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FRAUD IN THE MICRO-CAPITAL MARKETS INCLUDING PENNY STOCK FRAUD

HEARING

BEFORE THE
PERMANENT
SUBCOMMITTEE ON INVESTIGATIONS
OF THE
COMMITTEE ON
GOVERNMENTAL AFFAIRS
UNITED STATES SENATE
ONE HUNDRED FIFTH CONGRESS
FIRST SESSION

SEPTEMBER 22, 1997

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FRAUD IN THE MICRO-CAPITAL MARKETS, INCLUDING PENNY STOCK FRAUD

MONDAY, SEPTEMBER 22, 1997

U.S. SENATE,
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS,
OF THE COMMITTEE ON GOVERNMENTAL AFFAIRS,
Washington, DC.

The Committee met, pursuant to notice, at 1:35 p.m., in room SD-342, Dirksen Senate Office Building, Hon. Susan M. Collins, Chairman of the Subcommittee, presiding.

Present: Senators Collins and Cleland.

Staff Present: Timothy J. Shea, Chief Counsel/Staff Director; Mary D. Robertson, Chief Clerk; Ian Simmons, Counsel; Dennis McCarthy, Investigator; Kirk Walder, Investigator; Lindsey Ledwin, Staff Assistant; Jeffrey S. Robbins, Minority Chief Counsel; Bob Roach, Counsel to the Minority; Rachel Sullivan (Senator Glenn); Jonathan Frenkel (Senator Glenn); Barbara Olson (Senator Nickles); Steve Diamond (Senator Collins), Bill Greenwalt (Senator Thompson), Ann Reh fuss (Senator Cochran); Michael Loesch (Senator Cochran); Kevin Franks (Senator Cleland); Wayne Howell (Senator Cleland); and Barbara Perkins (Senator Levin).

OPENING STATEMENT OF SENATOR COLLINS¹

Senator COLLINS. The Subcommittee will please come to order. We expect Senator Cleland to be with us very shortly, but in the interest of time, I am going to begin.

Today, the Subcommittee will launch an investigation of securities fraud into what is known as the micro-capital markets. For those unfamiliar with the arcane terminology of Wall Street, the micro-cap segment of the market includes small companies with relatively low market values. It includes but is not limited to penny stocks.

These hearings are both the continuation of a tradition and a look to the future. They are a continuation a tradition because of our Subcommittee's long history of investigating security scams aimed at small investors. They are a look to the future because we will be examining new and growing abuses in our capital markets.

These hearings are also timely. Last fall, Federal prosecutors charged 46 individuals with stock fraud in New York. In May of this year, a 20-State task force acted to shut down some of the worst of the firms engaged in stock manipulation. And less than 3 weeks ago, on September 4, the Wall Street Journal published a

¹ The prepared statement of Senator Collins appears in the Appendix on page 55.

lengthy story entitled, "Despite Reforms, Penny Stock Fraud is Roaring Back."¹ That story noted the very disturbing fact that investors may lose as much as \$6 billion annually due to penny stock fraud, more than triple the 1980's peak.

We conduct these hearings against the backdrop of a booming stock market and a new generation of unseasoned investors. Hidden beneath the rising tide of the market, micro-cap fraud represents a pernicious undercurrent that potentially affects thousands of American families. Many of these families are, for the first time, investing their hard-earned money to save for skyrocketing tuition costs, unforeseen medical expenses, and lengthier retirements. While we have the safest and the most successful capital markets in the world, the irony is that public confidence in our markets actually creates opportunities for con artists to exploit the unwary.

Micro-cap fraud not only harms the small investor, it also has the potential to harm small companies. As this type of fraud increases, the willingness to invest in emerging enterprises decreases and legitimate companies are denied the capital which is the life blood of our free market system.

How exactly do these scams work? Unscrupulous brokerage firms, often operating through intermediaries, purchase large amounts of stock in a small company. The stock is virtually worthless or of very limited value, but the brokers act to drive its price higher by aggressively cold-calling thousands of unsuspecting individuals, many of whom have little or no prior investment experience.

