indirectly, that Schwab was able to offer to a limited number of investors an opportunity to realize quick and dramatic profits under a so-called "discounted securities" program by advancing cash on behalf of customers of Schwab who held treasury bills or other securities but could not wait until

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5/ 15 U.S.C. 77q(a).

6/ 15 U.S.C. 78j(b).

7/ 17 CFR §240.10b-5.

8/ The investors eventually recovered the funds they invested, through insurance carried by Schwab, but not their promised profits.

Only two of the investors had customer accounts at Schwab.

the maturity or regular availability of cash from liquidation of such securities since, for one reason or another (e.g. a divorce, a death) they required immediate cash and therefore were willing to "discount" their securities by substantial amounts. Arture stated that Schwab could not open this investment possibility to all of its customers since, among other things, it was such an attractive deal that if so handled it would be oversubscribed and impracticable to administer. In fact, Schwab had no such "discounted securities" program.

The record does not establish what use Arture made of most of the funds fraudulently extracted from the victims/investors but it does show that at least some part of the funds was used in Ponzi-scheme fashion to pay early investors the promised return on their investments.

In carrying out his scheme, Arture employed (by giving them "commissions") the services of two young men to locate new investors and to act as "couriers" in collecting cash from investors and delivering it to him. 9/ A number of these deliveries of cash occurred at the NBBO during business hours. On at least eight occasions, Arture gave receipts for cash on Schwab company forms in the effectuation of his scheme.

9/ At one point in the course of the scheme still a third individual became involved in the business of drumming up investors for Arture for a commission.

Some investors were unwilling to invest through a "courier" or other intermediary and insisted instead on dealing directly with Arture at the NBBO during business hours. Certain investors were also unwilling to hand over cash; these were persuaded to provide cashier's checks. Some of these last caused their name or some indication of the purpose of the payment to be placed upon the cashier's checks.

On at least 25 occasions during the relevant period Arture met with one or more customers or couriers at the NBBO in connection with carrying out his fraudulent scheme.

Arture also furnished on Schwab confirmation forms eleven confirmations of fictitious securities transactions in the course of carrying out his fraud.

Arture had both cash and margin personal securities accounts with Respondent Schwab. Arture used both of these accounts during the relevant period to help effectuate his fraud. Within the relevant period he caused one personal check and twelve (12) cashier's checks (10 of which were payable to Schwab) received from investors to be deposited into his personal cash or margin accounts, and later withdrew such funds for his personal use and benefit. The 13 checks thus processed through Arture's Schwab accounts totalled $342,000.

On October 7 and 8, 1980, with his Ponzi scheme on

the verge of collapse as investors demanded their overdue investments and promised profits, Arture signed and endorsed three unauthorized Schwab checks totalling $405,000 payable to himself and prepared at his request, although there were no such funds in his Schwab accounts. These checks were not cashed because on October 8, 1980, the fraud was discovered after a bank officer in Schwab's bank at Newport Beach called Schwab's Home Office to question why Arture had inquired whether the bank could negotiate a check for $1.2 million.

C. The Provisions of Section 15(b)(4)(E) Respecting Supervision.

Section 15(b)(4)(E) of the Exchange Act provides in pertinent part as follows respecting the supervision requirements:

> (4) The Commission, by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of any broker or dealer if it finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or revocation is in the public interest and that such broker or dealer, whether prior or subsequent to becoming such, or any person associated with such broker or dealer, whether prior or subsequent to becoming so associated --
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> * * *
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> (E) . . . has failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations [the statutes, rules, and regulations here referred to are earlier specified in paragraph (E) and include the Securities Act and the Exchange Act and rules and regulations promulgated thereunder],

> another person who commits such a violation, if such other person is subject to his supervision. For the purposes of this subparagraph (E) no person shall be deemed to have failed reasonably to supervise any other person, if --
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> (i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and
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> (ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.

As evident from its terms, Section 15(b)(4)(E) provides a basis for imposition of sanctions on a broker-dealer for its failure reasonably to supervise persons subject to its supervision who commit specified violations. There is no requirement in the statute that the failure to supervise be shown to have been wilful.

While the term "failed reasonably to supervise" is not expressly defined in the statute, the Congress has given significant indication of its purpose and intent by way of prescribing the "safe harbor" provision set forth in subparagraphs (i) and (ii) of paragraph (E). As a practical matter, if Respondent Schwab can show, as it vigorously contends is the case, that it (i) had in place established procedures and a system for applying such procedures which would reasonably have been expected to prevent and detect, insofar as practicable, Arture's fraud and (ii) reasonably discharged the duties and obligations incumbent

upon it by reason of its procedures and system without reasonable cause for believing that the procedures and system were not being complied with, there can be no finding against it of a failure reasonably to supervise Arture. Conversely, if the Division can show, as it argues with equal vigor is the case, that Schwab lacked established procedures or a system for applying them designed insofar as practicable to prevent and detect Arture's fraud or failed reasonably to discharge the duties and obligations incumbent upon it under any procedures and system it may have had, or a combination of such alleged inadequacies and failures, and can show also that such alleged failures and inadequacies made Arture's fraud possible or caused it to go undetected during the relevant period, the Division's contention that Schwab failed reasonably to supervise Arture will be established.

D. Absence of or Inadequacies in Established Procedures or Systems for Implementing the Procedures and Failures Reasonably to Discharge the Duties and Obligations Incumbent upon Schwab under Existing Established Procedures and Systems for Implementing Such Procedures.

