

# NEWS

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Investor Protection:  
The First Line of Defense

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INVESTOR PROTECTION:  
THE FIRST LINE OF DEFENSE

I am very pleased to have the opportunity to address this gathering today and would like to thank the faculty of Brooklyn Law School for their kind invitation to attend. I wish to talk to you today about self-regulation, a concept that has received much attention of late.

Today, changes in market conditions are raising challenges for the securities industry, challenges that are multifaceted and complex. While the pace of initial public offerings and the boom in trading volume has slowed somewhat, the pace of change in the securities industry generally has accelerated. The securities markets themselves, both primary and secondary, are changing under the pressure of increased competition. We are witnessing new distribution techniques, and the widespread use of automation. At the same time, the industry's genius for developing new securities products continues, bringing an ever wider array of types of securities into the markets, particularly in the derivative area. There are now options on stock indices, options on foreign currencies, and the Commission will consider shortly whether or not to permit trading in standardized options on stocks currently traded in the over-the-counter market.

As you can well imagine, this expansion and rate of change create problems for regulators. Our resources are decreasing in both absolute and relative terms. But, this whirlwind of activity also carries with it additional burdens for broker-dealers: principally the challenge of maintaining

adequate supervisory and investor protection standards while improving the cost efficiency of their operations. I believe that effective enforcement of the securities laws is a crucial factor in maintaining investor confidence in the integrity of our markets. The question remains -- what constitutes the most effective means of enforcement? Right now, we have a system of self-regulation with SEC oversight, a system that works well, but could work better.

Therefore, the securities industry in its push for greater productivity should give due regard to insuring investor protection through effective internal controls. While the surveillance and enforcement efforts of the Securities and Exchange Commission and the self-regulatory organizations (the exchanges and the National Association of Securities Dealers) are still of paramount importance in ensuring the integrity of the securities markets, broker-dealers themselves remain the first line of defense.

The past couple of years have not been particularly good ones for most brokerage firms, especially compared to the boom years of the late 70's. Most were plagued by poor financial performance. Therefore, it is understandable that many undertook cost-saving measures. Many firms reorganized, registered representatives were terminated, those who remained were "encouraged" to increase productivity, and the number of investor complaints rose. Coincidence? Frankly, I don't know. While I recognize that hard times bring disgruntled investors who've lost dollars out of the woodwork, I believe that hard times also provide an

incentive for brokerage firms to shirk some of their supervisory responsibilities in favor of improving the bottom line on their balance sheets. I also believe that there may be a tendency to give big producers, the money makers, freer rein.

With all these "I believes", you may well question whether I have a factual basis for my beliefs. Let me tell you how I've reached these conclusions. First, for the past nine months as a Commissioner, I've sat at weekly meetings during which I and my fellow Commissioners have deliberated and decided enforcement matters. Some of these cases have involved broker-dealers that seemingly have turned a blind eye to fraudulent sales practices by employees that are producing significant profits for their firms by generating substantial commissions for themselves. For example, you may have read last week that the SEC censured a major brokerage firm for failing to supervise adequately one of its branch offices in the mid-West. The branch had engaged in "overly aggressive" options sales resulting in customer losses of \$780,000. In its administrative order, the Commission noted its concern "about the inherent tension between productivity and adequate supervision in light of the competitive conditions presently confronting the securities industry. A production-oriented policy raises the concern that some broker-dealers may overlook compliance related difficulties by employees who are top salesmen."

When I combine the knowledge I have acquired when wearing my "enforcer hat" with that which I have gained from letters received from small investors, my conclusions that there

are problems brewing in the sales practice area, which may be indicative of a failure to supervise, are reinforced. Not only have I heard from investors, I have heard from current and former brokerage firm employees. Let me take a few minutes to recount for you some of the anecdotal information I have received.

One former broker from a major firm described an incident involving instructions from his branch manager to all of the account executives in his office to double the previous month's sales. If a customer asked to purchase, for example, 100 shares of IBM, the representative was told to be sure that 200 sales were ultimately sold. This broker also described a time when personnel at a branch office were told that the firm wanted to eliminate a significant amount of stock from its own inventory and that if the stock was not sold by the following day, "heads would roll". I have also heard stories about branch managers sitting on a representative's desk for 20 minutes while the representative made "cold calls". Finally, the supervisor asked the salesman if he knew where he would be working the following week. I could go on with similar stories, but those are enough to give you a flavor of the type of atmosphere I am told is pervasive in the industry today.

