

TESTIMONY OF DAVID P. DOHERTY
EXECUTIVE VICE PRESIDENT, ENFORCEMENT
NEW YORK STOCK EXCHANGE, INC.

before the
Subcommittee on Oversight and Investigations
of the
House Financial Services Committee

“Regulation of Broker-Dealers
and the Matter of Frank Gruttadauria”

May 23, 2002

Good morning, Chairwoman Kelly and members of the Subcommittee. My name is David Doherty and I am Executive Vice President for Enforcement at the New York Stock Exchange. I appreciate the opportunity to talk to you this morning about how the New York Stock Exchange regulates our member firms, and to provide some information about actions we have taken concerning Cleveland broker Frank Gruttadauria and others associated with him.

The New York Stock Exchange is committed to strong and effective regulation of our member firms to protect investors, the health of the financial system, and the integrity of the capital formation process.

The Exchange is proud of our regulatory program. We believe our program has proven to be an effective way to promote investor protection and ensure the financial, operational and sales practice integrity of our member firms.

Regulation of the securities industry in the United States depends upon self-regulation. While self-regulatory responsibility begins with the broker-dealer, the Exchange plays a critical role by maintaining an extensive system for monitoring and regulating the activities of its membership. The Securities and Exchange Commission (SEC) oversees these activities, and we work closely with the staff in the SEC Divisions of Enforcement and Market Regulation and the Office of Compliance Inspections and Examinations.

The Regulatory Group of the Exchange consists of three divisions: The Division of Member Firm Regulation (MFR) -- responsible for the financial, operational and sales practice regulation of member organizations; the Division of Market Surveillance -- responsible for surveillance of all trading activities on the Floor of the Exchange; and the Division of Enforcement -- responsible for investigating and prosecuting violators of Exchange rules and the Securities Exchange Act of 1934 and the rules thereunder. Currently there are approximately 560 people in the Regulatory Group representing approximately one-third of the Exchange's staff, with an operating budget of approximately \$142 million.

EXAMINATION AND SUPERVISION OF BROKER-DEALERS

The Division of Member Firm Regulation (MFR), with a staff of approximately 265, among other activities, oversees approximately 260 member organizations that deal with the public. These organizations service nearly 93 million customer accounts, operating from over 21,000 branch offices around the world and employ approximately 157,000

registered personnel. The firms that we regulate account for more than 85% of the public customer accounts carried by broker-dealers in the United States.

Member firms that do business with the public are required to file annual audited financial reports with the Exchange. Additionally, monthly reports, known in the industry as FOCUS Reports, provide detailed financial and operational information. These are filed electronically with the Exchange and are analyzed by an Exchange automated financial surveillance system to identify any emerging financial or operational problems. MFR also receives detailed complaint information through required filings that is used to identify significant sales practice trends. Through these reports, periodic surveys, and discussions with our member firms, MFR surveillance staff remains knowledgeable about the firms to which they are assigned responsibility.

The surveillance staff is responsible for monitoring their assigned firms' financial, operational and sales practice conditions and for alerting Exchange management of any adverse changes. At the first sign of a problem, meetings are held with firm management in order to assess the extent of the problem. Depending on the circumstances, management may be required to provide a corrective action plan. Additionally, firms may be subjected to special examinations, intensified surveillance and/or monitoring for the corrective action of prior problems. Special problems or those meeting the alert or early warning criteria are reported to the Financial and Operational Surveillance Committee of the Exchange's Board of Directors, as well as to the SEC, Securities Investor Protection Corporation (SIPC) and other SROs.

MFR conducts two types of on-site examinations of firms with retail accounts. To carry out these exams, MFR uses a range of techniques that include comprehensive computer analysis as well as field examination visits.

The Financial and Operational Unit (Fin/Op) conducts annual on-site financial exams of every firm that deals with the public. The primary objectives of these exams are to address the safety of customers' assets, the firm's financial and operational viability, and its sales practice compliance.

The Sales Practice Review Unit (SPRU) examines firms on a cyclical basis to determine compliance with Exchange rules and federal securities laws governing the handling of customer accounts. Each year SPRU examines the eight largest member firms based on the number of customer accounts, as well as any member firm identified as a particular risk that year. The next six largest member firms are examined on a biennial basis, and any firm referred by Fin/Op for sales practice concerns, as well as all other member firms are examined on a four-year cycle. Additionally, in years in which the SPRU examiners are not conducting an examination of a particular firm, Fin/Op examiners include a less detailed sales practice review in their examination scope. Thus, sales practices are reviewed every year at firms that deal with the public.