During the relevant period the staff at Schwab's Newport Beach Branch Office ("NBBO"), where Arture's fraud occurred, included a manager, an assistant manager/trader (Arture), three other registered representatives, or "traders", as Schwab calls them, and two cashier/receptionists.

The NBBO consisted of approximately 1000 square feet of open office space on one floor. A desk-high divider separated the reception area from the employee work area. The reception area had a couch, coffee table and chairs on one side. A floor-to-ceiling panel extended to about 6 to 8 feet from the wall next to the couch area. In the employee work area cashier/receptionists Victoria Jones and Lisa Gouldsmith sat at desks next to the divider. Four trading desks, grouped together to form a compact rectangle and each equipped with a computer terminal, at which the registered representatives/traders sat, a separate branch manager's desk, and various file cabinets occupied the rest of the employee work area. A bathroom and some storage space were at the rear of the NBBO. The couch area was not visible from the manager's desk because of the floor-to-ceiling panel described above. The reception area at the front of the NBBO also included a telephone for walk-in customers to use in placing orders with traders in the office and a quotron machine on which stock quotations were displayed.

The most glaring and significant deficiencies in supervisory procedures and their implementation and execution disclosed by this record spring to light upon an examination of how it was that Arture was able to run $342,000 worth of checks received from investors in his fraudulent scheme through his personal securities accounts at Schwab.

Schwab concedes that within the relevant period Arture deposited 12 cashier's checks and one personal third-party check from investors in his scheme totalling $342,000 and that shortly after each series of deposits he withdrew such funds from his accounts at Schwab in furtherance of the fraud.

On April 7, 1980, two cashier's checks, one for $65,000 and one for $85,000, each dated April 7, 1980 and payable to Arture, were deposited to Arture's cash account at Schwab. Each check bore the notation "For purchase of U.S. Treasury Bills maturing June 20, 1980, c/o Bull and Bears Group."

The parties have stipulated that during the relevant period Schwab policy (unwritten) required that releases be obtained from issuers of all checks drawn on accounts which did not agree with the Schwab customer account name.

Schwab concedes that industry practice required that the cashier verify whether cashier's checks bearing such notations should be deposited into an employee account. If an account existed for the "Bull & Bears" group, a release from that account would first have to be obtained before the funds could be deposited to Arture's account. If no such account existed the cashier would have to refer the matter to the Branch Manager or the Home Office for determination.

Schwab further concedes that its own unwritten company policy required the cashier to obtain a release if after review such checks were found to be third-party checks.

Cashier Jones obtained no releases and raised no question about depositing the checks to Arture's account. Proper inquiry would have disclosed that the cashier's checks were purchased by two separate investors, and not by Arture. Had industry practice and Schwab's own unwritten policy been followed at this point, Arture's fraud would have been detected at an early stage.

About two months later, in June of 1980, Arture again deposited into his personal Schwab account cashier's checks purchased by investors in his fraudulent scheme. On June 19th Arture deposited 8 of such cashier's checks, payable to Schwab and totalling $90,000, four of which bore on their face notations of the investors' names. On June 23rd Arture deposited into his account a cashier's check payable to Schwab in the amount of $10,000. On June 24th Arture had deposited into his account at Schwab a cashier's check payable to Schwab in the amount of $70,000 that bore on its face the name of an investor.

Schwab concedes that industry practice required that cashier's checks with persons' names noted on their faces be deposited to the accounts of such persons unless a release was obtained authorizing the funds to be deposited into the account of another named party (i.e., here, Arture). Schwab contends that its unwritten third-party-release policy was consistent with that industry practice.

Schwab further concedes that before depositing cashier's

checks made payable to the firm (Schwab) and which bear no notation of purchasers' names into an employee account (Arture's), industry practice required a cashier to verify the source of those funds by calling the banks and identifying the purchasers of the checks. Unless this verification confirmed that the employee himself had purchased the cashier's checks, industry practice required the cashier to obtain a third party release from the purchasers of the checks before deposit into an employee account. Schwab contends that its unwritten third-party-release policy was consistent with that industry practice.

Schwab's cashier Jones obtained no releases with respect to any of the 10 checks totalling $170,000 deposited to Arture's account in June and raised no question with respect to making such deposits. Required inquiry would have disclosed that the checks were purchased by separate individuals who turned out to be investors in Arture's fraudulent scheme. Had industry practice and Schwab's unwritten third-party-release policy been followed with respect to these June deposits, the Arture fraud would have been discovered at that time rather than over three months later in October.

On September 11, 1980 the personal check of Dorothy Babish payable to Arture in the amount of $22,000 was deposited into Arture's Schwab account. Again, cashier Jones failed to obtain a third party release from Babish and raised no question regarding depositing the check into Arture's account.

Schwab further concedes that as to all of these checks, totalling $342,000, as to which releases should have been sought before depositing the checks to Arture's Schwab accounts, industry practice required that the releasors specify their relationship with the registered representative/trader and the purpose of the funds. The reason behind this practice was to ensure that the registered representative was not independently engaged in the business of buying and selling securities without the knowledge of his employer. As to none of the 13 checks in April, June, or September did Schwab's NBBO cashier Jones make any such inquiry.

How was it that Schwab's stipulated third-party-release policy, purportedly fully in accord with industry practice, failed to prevent or to detect Arture's extended on-going fraud? Was it simply the case, as Schwab disingenuously urges, that one cashier in one branch office among Schwab's numerous branch offices did not understand and therefore failed to apply the policy? No, the record herein indicates that the deficiencies and inadequacies respecting the third-party-release policy were far more numerous and extensive than that.