One cannot disregard one final factor when evaluating pressures affecting internal controls in the securities industry today. As you all know, typically a registered representative's compensation is a percentage of the gross commissions he or she brings in. These payouts have always increased incrementally with the amount of commissions earned. Recently, however, firms

have lowered payouts for those at the low end of the commission production scale while maintaining the same payout schedules for those at the scale's upper end. Furthermore, minimum production levels are being set.

I wish to emphasize that I am not questioning the wisdom or appropriateness of any particular cost reduction or productivity enhancement measures taken by a broker-dealer firm. How these firms organize themselves and compensate their personnel is their concern, not mine. My concern is that supervision not take a backseat to productivity.

Therefore, I have concluded, the SEC must adopt and maintain a high profile in ensuring that broker-dealers are aggressively supervising their employees. Section 15(b)(4)(E) of the Securities Exchange Act of 1934 is the statutory hook by which the Commission enforces the "duty to supervise" imposed on broker-dealers. In discussing this legislation when it was first proposed, then-Chairman Cary, in emphasizing that firms as well as individual brokers would be held accountable under the statute, said to the House Subcommittee of the Committee on Interstate and Foreign Commerce:

"Concern has been expressed that the effect of these provisions will be that individual salesmen will be disciplined, while their firms go undisturbed. Let me assure this subcommittee that this bill is not intended to, and in no way will, relieve firms of their legal or moral responsibility for the conduct of their personnel or replace Commission discipline of firms with discipline of individuals only. Indeed, the bill expressly codifies the Commission view that a failure to supervise is a basis for proceeding against a firm. In nearly all cases, action will be taken against both firms and individuals.

Only in the relatively unusual case where it is clear that no administrative sanction against the firm is warranted will action be taken solely against individuals . . . .  
(emphasis added).

Chairman Cary's words still ring true today. Entities, of course, act only through their employees. Therefore, an entity cannot seek to avoid liability for the actions of its employees, while it reaps the benefits enuring to the firm by virtue of the employees' activities. It is, therefore, incumbent upon management of broker-dealer firms to supervise effectively each and every employee. A watchful eye must be kept on rookie registered representatives, on the seasoned brokers who are big producers, on the back office personnel, on clerks, and on managers -- no one can fall outside of the oversight chain.

I view the structure of the enforcement of the federal securities laws, at least with respect to market regulation, as a pyramid. At the top of the pyramid is the SEC, the federal watchdog. At the middle level are the SRO's, and finally, at the largest, and perhaps most important level, are the broker-dealer firms themselves. It is at this level that customer protection begins. Working together, the three tiers of the pyramid are responsible for maintaining the integrity of the securities markets and investor confidence in those markets. A propos of investor confidence, there has been much concern expressed of late about the flight of the individual investor from the market. The then-Chairman of the Securities Industry Association, Richard Jenrette, voiced such a concern at the SIA's annual meeting last November. Some speculate that the increased participation in the

marketplace by large institutions is the cause of this defection. It is said that the individual investor fears that he does not stand a chance to succeed in a market dominated by the big dollars and superior knowledge of institutional traders. This may, indeed, be one of the reasons the individual investor has left the market; but, I think he may also be leaving the marketplace because he senses that his broker, a one-time ally, can no longer be counted on to provide the experience, information, and counselling necessary for successful investment strategy. Perhaps, if we can restore a sense of trust between broker and investor, the individual investor will return to the marketplace, thus ensuring maintenance of the depth and liquidity for which our capital markets are reknown. I am suggesting that the securities industry itself can go a long way to increasing investor confidence by eliminating back-office problems and sales practice abuses.

You may be wondering if I really expect an executive vice-president or general counsel of a major firm in New York personally to keep supervisory tabs on a single account executive out in Boise, Idaho. Well, obviously he can not. But, he can keep track of his compliance and internal control systems and take steps to ensure that they work in every case. Close supervision can be implemented in a decentralized environment. It has to be.