In repeated cold calls, the scam artists hammer away at the investor on the telephone, promising glowing returns and emphasizing the need for immediate action. The inevitable result of these aggressive sales tactics is to push the stock price higher, at which point the brokerage firms' insiders dump their shares, leaving the public with worthless securities and the brokers with millions in ill-gotten gains.

Scratch the surface of a stock manipulation scheme and you will inevitably find false or exaggerated information. If you doubt the potentially tremendous impact of false information, consider the \$6 billion Bre-X scam. In that instance, phony reports about the gold content of the company's mines drove the price of the stock from a few pennies to \$240 per share, until the fraud was exposed and the stock fell back down to earth. As you can imagine, the so-called unsophisticated investors who rode the stock down hit the ground with a thud.

Coercive cold-calling and spreading false information are not the only tactics used by boiler rooms engaged in stock manipulation. Other practices which I expect we will hear testimony on today include making unauthorized purchases in consumers' accounts, refusing to execute sell orders in order to maintain a stock's upward momentum, using unlicensed persons who are paid under the table for making sales, and bribing brokers to recommend the stock being manipulated to their unsuspecting consumers.

¹ Exhibit 5 appears in the Appendix on page 345.

One particularly troubling problem that we will hear about today is the difficulty that regulators have in driving unethical brokers out of the industry. When a boiler room operation is closed down, often after lengthy proceedings, it is unfortunately common for the employees to show up in a host of new firms. Not unlike a grade-B science fiction movie, killing one of these monsters only seems to create a new army of them. Our regulatory system must ensure that when a broker participates in this type of fraud, he or she is not allowed to remain in the industry and once again pick the pockets of unwitting investors.

There are a number of other regulatory questions that we must consider. For example, should the large Wall Street clearing houses that process transactions for penny stock brokerage firms have more of a role and responsibility in stopping fraud and manipulation in the micro-cap markets? How effective has the 1990 penny stock legislation been in limiting abusive practices? More specifically, since that legislation applies only to stocks selling for \$5 or less, has the fraudulent activity simply moved to somewhat higher price stocks, also traded in the micro-cap market? What more should be done to police the bulletin board markets?

While we are confronted with many complex issues, we are indeed fortunate to have an outstanding set of witnesses who are well-qualified to address those issues. We will first hear today from the Hon. Arthur Levitt, Jr., the distinguished Chairman of the United States Securities and Exchange Commission.

We will then hear from three individual investors who were victimized by fraudulent practices and who have kindly agreed to share their experiences with us.

Finally, we will hear from two other regulators, Mr. Barry Goldsmith, the Executive Vice President for Enforcement of NASD Regulation, the regulatory arm of the Nasdaq market, and Mr. Joseph Borg, the Director of the Alabama Securities Commission, who will present the very important perspective of the States.

As we proceed with today's hearings, as well as with future sessions on securities fraud, we should remember that this Subcommittee has a dual role. Mindful of Justice Brandeis's observation that sunlight is the best disinfectant, we have a responsibility to expose abusive practices so that the American people can be on guard against them.

We also have the obligation to determine whether our current regulatory scheme affords adequate protection to an ever-growing investing public. As I noted earlier, this Subcommittee has a proud tradition of looking out for the interests of small investors and I am determined, as the new Chair of this Subcommittee, to continue that tradition.

In carrying out our responsibilities, we are indeed very fortunate to have the participation of my colleague from Georgia, Senator Cleland. As Secretary of State, Senator Cleland oversaw securities regulation in Georgia, a State that has been in the forefront of the battle against penny stock fraud. His experience and his leadership and commitment in this area will be an invaluable asset to the Subcommittee.

I would now like to turn to the Senator for any comments that he might have.

OPENING STATEMENT OF SENATOR CLELAND ¹

Senator CLELAND. Thank you very much, Madam Chairman. Mr. Levitt, it is nice to see you.