Firstly, as already noted, the policy was not written. While it is not imperative that all policies or "established procedures," to use the language of the relevant statute, be in writing, it would certainly have facilitated communication of

such policy to the cashiers, branch managers, and others had such policy been in writing. The record contains no satisfactory proof that the policy was ever written down prior to its incorporation in a Schwab "Branch Office Procedures" manual dated September 1980 and distributed early in October of that year. The desirability of a written policy statement on this critical point is further emphasized by the fact that Schwab's outside auditor, Deloitte Haskins & Sells ("DH&S"), had recommended as early as January 1979 that Schwab prepare a Branch Office Compliance Manual "covering branch manager supervisory responsibilities."

Secondly, the policy was somewhat lacking in clarity or specificity in that, for example, it did not specifically deal with how a cashier should handle cashier's checks or with whether checks drawn in favor of an employee/customer were to be treated differently from checks drawn in favor of Schwab.

Thirdly, the policy was not comprehensive, in that it clearly did not cover the industry practice of requiring releasors to specify their relationship with the trader and the purpose for which the funds were given.

10/ This was true even after a statement of the policy appeared belatedly in the September 1980 manual, distributed in October.

The most solid evidence that such an unwritten third-party-release policy even existed at Schwab during the relevant period (apart from the parties' stipulation) lies in the fact that Schwab's compliance officer, in the course of conducting an internal "audit" of the NBBO on July 23, 1980, concluded that NBBO personnel were accepting "third-party checks without releases and without verifying the propriety of the deposits." However, the record shows unmistakeably that neither of the two cashiers at the NBBO was aware of the policy or had ever sought or obtained releases and that even the Branch Manager had no awareness of the policy--had never seen it in writing or heard of it. Nor does the record contain satisfactory proof that other Schwab branch offices uniformly or generally applied that policy and that the NBBO's ignorance of the policy was merely an aberration.

Assuming, arguendo, the overall adequacy of Schwab's third-party-release policy as an "established procedure" (something far from clear, as noted above), I conclude from the entire record that Schwab lacked a reasonably adequate "system for applying" such policy or procedures in that it failed entirely to make the NBBO personnel aware of the policy. Significantly, even after the July 23 "audit" uncovered the failure of the NBBO to require third-party releases, no prompt or effective steps were taken to ensure compliance, with the result, as already noted, that

still another failure in applying the policy occurred with respect to an Arture account on September 11, 1980.

Closely related to Schwab's supervisory deficiencies as respects a third-party-release procedure as found above is Schwab's failure to have reasonably adequate procedures and a system to apply such procedures for training its cashiering personnel at the NBBO. Schwab contends that its procedures for training cashiering personnel in their cashiering duties during the relevant period were on-the-job training. There were no written procedures covering responsibility for training of Schwab's cashiers. In practice, such training as occurred took place at the branch office. Contacts of the cashiering personnel of the NBBO with home office personnel in the margin and other departments were not of a kind that were likely to result in the kind of training that was here found to be lacking. Jones received about two weeks' on-the-job training from Shari Roberts, the outgoing cashier, who also helped train Gouldsmith for a few days. There is no indication in the record whether Roberts covered the matter of third-party check procedure or whether she was herself aware of the unwritten policy or had ever herself applied the policy.

As respects any on-the-job training of the NBBO cashiers in their cashiering functions by the Branch Manager, the record shows both that such training could not have covered the third-party-release policy -- since the Branch Manager had never seen

any written evidence of it or heard of it -- and that apart from that particular policy, he conducted no meaningful training of the cashiers in respects here pertinent.

Significantly, Schwab's compliance officer, after his July 23, 1980 internal "audit" of the NBBO revealed that NBBO cashiers were not requiring releases in third-party-check situations, appeared to conclude that the fault lay, at least in principal part, with the home office in failing to provide the necessary cashiering training. His September 2, 1980 audit report commented, in pertinent part (Exhibit 6, pp. 1, 4):

> Cash Processing
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> * * *
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> Third party checks (items drawn on the account of an individual or entity other than the Charles Schwab & Co. account name) were routinely accepted without releases and without verifying the propriety of the deposit. The branch cashier should review all checks to insure that funds deposited are drawn on the bank account of the individual who will receive benefit of the deposit.
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> Conclusions
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> Many of the functions performed in the branch office seemed to suffer, at least to a slight degree, from an inadequate understanding of proper procedures and an inefficient use of employee time. Customer service, new accounts and some other functions not previously mentioned are included in this analysis.
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> I would emphasize however, that the principal problem appears to be a failure on the part of the home office to provide adequate training and is not the result of an unwillingness on the part of the branch employees to properly perform their assigned functions.

Belatedly, on or about October 7, 1980, at or about the time Arture was fired after his fraud was uncovered, Michael Russell was sent to the NBBO from the Home Office by Hugo Quackenbush, administrator of branch offices, to deal with the problems identified in the audit report, including the training of cashiers. From this action it is clear that in the judgment of the Home Office no adequate capability existed in the Branch Manager for training cashiers in these cashiering duties. That this was so is evident from the fact that the cashiers in that branch did not seem to appreciate the quite obvious point that the 10 cashier's checks payable to Schwab should clearly not have been credited to Arture's account absent a showing that he had purchased or paid for those checks. Quite apart from whether Schwab's third-party-check release policy was known to them or not as such, the NBBO cashiers, had they been trained in the rudiments of cashiering, would have known enough in these circumstances to at least check with the Branch Manager as to appropriate procedure when so many cashier's checks totalling so much were presented within a relatively short period of time for deposit to Arture's account.