A firm's first obligation is to have written procedures, both for representatives and for the supervisory chain of command. Obviously, the next obligation is to use those procedures. Records must be kept, and they must be examined with regularity



by branch managers. Periodic reviews of customer accounts must be conducted, not just for the broker who is not making money, but also (perhaps more importantly) for the account executive who is generating huge commissions. (In which instance, do you think one is more likely to spot sales practice abuses, say, for example, churning?) Inspections of entire branches must be undertaken. And, if irregularities or questionable practices are uncovered, they must be investigated expeditiously and thoroughly, and above all, acted upon. You are absolutely right if you think this all sounds like common sense and good business practice. But my experience is that recordkeeping at many firms is not what it should be. Moreover, the Commission uncovered one instance where written reports of discipline problems with a particular registered representative forwarded to the home office of a firm over a period of years were supposedly filed away by a clerk without anyone reading them. I would call that a significant breakdown in the system. Finally, there is some indication that such problems are ignored at all levels -- especially when a thorough investigation may jeopardize (short-term) profits.

Training and education are also of vital importance. According to my sources, training programs at many firms are now shorter, and the emphasis is clearly on selling, rather than the legal obligations of a representative to his customer. I believe, though, that firms will soon learn that they cannot use young "trainees" as scapegoats for sales practice abuses -- the firms will also be held responsible.

Obviously, education and training cannot stop at the account executive level. Branch and regional managers must have the necessary expertise to supervise, to ensure that suitability rules are not overlooked, account information is accurate, and customer records are reviewed, to name just a few areas where supervision has been deficient. Final supervisory responsibility rests with the compliance staff at the headquarters office of every firm.

Home offices must establish procedures and insure their enforcement through comprehensive examinations and oversight. When problems are brought to the attention of the home office compliance personnel, they must pursue vigorously an investigation and a remedy. It may surprise you to learn that there are occasions when home office personnel were apprised of egregious practices in the field and simply ignored them for years. A firm must not only detect irregularities, they must follow-up and keep a continuous watchful eye on branches of employees with a history of problems.

Unfortunately, the Commission's resources are limited, and it cannot pursue every case involving violations of the law by single registered representatives. Therefore, we must rely to a greater degree on the brokerage firms to police their own ranks. Should the first line of defense prove insufficient, the inspection and oversight capabilities of the various SRO's help to insure investor protection through effective supervision of member firms. SRO rules require members to maintain elaborate written procedures, particularly with respect to supervision.

SRO initiated examinations and enforcement actions further promote effective supervision.

While I firmly believe that the self-regulatory system is a good one, it is up to the Commission to step in, in an enforcement context, to deal with sales practice abuses. The statute, in its current posture, grants the Commission the needed flexibility to pursue either individual violators or their employers. In many instances, where a breakdown in supervision has facilitated the sales practice abuse, action is warranted against the representative, the firm, as well as against individual supervisors.

I, and my fellow Commissioners, do not take lightly the impact that an SEC action has on brokerage firms. We are fully cognizant of the ripple effect that a civil injunctive action or an administrative proceeding, and the resulting publicity, can have on a business' reputation. Therefore, before we make a determination to charge failure to supervise, we consider many factors, and no enforcement proceeding is ever authorized without a thorough analysis of all the issues -- both factual and legal. However, this concern cannot be permitted to overshadow our obligation to protect investors.

Section 15(b)(4)(E) is an important and effective tool in the Commission's arsenal. It allows the SEC to fulfill its Congressional mandate to protect investors in a number of significant ways. The goals of both remedial enforcement and future deterrence are promoted by actions alleging failure to supervise.

While a sound system of supervisory controls is important to the success of any profit-making organization, it is particularly critical to the securities industry where customers rely on a firm's integrity when they hand over their savings for investment. A breakdown in these controls may result not only in monetary loss to the customer and the firm, but a loss in the integrity of the firm, the industry, and the market as a whole. Consequently, it is important for the Commission and the self-regulatory organizations, through their enforcement programs, to remind firms of their continuing duty to supervise their employees.

Thank you.