Ladies and gentlemen, one of the wonderful pleasures of serving in the Senate is to serve with great talented people like Senator Collins, who has a flair for quotes. I often find myself quoting her. We are cosponsors of the McCain-Feingold bill, which has found a new life based on the full Governmental Affairs Committee. She had a great quote on the floor of the Senate the other day about the \$50 billion tax handout to the tobacco companies, a quote from Harriet Beecher Stowe, that "like Topsy, she was not born, she just was." I thought that was pretty good. I love your Brandeis quote now about sunlight is the best disinfectant. I think that is probably a great prelude to these hearings.

Senator Glenn would like to be here. He has a strong interest in the matters we will be discussing, but he asked me to be the ranking member here on our side.²

Madam Chairman and Members of the Subcommittee, it is a pleasure for me to be here today seeking information and, hopefully, some solutions to a major problem that has faced our country for years. I did serve as Georgia's Secretary of State and Commissioner of Securities for many years. I was responsible for administering Georgia's security laws and providing investor protection for our residents.

The securities markets are an integral part of our Nation's economy and we have experienced tremendous growth, as has been observed, in these markets. In fact, this year alone, the markets have reached an all-time record. Unfortunately, these successes have led to a tremendous increase in fraud and abuse.

In 1990, for example, only about 18 percent of all Americans were investing in equities. Today, I understand that some 31 percent of all Americans are now investing in equities and that one in three households now own securities. Just as recently as 1992, the daily share volume for the New York Stock Exchange and Nasdaq was only about 200 million shares a day. Today, the New York Stock Exchange and the Nasdaq market consistently trade in excess of 500 million shares. At the end of 1996, the market capitalization of Nasdaq was over \$1.5 trillion, more than a three-fold increase from \$508 billion at the end of 1991.

The securities markets would not exist without public confidence in the integrity of the professionals who work in and manage these markets. I salute these professionals and commend them for their efforts in promoting and encouraging a strong securities market that provides the capital to make our country grow and provide economic security for our citizens.

While there are justifiable criticisms of the markets, the purpose of these hearings is to deal with a few bad apples, not to force regulatory changes that would be burdensome and a hindrance to legitimate capital formation.

¹The prepared statement of Senator Cleland with attachments appears in the Appendix on page 58.

²The prepared statement of Senator Glenn appears in the Appendix on page 107.

The success of our markets is shown by the billions of dollars that change hands each day, either from a telephone call, a head nod, or a handshake, which clearly reflect the trust and confidence we have placed in their integrity. Should this integrity be replaced with mistrust, our confidence would erode in the markets, as well as the American economy would ultimately suffer.

We now have, beyond any doubt, the best securities markets in the world and it is very important we strive to keep these markets strong and the playing field level in order to give all of our investors an opportunity to be successful in the market. The confidence in our securities markets results, in part, because of the excellent cooperation that has existed between State and Federal Government regulators and self-regulatory organizations. This regulatory partnership has proven to be one of the most efficient and effective regulatory collaborations in the country.

Substantive securities regulation in this country began at the State level, as a matter of fact. It was in 1911, the State of Kansas enacted the Nation's first blue sky law. Other States quickly adopted their own version of such legislation. In 1929, as a result of the stock market crash, Congress began a series of legislative efforts that encompass the body of law known today as the Federal securities laws.

In the 1970's, a major cooperative effort was initiated between the States, the SEC, and the NASD and the stock exchanges. The results of this effort include a uniform competency exam that allow an individual to take one examination accepted in all the States, uniform registration forms that allow a firm or an individual to use the same forms for the States, the SEC, and the self-regulatory organizations, and a Central Registration Depository, CRD, that allows for an automated one-stop registration filing system.

Georgia was one of the initial supporters of the CRD. This registration and licensing process provides an efficient and uniform process that compliments the fundamental purpose of State and Federal securities laws to provide investor protection and foster the confidence that will encourage the investments necessary for capital formation, economic growth, and job creation.

For a regulatory program to be successful, you must have vigorous enforcement. When the securities laws were framed in the 1930's and 1940's, Congress wisely realized that there would never be enough "cops on the beat" in the form of government-paid securities regulators but that it would be necessary for the private bar to enforce the law on behalf of defrauded citizens. It is these attorneys who, in the words of SEC Chairman Levitt, "serve a crucial role as a deterrent and are a vital supplement to the Committee's enforcement resources."