Not until early October, 1980, at the close of the relevant period, did Schwab delineate clearly the Branch Manager's responsibilities for training of cashiers and other branch office personnel when it distributed a manual on Branch Office Procedures for the first time (Exhibit 2, Section 21, Supervision). Prior to that time Schwab lacked procedures clearly assigning

responsibility for training cashiers in their cashiering functions or a system for implementing such training. To the extent it may be concluded that Schwab had training procedures in the sense that training was on-the-job, the record is clear that Schwab fell woefully short, at any level, of reasonably discharging the duties and responsibilities incumbent upon it under any rational system of on-the-job training of cashiers at the NBBO. There is no satisfactory proof as to whether inadequately trained cashiers existed at other branches of Schwab as well during the relevant period.

The inadequacies found herein with respect to third-party-check procedures and system and with respect to training of cashiers at the NBBO are alone sufficient to support a finding of failure to supervise against Schwab. They related to critical elements in the supervisory scheme. Without these two related categories of deficiency and breakdown, the Arture fraud could never have gotten off the ground. This is not to say that Schwab was a guarantor of a reasonable level of competence among its cashiers, but it was obligated to have reasonably adequate procedures and a system for applying such procedures reasonably designed to attain that end, and it was obligated reasonably to discharge its obligations under such procedures and system. This Schwab failed to have or to do.

Respondent contends that it had in place during the

relevant period certain Home Office controls and review procedures over NBBO and other branch office activities that, taken together with purported supervision exercised at the NBBO, served to meet the statutory requirements respecting supervision. Of especial relevance here, as pertinent particularly to the examination of how it was possible for Arture to misuse his personal accounts at Schwab in the effectuation of his fraud, are certain controls on the disbursement of funds exercised by the Margin Department in San Francisco and the responsibility of the Compliance Department at the Home Office for monthly review of customer accounts for any "unusual" activity.

During the relevant period a branch office was not authorized to issue Schwab checks to customers without prior authorization from the Margin Department in the Home Office. Any disbursement in excess of $20,000 had to be approved by a supervisor or by the head or assistant head of the Margin Department. Although this procedure was designed primarily to protect the Schwab fisc, it had the incidental effect, if properly applied, of serving as a control upon misuse of a customer's account in the antifraud context.

On April 10, 1980, the Margin Department considered the request of Arture, an employee earning some $18,000 [11/] per annum at the time, for the issuance of $150,000 out of one of

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11/ The parties stipulated that during 1980 until being fired on October 8, 1980, Arture earned $13,597 at Schwab.

his Schwab accounts. The matter was referred to the head of the Margin Department, Dennis Avelli, an employee with some 14 years experience in the securities industry. Because of the size of the requested disbursement, Avelli looked at the underlying checks that had been deposited into the Arture account and that were the source of the funds that Arture was seeking to withdraw. Avelli testified that under the existing circumstances it was prudent and good practice to look at the checks deposited into Arture's account. The checks Avelli looked at were the two checks earlier referred to, one for $75,000 and one for $65,000, each of which bore on its face the notation "For purchase of U.S. Treasury Bills maturing June 20, 1980, c/o Bull and Bears Group." Avelli testified that he failed to notice, or overlooked, the notations on the checks. He further testified that, had he observed such notations he would have, in accordance with industry practice, made further investigation before approving the disbursement of funds. As it was, Avelli merely called the NBBO Branch Manager, who told him the funds in the Arture account had come from prior employment, and approved the disbursement. Avelli's failure to observe the notations on the deposited checks and to follow up thereon was at the minimum negligent, given his experience and the purpose for the inquiry. If one looks at underlying documents he must do so purposefully and carefully. Further, Avelli did not flag the Arture accounts

in any way for critical future surveillance or advise the supervisors in his Margin Department or the Compliance Department to be alert as to future activity in the Arture accounts. Proper observance of the notations and the called for further inquiry would have disclosed that the purchasers of the two cashier's checks here involved were investors Toby Tsuma and Tashiyuke Omote and this would have led to early discovery of the Arture fraud.

In early May, 1980, Guy Bryant, head of Schwab's Compliance Department, became aware of Arture's April deposits and withdrawal of $150,000 in the course of reviewing customer accounts on a monthly basis to check for "unusual" activity. Bryant did not look at or cause to be examined the underlying checks for $75,000 and $65,000, even though Avelli testified it was good practice to do so. And copies of such checks were readily available both at the Home Office and the NBBO. Nor did Bryant check with the Margin Department as to any inquiry that Department might have made into the matter, though Bryant must have been aware of the Schwab Company policy requiring a supervisor in the Margin Department to approve any disbursement exceeding $20,000, and, indeed, for Margin Department approval of any disbursement. Instead, Bryant contented himself with a call to the NBBO Branch Manager, from whom he obtained an "explanation" that Arture had "inherited some money" and had put it into his account expecting to buy shares in Schwab's money market fund but then had

withdrawn the funds purportedly because the Schwab Fund was not as yet available. This "explanation" was at variance with the one Avelli had received and was also otherwise suspect since the record is clear that the Schwab money market fund had in fact been available for some time and a company officer at Bryant's level must certainly have been aware of that fact. Bryant did not ask the NBBO Branch Manager whether he had made any check as to the truth of Arture's purported inheritance. Bryant did not flag the Arture accounts for future critical surveillance.