In preparation for each examination, MFR uses a risk-based approach to determine the particulars of the examination scope for each firm. However, given the different focus of Fin/Op and SPRU exams, they use different criteria as part of this risk-based approach.

For example, at the time of a Fin/Op examination, MFR surveillance staff processes the firm's most current FOCUS Report through our Examination Scope Selector System.

This automated system subjects the report to 156 financial calculations to identify potential examination risks. The surveillance staff and examination staff assigned to the firm meet, together with their management, to develop a final examination scope for the firm.

Similarly, SPRU uses a risk-based approach to select which member firms to examine in a given year. The SPRU risk criteria are designed to identify areas of sales practice concern and risk in an effort to select a meaningful sample of member firms to visit. This approach assigns different weights to the various risk criteria. This has enabled SPRU to examine more frequently those firms that pose a greater risk and sales practice concern.

Moreover, in addition to visiting the main office of a firm, SPRU examiners visit some of the firm's branch offices each year. During each of the last three years, SPRU examiners have visited, on average, 200 branch locations across the United States. These branch offices are selected from among those meeting certain predetermined criteria. They are also chosen based on an analysis of such items as customer complaints, number of high profile registered representatives, commissions generated over a specific period, number

of active accounts during a specific period, number of restricted accounts in the office, number of account designation changes and/or order error and other factors that may be indicative of problems.

Visits to branch offices to detect problem registered representatives or violative conduct are an integral part of our sales practice program and we believe they also act as an incentive to maintain strong supervision over the sales activities of our members.

SPRU examiners also use a risk-based approach to determine which particular accounts and brokers to review. Account reviews conducted at the main office encompass accounts serviced by registered representatives throughout the firm; those reviewed during branch office visits are specific to that branch. Accounts also may be selected for review based on the examiner's analysis of several factors, including customer complaints, margin extensions, account designation changes and order errors. Specific brokers are selected for review based on the number of customer complaints against them and/or other criteria.

This risk-based approach to regulation means that, while all aspects of a firm's business operations or its branches and accounts are not subject to detailed inspection during every exam, MFR is able to concentrate on areas of greater potential risk to investors and to examine more frequently those firms or area within firms that present these risks.

The Exchange's examination program has greatly evolved over the past several years with regard to automation, which has led to a more efficient and effective program. Member organizations now file electronically required notices regarding customer complaints. We keep track of and analyze these complaints via an internal database. Technology has also enhanced the examination planning process by enabling us to perform a more meaningful and efficient review of data prior to the start of an examination.

In addition, both Fin/Op and SPRU examiners currently use laptops to assist in their on-site exams. The laptop has the final examination scope, as well as the relevant rules, regulations, corresponding interpretations and the general procedures to be followed in examining each area. The examiner has the authority to add additional questions or objectives to the exam while in the field, but needs supervisory approval to delete any planned work.

In 1999 an Electronic Communications Review was added to the SPRU examinations scope, which addresses, among other items, e-mail correspondence of registered representatives, use of personal computers, and unauthorized Internet communications.

Every examination includes an opening meeting with the firm's management concerning the firm's business in order to provide the staff with an understanding of the firm's procedures and controls, the types of records maintained and management reports produced. Through questioning, observation, and testing, the examiners assess

compliance with the rules governing the particular area under review. In addition, they seek to identify any material risk.

Examinations conclude with an exit review in which any findings and observations are discussed with the firm's management. Written examination reports are generally issued within 35 calendar days from the exit review. The reports cite any findings the examination team has made as well as the corrective actions indicated by the firm's management. Firms are required to respond in writing to confirm such corrective actions.

After each examination, serious or repeated violations are referred to the Exchange's Enforcement Division to consider possible disciplinary action. Any formal disciplinary action is made public in order to caution other firms to avoid similar problems.

ENFORCEMENT AT THE EXCHANGE

The Division of Enforcement, with a staff of 136, the majority of whom are attorneys, has a mandate to investigate and prosecute violations of the Securities Exchange Act of 1934, the SEC Rules promulgated under that Act, the Exchange Constitution, and the Exchange Rules by persons and entities within the member firm community. Within this regulatory framework, Enforcement focuses on certain types of conduct, including sales practice violations, financial and operational violations by members and member organizations and trading and Floor-related violations.