In testimony before Congress and in court documents, the SEC has repeatedly emphasized the critical role of the private lawsuit. However, despite the best efforts of the SEC, the 50 State securities agencies, and the SROs, there continues to be an unacceptably high level of fraud and abuse in today's capital markets. Recently, top securities watchdogs in the United States have warned investors that the explosion in the stock market has brought a sharp rise in securities sales fraud and stock price manipulation.

At a town meeting in Los Angeles, Mr. Levitt cautioned that investors are "more vulnerable than ever to fraud." This concern has been echoed by others who point to a disturbing rise in the level of securities fraud and allege that organized crime is seeking a foothold in certain sectors of the marketplace.

What is unusual about the increasing evidence of wrongdoing in the stock market is that shady practices tend to go unnoticed in the days of a strong bull market. Usually, the misconduct is uncovered only after a sharp sustained market drop similar to that of 1987. This has the regulatory community wary about what it would face should the stock market collapse.

In the past 5 years, the number of stockbrokers doing business in the United States has grown by 50 percent, to some 650,000. However, during the same time period, the regulatory staffs of the Securities and Exchange Commission and the National Association of Securities Dealers grew just 18 percent.

Let us all understand who suffers in cases of security fraud. It is retirees living on fixed incomes, young families struggling to make ends meet and save for their children's education, teachers, factory workers, and bankers. Each day, devastating cases are brought to the attention of securities regulators, law enforcement officers, and the private bar. Indeed, I am convinced that financial fraud is a serious and growing problem.

Today's hearing will focus on micro-cap fraud, as Senator Collins has mentioned. This is a new and modern term we are famous for here in Washington for what we have known for years as penny stock fraud. In Georgia talk, we call it cheating and stealing.

In the late 1980's, as Secretary of State, I directed a series of public hearings to focus on the penny stock fraud taking place in Georgia. We heard substantial evidence about serious securities violations involving misrepresentations, omissions to State material . . . enough about illegalities. What they were doing was lying, cheating, and stealing and swilling our citizens out of their hard-earned money.

In the Governmental Affairs Committee, we have been looking at the campaign finance fraud and the terms hard money and soft money are used. Here, we are talking about hard money, the hard-earned money of our citizens and investors. Of course, this hard-earned money comes from them to provide capital for economic growth, not only that, but unfortunately, a lot of that money goes off to those who would line their own pockets for ill-gotten gain.

This led me, when I was Secretary of State, to recommend a series of changes to strengthen Georgia's securities laws. These recommendations were unanimously enacted as amendments to the Georgia Securities Act and gave my staff more tools to effectively deal with penny stock fraud.

In 1990, the SEC recommended and Congress enacted penny stock reform. The resulting reforms, both State and Federal, were effective for a few years. However, these crooks are clever. They accumulate their wealth by stealing, not with a gun but with a telephone and a fast line and often through threats and intimidations. It did not take long for them to figure out how to avoid the reform requirements.

Now we see the micro-cap fraud being perpetrated by rogue brokers making cold calls all over the country, promising people that they can get rich quick in today's growing market. They use the success of the legitimate market to demonstrate the misrepresented potential for trade in their presentations. They say whatever it takes to close the sale. They take advantage of honest, hard-working people trying to live the American dream who make honest money in the market.

I recognize the right of investors to seek legal remedies against those persons selling fraudulent securities. I have supported an investor's right to seek redress through mediation, arbitration, and civil litigation. While I worked to streamline the regulatory process in Georgia, I opposed amendments to Federal regulations that would have impaired the ability of a State to protect its investors. However, in 1995, as Secretary of State and Commissioner of Securities in Georgia, I opposed S. 240, the Private Securities Litigation Reform Act.