The record establishes that the deposit of eight cashier's checks into an account of Arture's at Schwab on June 19, 1980, as found above, which checks totalled $90,000 and were payable to the firm, was followed by a withdrawal from that account on the following day, June 20, 1980, of $90,046.20. And the deposit of two separate cashier's checks into an Arture account at Schwab on June 23 and June 24, 1980, totalling $80,000, was followed, three days later, on June 27, 1980, by a withdrawal of $80,000 by Arture from that account.

These substantial June withdrawals were authorized by two different Margin Department supervisors simply on the basis of calls to the NBBO cashiers to determine if the money was in the account. After learning that the checks deposited were cashier's checks the Margin Department

supervisors approved the withdrawals. There is no reliable evidence that they asked or were told the number of checks involved or that they were payable to Schwab, not to Arture. The supervisors made no effort to look at the underlying checks deposited to the Arture account, even though, as noted, Avelli, head of the Margin Department, testified that good practice called for such examination under such circumstances and copies of the deposited checks were readily available both at the NBBO and at the Home Office. Avelli testified that if this matter had come to his attention he would have looked at the underlying checks because it was good practice to do so; but, he testified, he had no instructions out to his supervisors or other department personnel to do so. Had such examination been made, some pertinent questions would surely have been raised, including the question of why NBBO cashiers were crediting cashier's checks drawn in favor of Schwab to an Arture account without obtaining third-party-check releases under existing Schwab policy.

On or about July 10, 1980, Bryant became aware of the June deposits and withdrawals from an Arture account at Schwab. Again, Bryant failed to look at copies of the checks deposited into the Arture account nor did he ask anyone else to do so or check with the Margin Department as to their basis for approving the withdrawals/disbursements. Bryant testified that he was told, presumably by the NBBO

Branch Manager, that the Arture funds were "the same funds" as were involved in the April account transactions (notwithstanding a $20,000 "growth") and that the money was deposited pending close of escrow on a house purchased by Arture. Bryant did not ask the NBBO Branch Manager or anyone else to inquire into the accuracy of Arture's purported statements. A simple look at the underlying checks would have revealed the fraud to Bryant.

On September 16, 1980, the Margin Department authorized the disbursement of $23,000 to Arture from one of his Schwab accounts. The source of $22,000 of those funds was a third party personal check from an investor that had been deposited in Arture's Schwab account without obtaining a third party release as required by Schwab policy. The Margin Department made no inquiry as to the source of the funds deposited.

Schwab argues that it had a right to rely on Arture's statements in the above respects since he was a trusted employee. This argument suffers from a number of weaknesses. Firstly, Arture had been with Schwab only since October, 1978, and had therefore not had overly much time in service to establish a basis for special trust. Secondly, if a firm's established procedures for preventing and detecting fraud by employees come down in the last analysis to taking the employee's word on explanations when questionable events are looked into, then the procedures cannot be very effective. As to the Home Office procedures here under examination, the

record shows a failure to apply customary checks, i.e. to look at the underlying checks deposited into the Arture account, as Avelli, Schwab's head of its Margin Department, indicated good practice required, an astounding failure on Avelli's part in carrying out his obligations under the procedures he supported when he failed to observe the critical notations on the two large checks, an unreasonable reliance upon the word of the employee whose actions were in question, and an unreasonable failure on the part of the Home Office to coordinate between the Compliance and Margin Department and to flag Arture's account for possible future scrutiny after an initial inquiry had been made. From the foregoing, I conclude that Schwab did not reasonably carry out its obligations under the above discussed Home Office procedures and policy it relies upon (in conjunction with other claimed supervisory elements) to bring it within the safe harbor provisions of Section 15(b)(4)(E).

Respondent Schwab also endeavors to pull into a safe harbor in part on the strength of Bryant's "audit" of the NBBO conducted on July 23, 1980. Reliance on the audit, along with other aspects of claimed supervision, is intended to show that Schwab reasonably supervised Arture through activities of the Home Office. This was the audit, as found above, in which Bryant discovered that NBBO cashiers were completely unfamiliar with Schwab's third-party-check release

policy and were not applying it.

Without passing upon the overall adequacy of the "audit" conducted by Bryant and two other Home Office personnel -- as to which there is insufficient evidence in the record to permit a reliable conclusion -- it is clear both that the audit came much too late and that its here-relevant findings were not followed up on with reasonable dispatch.

Thus, though the NBBO office was opened in May, 1977, Bryant's Compliance Department did not conduct its first "audit" of that office until July 23, 1980, over three years later. Even allowing for the fact that the NBBO began at a very low level of operations and personnel, and without attempting to conclude whether the "audits" by Compliance should have been annual or at any other particular intervals, it is clear that three years is an unreasonably long period to wait for the first such audit of a branch office. Had the Bryant "audit" occurred a year or even six months earlier, it would have disclosed so much sooner the here-critical fact that the NBBO cashiers were ignorant of Schwab's third-party-check release policy, were consequently not applying it, and were in related respects deficient in their on-the-job training.

Bryant did not promptly review the results of his audit with the NBBO Branch Manager, the cashiers, or any other NBBO personnel. He sent a memorandum covering the results

of the audit on September 2, 1980: to the NBBO Branch Manager, William C. Vosburg; to Hugo Quackenbush, a director and senior vice president of Schwab in charge of branch office operations; and to William L. Pearson, an executive vice president and director of Schwab. The record does not disclose that Schwab took any steps to remedy the deficiencies in cashier training and knowledge with respect to third-party-check procedures that the "audit" uncovered until on or about October 8, 1980, the day the Arture fraud was discovered. No reason appears in the record why Bryant should not have taken immediate steps to rectify the dangerous situation he had uncovered by promptly notifying Vosburg, the NBBO Branch Manager, of the deficiency and then giving him any help he might have required to remedy it. Given the critical nature of the deficiency, it was unreasonable not to take reasonable steps to rectify it promptly.