Enforcement receives information about possible violations from various sources, including investor complaints made directly to the Exchange and certain required filings by member firms. Member firms are required to report to the Exchange, among other things, when an internal investigation reveals violative activity, when the firm enters into a settlement of a customer complaint in excess of a specified amount¹, and certain types of disciplinary action taken by a firm against an employee. Enforcement currently receives over 10,000 such filings a year and reviews each one of them. A large majority of these filings relate to sales practice matters.

Enforcement may also commence an investigation as a result of referrals from our other regulatory divisions including Member Firm Regulation and Market Surveillance, as well as from the SEC. On certain matters, from the inception of the investigation, Enforcement works hand in hand with MFR or Market Surveillance or with the SEC. Enforcement typically carries a caseload of approximately 700 matters and initiates over 200 enforcement actions a year.

When we bring an enforcement action, the consequences are likely to be significant. Fines imposed on our member firms of \$250,000 or more are no longer unusual. Also, as part of a settlement, we often require an undertaking by the firm to conduct internal reviews and adopt new procedures designed to prevent a recurrence of violative activity.

¹ The specified amount for an individual is \$15,000; for a member firm it is \$25,000.

Sanctions against individuals are significant as well. More than half of the individuals that we suspend or bar each year are put out of the business for at least one year or more. Also, member firm and management responsibility for misconduct within a firm is very high on our priority list. We look closely at this issue in virtually all of our cases. In a typical year, more than 25% of the enforcement actions we bring are against firms or management officials at those firms.

The purpose of an investigation by Enforcement is to ascertain the relevant facts in order to determine whether violative activity has occurred and, if so, what action should be taken. In conducting its investigations, which are all non-public, Enforcement may request documents from member firms, employees of member firms, and other persons having information relevant to Enforcement's inquiry. Enforcement also typically interviews customers who may have been harmed by violative activity and takes the formal testimony of firm employees or other individuals with relevant information.

Following the completion of its investigation, Enforcement reviews the facts and determines whether any violative activity has occurred, and if so, decides whether to recommend enforcement action.

After enforcement action is authorized, we can proceed to file charges before an Exchange Hearing Panel, which may result in a contested hearing, or we may reach a settlement of the action with the respondent in lieu of a contested matter. Enforcement

actions result in a written decision by a Hearing Panel, which is published by the Exchange.

The short-term objective of an effective enforcement program is to catch the people who break the rules and sanction them. The long-term objective is to deter other violative activity, induce compliance, and ultimately enhance investor confidence in the integrity of the market.

THE GRUTTADAURIA MATTER

On Tuesday, January 22, 2002 Lehman Brothers officials advised the Exchange of a matter involving a producing branch office manager at Lehman Brothers' Cleveland Branch office who may have stolen a significant amount of customer funds. The Exchange was advised that Gruttadauria had mailed a letter to the Federal Bureau of Investigations, postmarked January 14, 2002 which arrived on January 17, 2002, indicating that for 15 years he had misappropriated funds through various methods from his customers at Lehman and his prior employers, including S.G. Cowen and Cowen.

The Exchange immediately put together a team including Enforcement attorneys and MFR examiners, and commenced an investigation of the matter. We asserted jurisdiction over Gruttadauria and required his appearance to provide testimony before the Exchange, and discussed the case with the Securities and Exchange Commission. By Thursday morning, January 24, the Exchange had staff on-site in the Cleveland Lehman branch office, in Lehman's main office in New York, and in S.G. Cowen Securities

Corporation's main New York office, gathering relevant information. Within two weeks we had taken the investigative testimony of over a dozen witnesses.

On February 5, 2002, when Gruttadauria did not appear to give investigative testimony as required, the Exchange issued charges against him for misappropriation of customer funds and failure to cooperate with the Exchange's investigation. On March 16, 2002, a hearing was held before an Exchange Hearing Board, which found that Gruttadauria had engaged in the misconduct alleged, and Gruttadauria was permanently barred from association with a member or member organization.²

We also issued charges on February 27, 2002, against William Kall, one of Gruttadauria's administrative and sales assistants in the Cleveland branch office, based on his refusal to answer certain questions during his sworn testimony before the Exchange. On May 14, 2002, a hearing was held before an Exchange Hearing Board, which found that Kall had engaged in the misconduct alleged, and Kall will be permanently barred from association with a member or member organization unless he complies with the Exchange's requests for testimony within 30 days.³

Also on April 23, 2002, Enforcement issued charges against Laurene English, Gruttadauria's long-time sales assistant, based upon her failure to comply with Enforcement's request for additional testimony. A hearing has been requested in this matter.