Respondent Schwab urges that it had a number of other procedures in operation during the relevant period that demonstrate that it exercised a reasonable level of supervision over Arture, e.g. the computer system that linked its branch offices with the Home Office in San Francisco. However, as the Division correctly points out, such procedures were designed to permit Schwab's business operations to proceed efficiently and were not designed, nor did they operate incidentally, to prevent or discover the Arture type of fraud or similar frauds. In short, they

are simply irrelevant to the matter of supervision here in issue. This is particularly true in light of the specific deficiencies found herein to have existed in relevant Schwab procedures and system for applying the procedures and in the discharge of the duties and obligations incumbent upon Schwab by reason of such procedures and system.

The findings already made regarding inadequacies with respect to third-party-check procedures and the training of cashiers at the NBBO indicate that there was inadequate supervision on the part of the Branch Manager at the NBBO. As already noted, there were no written procedures setting forth the duties of a branch manager until Schwab belatedly distributed a written manual covering Branch Office Procedures in October, 1980, after its outside auditor, DH&S, had recommended as early as January 1979 that Schwab prepare a branch office compliance manual covering the branch manager's supervisory responsibilities. Also, as already found, the Branch Manager appeared to accept Arture's "explanations" concerning the source of his funds at face value without any examination of the checks deposited to Arture's account. Even after Vosburg became aware of Arture's clearly erratic behavior during the last week to 10 days before his fraud was discovered -- Arture was begging personnel in the office, including

Vosburg, some on his knees, for loans -- Vosburg took no steps to investigate or to suspend Arture from his functions as assistant branch manager.

The Home Office was deficient in taking reasonable steps to look into the nature of Vosburg's supervision at the NBBO. In over three years since the NBBO office had been opened, Quackenbush, who was in charge of evaluation of branch managers, never visited the NBBO; he once sent Vosburg a blank performance evaluation form for him to complete.

The Compliance Department's first "audit" of the NBBO, as already found above, was not conducted in timely fashion.

Schwab contends that a decision by a Business Conduct Committee of the NASD on October 15, 1981, following an informal hearing on charges that Schwab and Vosburg had failed properly to supervise Arture, dismissing the charges while finding that Schwab's training of cashiers was inadequate and ordering Schwab to communicate to it the remedial steps taken to improve such training, evidences the industry practice or standard regarding supervision during the relevant period.

I conclude that no such inference can be drawn here. The record upon which the Business Committee acted is completely distinct from the record in this proceeding and that record and the decision based upon it afford no basis for the inference Schwab seeks to have drawn. While the Business Committee's decision was received in evidence as

the opinion of "an expert body", the record upon which it acted is so materially at variance with the record in this proceeding that I am unable to give it the substantial weight that Respondent Schwab would have me do. Schwab does not urge that the business committee's decision has any collateral-estoppel effect.

Schwab also argues that the fact that its independent auditor, DH&S, gave Schwab an unqualified opinion for fiscal 1980, after discussing the Arture fraud with Schwab personnel, indicates that its supervisory procedures were adequate. There is no merit to this contenion; DH&S is not charged with making adjudications under Section 15(b)(4)(E) of the Exchange Act and its audit did not in fact involve any investigation into the facts or circumstances surrounding the Arture fraud. DH&S merely satisfied itself that the Arture fraud would not have a financial impact on Schwab that would need to be taken into account in rendering its opinion.

Moreover, in a letter to Schwab dated December 16, 1980, DH&S made clear its limited examination into the adequacy of Schwab's internal accounting controls (which covered, inter alia, Schwab's internal audit procedures) as follows (Exhibit 33, pp. 1, 2):

> . . . As part of our examination, we made a study and evaluation of the Company's system of internal accounting control to the extent we considered necessary to evaluate the system as required by generally accepted auditing standards. The purpose of our study and evaluation was to determine the nature, timing, and extent of the

> auditing procedures necessary for expressing an opinion on the Company's financial statements. Our study and evaluation was more limited than would be necessary to express an opinion on the system of internal accounting control taken as a whole.
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> * * *
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> Our study and evaluation made for the limited purpose described in the first paragraph would not necessarily disclose all material weaknesses in the system. Accordingly, we do not express an opinion on the system of internal accounting control of Charles Schwab & Co., Inc. taken as a whole. The results of our study and evaluation as to material weaknesses were reported to you in our Supplementary Independent Auditors' Report on Internal Accounting Control dated November 14, 1980.

For reasons analogous to those discussed above with respect to the determination of a Business Conduct Committee of the NASD and the 1980 audit by DH&S, I conclude that the fact that the NYSE accepted Schwab into membership in 1981 after processing its application in 1980 does not support Schwab's contention that this gave Schwab a "clean bill of health" with respect to the adequacy of its supervision of Arture during the relevant period.

The foregoing findings manifest a clear failure to meet the statutory supervision requirements of Section 15(b)(4)(E) in multiple respects and at various levels. As the Commission stated in a recent decision:

> Effective supervision by broker-dealers is a critical element in the regulatory scheme and its importance has increased as firms have grown in size. As broker-dealers expand their activities, through the acquisition of branch offices or into new areas within the securities business, there must be a concomitant expansion of their supervisory procedures to insure regulatory compliance and sound internal

> controls. Apart from adopting effective procedures broker-dealers must provide effective staffing, sufficient resources and a system of follow up and review to determine that any responsibility to supervise delegated to compliance officers, branch managers and other personnel is being diligently exercised.

Mabon, Nugent & Co., Exchange Act Release No. 19424, January 13, 1983, 26 SEC Docket 1846, 1852.

E. Conclusions of Law.

In general summary of the foregoing, it is concluded that within the relevant period from about January 1980 to October 8, 1980, Respondent Charles Schwab & Co., Inc. failed reasonably to supervise, within the meaning of Section 15(b)(4)(E) of the Exchange Act, a registered representative in its Newport Beach Branch Office who, during the relevant period, wilfully violated antifraud provisions of the Securities Act and of the Exchange Act.

III. THE PUBLIC INTEREST

Respondent Schwab correctly notes that a finding of failure to supervise does not require the imposition of a sanction under Section 15(b)(4)(E) unless imposition of a sanction is determined to be in the public interest. In light of the great importance of proper supervision in the overall Congressional system for providing investor protection and confidence in the securities markets, and in view of the findings herein indicating a serious failure to afford reasonable

supervision in various respects and at various levels [12/] within the Schwab firm, during the relevant period, which failure resulted in a serious and extensive fraud by one of its employees, I conclude that an appropriate sanction is required in the public interest.

In its opening brief the Division recommends ". . . that the Respondent be censured and ordered, prior to opening any more branch offices or within a six-month period, whichever is shorter, to: 1) give direct and formal training to all its branch office cashiers at the Home Office in all firm policies, practices and procedures relating to the cashiering functions; 2) develop and implement written procedures to monitor any

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12/ In firing the NBBO Branch Manager, Schwab wrote him in part as follows (Ex. 4e):

> 1. Although we do not intend to imply that you have any personal involvement in the Arture matter, which has resulted in considerable financial loss to the firm and our bonding company, extraordinary legal and administrative expenses, and has the potential of seriously damaging the firm's image, the fact remains that, as manager of the office you did not institute the proper internal controls to preclude the occurrence of such an incident. We are, likewise, most distressed that the unorthodox actions of your assistant manager, of which you were aware, did not cause you to initiate an investigation; specifically, that no apparent action was taken when you became aware of Mr. Arture's serious financial situation and the large amounts of funds passing through his account. We fully subscribe to the directions of our various regulatory authorities that a manager must not only be aware of the activities of his staff, but must provide the proper supervision of the office to ensure a smooth running operation which is in compliance with all internal procedures and external requirements. Unfortunately, we found almost no evidence of this expected managerial activity in the Newport Beach office.

contact between account traders and customers; 3) require that all Branch Managers and Assistant Branch Managers who have not received formal training since October 1978, undergo training conducted at the Home Office in all phases of firm policies, practices and procedures, and; 4) implement a program of annual branch office audits to insure compliance with all policies, practices and procedures."

In its reply brief, after the Respondent in its brief questioned the legality of applying dual sanctions (i.e. both a censure and limitations upon the activities of Respondent) as well as the legality of requiring affirmative acts of the Respondent, as distinct from requiring it to abstain from proscribed activities, the Division urges as alternative sanctions that Respondent be censured and indefinitely prohibited to open any new branch offices, with a provision that Respondent could at an appropriate time apply to the Commission to have the restriction upon opening new offices lifted or rescinded.

I do not reach the legal question regarding "dual" sanctions since I conclude that the public interest will be adequately served by the imposition of limitations upon the activities and operations of the Respondent for a prescribed period without adding to that remedy the lesser sanction of a censure. Nor do I reach the question of whether Respondent may legally be required to perform affirmative acts since the limitations I find to be adequate under all the circumstances

will not require Respondent to perform any affirmative acts unless it should voluntarily elect to do so in order to avoid incurrence of the limitations that will otherwise apply.

The Division points to a number of securities regulation violations by Respondent in the past. However, these do not appear to be remarkable either in type or in number given the size of, and number of branches involved in, Respondent's operations. Nor are they the types of violations that were directly the results of failures to supervise. For that reason the prior violations are not deemed to be particularly significant as an aggravating factor.

The Division's alternative suggestion of an indefinite suspension of Schwab's ability to open new offices is too Draconian a remedy to be warranted in the public interest and would also raise some of the same objections that apply to the initially suggested sanction, as found below. 13/

The sanction suggested by the Division in its initial brief -- that Schwab be required to take four specified actions before opening any additional branch offices or in any event within six months time -- appears to me to be impractical in that it would commit the Commission's limited

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13/ Opening new offices involves considerable planning for office space, commitment to existing and intended personnel, and other matters that it would be unreasonable to interrupt in mid stream absent the strongest kind of showing that other sanctions could not be effectively employed.

staff and resources in necessary follow-up investigations to ascertain whether the steps proposed to be mandated had in fact been carried out, quite apart from the question raised by Respondent's argument that affirmative programs of this kind may not legally be mandated in the guise of imposing "limitations" upon its activities. The Division's proposed formulation of requirements would overly and unnecessarily substitute the Commission for Schwab as the architect of Schwab's supervisory procedures and its system for applying such procedures and for discharging the duties and obligations incumbent upon it under such procedures. Given the diversity in the ways in which broker-dealer firms conduct their businesses, they should be allowed considerable discretion in how they meet their statutory obligations to provide reasonable supervision.