² Exchange Hearing Panel Decision 02-59, dated March 19, 2002

³ Exchange Hearing Panel Decision 02-103, dated May 15, 2002

It is worth noting that, originating with prior MFR examinations of Cowen, in 1998 Enforcement initiated enforcement action against Cowen & Company for violations of a number of Exchange rules and federal securities laws that involved a variety of both sales practice and financial/operational violations.⁴ A major focus of the case was the improper preparation, entry and maintenance of order tickets, and the failure to comply with margin requirements (Regulation T). Other violations included the failure to reasonably supervise branch office managers acting in the capacity of registered representatives, failure to review outgoing correspondence, failure to comply with research rules, failure to comply with discretionary account rules, failure to adhere to obligations with respect to allocating new issues, and supervisory deficiencies. Although we visited Cowen's Cleveland, Ohio office during one of the exams which underlie the Exchange's 1998 enforcement action, the main problems disclosed by these exams emanated from Cowen's Financial Square, New York and Boston, Massachusetts offices. Because these New York and Boston offices accounted for the bulk of the significant deficiencies in these earlier exams, MFR returned to these offices in subsequent SPRU exams to follow-up on the deficiencies noted. The 1998 Enforcement action resulted in an Exchange decision, by consent, in which Cowen received the sanction of a censure, a \$380,000 fine and a requirement to comply with an undertaking whereby Cowen committed to correcting certain procedural and supervisory deficiencies.⁵

⁴ At the time of Enforcement's action, Societe Generale had recently purchased Cowen's assets and the firm was then known as S.G. Cowen Securities Corp.

⁵ Exchange Hearing Panel Decision number 98-64, dated July 10, 1998

Pursuant to that undertaking, outside counsel for Cowen conducted a review to determine whether the firm complied with its commitments to address these deficiencies, including Cowen's agreement to enhance its corporate compliance functions. In 1999, outside counsel concluded in its report to the Exchange that Cowen had satisfied its undertaking in all material respects and made significant efforts in addressing the areas of deficiencies. As required by the Exchange, Cowen's Board of Directors and Chief Executive Officer also provided written representation that all actions referred to in the report were completely implemented.

Our investigation into the Gruttadauria matter is ongoing. To date the Exchange has taken the investigative testimony of over 25 witnesses. Our interest continues with respect to, among other areas, the potential responsibility of the firms involved, including the adequacy of their supervisory systems and procedures. One issue in our current investigation, of course, is whether the procedures affirmed in the Cowen undertaking report were actually put into effect and implemented. We are closely coordinating our efforts with the Enforcement Division of the SEC and have been cooperating with the FBI, as well.

INTERNAL CONTROLS SURVEY

Since the beginning of this year, the Exchange has undertaken a number of initiatives focusing on compliance systems and procedures at retail brokerage firms. These initiatives were partly in response to the Gruttadauria matter, but also reflect our

commitment to continually review, expand and improve our regulatory program to adapt to new information and technological advances.

Among these new initiatives was the creation of an Internal Controls Committee in Member Firm Regulation to address issues relating to possible supervisory and other weaknesses at our member firms. Another initiative was the distribution on March 11, 2002 of a comprehensive survey to 30 broker/dealers representing a cross section of our retail client-based member firms. This survey sought information about a variety of firm procedures, including those relating to the supervision of producing branch office managers, customer account address changes, transfers of customer funds, the use of personal computers at the office and the issuance of certain reports and materials to customers.

A key task of the Internal Controls Committee has been to analyze the results of this survey and develop a plan to appropriately address its findings. Among the actions being considered by the Internal Controls Committee are the adoption of new rules and/or amendments to existing rules, adding clarifications to existing rule interpretations, and the issuance of information memoranda to educate the member firm community. In addition, special examinations are being considered for certain firms, based on the results of the survey. Further, additional examination objectives have been added to the SPRU examination scopes to augment our review of issues related to producing branch office managers, customer address changes and the use of post office box addresses. Based upon information being developed in our on-going investigation, other additions to the SPRU examination scopes, as well as scopes for Fin/Op exams will be considered.

Let me assure you of the Exchange's continuing commitment to our strong regulatory program, which is a vital ingredient to investor confidence in our market.

Thank you again for the opportunity to testify today.