Apart from these other considerations, I am not satisfied that certain of the requirements that would be imposed under the Division's recommendation are necessary or desirable. For example, while it is common knowledge in the securities industry that a number of discount broker-dealers for business reasons monitor conversations between customers and their registered representatives by taping them, there is no evidence in this record to suggest that that form of monitoring or any other form of monitoring <u>all</u> contacts with customers is necessary to an adequate system of supervision. As another

example, the matter of whether training programs are carried out at a firm's home office or its branch office, or in a combination of such places, is best left to the firm involved, so long as the method selected is reasonably designed to be effective.

Respondent Schwab contends that any supervisory deficiencies it may have had during the relevant period have been eliminated by changes made in various procedures respecting supervision. While the record does indeed contain evidence of some such changes it falls short of establishing convincingly that all changes in supervisory procedures that may reasonably be required to afford reasonable safeguards against the recurrence of an Arture-type fraud have been made and, just as importantly, as argued by the Division, there is scant evidence in the record to show that Schwab has a system for application of such procedures that will afford reasonable assurance that the duties and obligations incumbent upon Respondent under such procedures and system are in fact being carried out.

In light of the multiple considerations discussed above, it is concluded that the public interest will best be served by fashioning a sanction that will forbid Respondent Schwab to open or to serve new accounts for a prescribed period with a proviso that it may elect to attempt to avoid the incurrence of that sanction by taking certain steps that would provide reasonable indication that its supervisory procedures and implementing policies in fact currently are

consistent with meeting the statutory requirements.

The utilization of the feature of this proviso is suggested by the evidence in the record, already referred to above, that in conducting the 1980 annual audit of Respondent its outside auditors, DH&S, studied the firm's internal accounting controls, including its internal audit procedures, only to the extent considered necessary to evaluate the system for purposes of expressing an opinion on the Company's financial statements and not to the extent that would be necessary to permit expression of an opinion on the system of internal accounting control taken as a whole. It would appear that provision for a special study of Respondent's internal accounting controls, including its internal audit and other relevant procedures, from the point of view of determining their consistency with meeting the supervision requirements of Section 15(b)(4)(E) in terms of affording reasonable assurance against a recurrence of an Arture-type fraud, by an independent outside certified public accountant would be a desirable option to afford to the Respondent as an alternative to incurrence of the mentioned temporary limitations upon its activities. If the option is utilized and successfully carried out the public interest will be adequately served; if Respondent elects not to have the special study made or its results prove to be negative, the temporary limitations on Respondent's activities will operate as an adequate sanction in the public interest.

IV. ORDER

Accordingly, IT IS ORDERED as follows:

Effective July 2, 1984, or on such later date as this decision may become final, Respondent Charles Schwab & Co., Inc. shall limit its activities and operations by ceasing to open or service any new customer accounts or to negotiate for the future opening of new accounts for a period of 30 calendar days: Provided, however, That if on or before June 30, 1984, Respondent Schwab shall have complied with each of the following conditions, the aforesaid limitation on its activities and operations shall be deemed to have been rescinded nunc pro tunc:

(1) Respondent must engage at its expense an independent certified public accountant, qualified by experience to perform such a study, to perform a special examination and study of Schwab's internal accounting controls, including its internal audit procedures and other procedures, policies and practices relevant to a determination of whether such controls, procedures, policies, and practices are consistent with meeting the supervision requirements of Section 15(b)(4)(E) of the Exchange Act with respect to the general type of fraud found herein to have been committed.

(2) Such examination and study must be completed on or before June 30, 1984 and its results must be positive, i.e., the certified public accountant must certify that Schwab's

controls, procedures, policies and practices are consistent with meeting the requirements of Section 15(b)(4)(E) with respect to the general type of fraud found herein to have been committed. The report shall state the nature of the study and investigation made and the basis for its conclusions.

(3) The taking of an appeal from this decision to the Commission by either party or a decision by the Commission to review this decision on its own initiative shall not operate to extend the completion date prescribed in paragraph (2) above nor shall review of this decision by the Commission, however instituted, preclude the Respondent from attempting concurrently to meet the stipulations of this proviso, so long as the stipulations are met on or before June 30, 1984. The time stipulations in paragraphs (2) and (3) stem from the strong public interest in an early determination of the adequacy of Schwab's current supervision in the event Respondent chooses to pursue the option afforded in the proviso regarding sanctions.

This order shall become effective in accordance with and subject to Rule 17(f) of the Commission's Rules of Practice, 17 CFR §201.17(f).

Pursuant to Rule 17(f), this initial decision shall become the final decision of the Commission as to each party who has not, within fifteen (15) days after service of this initial decision upon him, filed a petition for review of this initial decision pursuant to Rule 17(b), unless the Commission

pursuant to Rule 17(c) determines on its own initiative to review this initial decision as to him. If a party timely files a petition for review, or the Commission takes action to review as to a party, the initial decision shall not become final with respect to that party. 14/

David J. Markun
Administrative Law Judge

Washington, D.C.
December 28, 1983

14/ All proposed findings, conclusions, and supporting arguments of the parties have been considered. To the extent that the proposed findings and conclusions submitted by the parties, and the arguments made by them, are in accordance with the findings, conclusions and views stated herein they have been accepted, and to the extent they are inconsistent therewith they have been rejected. Certain proposed findings and conclusions have been omitted as not relevant or as not necessary to a proper determination of the material issues presented. To the extent that the testimony of various witnesses is not in accord with the findings herein it is not credited.