It appears that we are now seeing a move to preempt existing State securities laws by extending the Private Securities Litigation Reform Act of 1995 to the States. It is not yet clear whether this Act will provide sufficient protection to defrauded investors. The main concern here is if the courts ultimately interpret it in a way that makes recoveries under the Federal law impossible, State remedies will be the only means for defrauded investors to redress their injuries.

In the 19 months since its passage, the new Act has barely been tested, with no trials, no appellate decisions on substantive provisions, no summary judgments, and few decisions on any of its provisions. It will take more time to adequately assess this law's impact as the courts struggle to interpret its provisions.

The Congress did an excellent job of balancing competing interests in the adoption of the National Securities Market Reform Act of 1996. I have always favored improvements in the regulatory system that do not curtail enforcement efforts to protect investors. The current efforts by some industry segments to preempt a State's role in the registration and licensing of broker-dealers and sales representatives would seriously impede the authority of the States to protect their residents from unscrupulous firms and brokers.

I am confident that the SEC will find in its report that the States are an integral part of the regulatory process and that it would be a mistake to hamper our State regulators by removing their jurisdictional authority over broker-dealers. I have several suggestions as to where to go from here.

Investor education—I am interested in new and innovative ways to educate the public about the securities markets and the risks associated with investment opportunities. A program of this type must be fully supported by the regulators and the industry.

The CRD system—modernization of the Central Registration Depository should be one of the highest priorities of the regulators. Quality information made promptly available to regulators is often the key to a successful investigation and prosecution of violations. The CRD must be able to deliver both data and analytical reports in order for it to be successful as a regulatory tool. I encourage regulators to continue support for a viable customer complaint data-

base that will provide information that could be useful in multi-State investigations.

Another point is the administrative process. The administrative process provides regulators with the most effective tools to investigate misconduct and to discipline those firms and individuals who commit violations. However, regulators must not misuse or abuse the administrative process and the process must not be viewed as the ultimate weapon to deter fraud in the securities business.

Civil actions—the filing of civil actions against firms and individuals who commit violations appears to have been the remedy of choice for the SEC. I think it is time to study the effectiveness of the civil process in dealing with serious fraudulent conduct by such firms and individuals.

Criminal prosecution—the filing of criminal complaints and the seeking of indictments against rogue brokers and con artists will be the most effective tool to deter this type of criminal activity. I strongly encourage regulators to work with local, State, and Federal prosecutors in developing coordinated investigations and prosecutions. Also, State and Federal task forces could also provide a opportunity in demonstrating to criminals that justice will prevail.

The taping of sales presentations—I commend NASD for its recent recommendation to require certain firms to tape sales presentations by certain brokers. The taping of these potential problem brokers is a positive step toward better investor protection.

Cold call practices—this is not campaign finance here, this is stock brokering here. I also commend the regulators for their efforts to place some limitations and restrictions on cold calls. I encourage further monitoring and study regarding the control of cold calls.

Clearing firms—I question how many investors have been improperly influenced to purchase high-risk and speculative securities by using the name of a prominent firm that is merely acting as a clearing agent.

Disclosure—disclosure has always been, as Senator Collins, Madam Chairman, quoted Justice Brandeis, disclosure has always been the foundation for investors in making investment decisions. Regulators have done a good job requiring proper disclosure of material facts in registered offerings. In fact, some might say that the quantity of disclosure today may be a deterrent to real meaningful disclosure. Disclosure in the secondary markets, even by market makers, has not been effective. I realize that the use of the telephone and market volatility require prompt decisions. However, we must be sure to find a way for regulators to require that investors in the public markets be provided with sufficient information prior to making their investment decision.

The Internet—it is imperative that our regulators have access to modern technology and provide programs to monitor investment activities on the Internet. Cyberspace fraud will be the wave of the future.

The future of State regulation of securities—I support strong enforcement of our securities laws and I am confident the States must play a major role in these enforcement efforts. I want to encourage the States to be more flexible in licensing and registration procedures. I believe in using registration as an enforcement tool,

but I do not think that States should place unreasonable burdens on firms and individuals attempting in good faith to become registered in their jurisdictions. I have been informed of many such unreasonable and inappropriate tactics. In Georgia, I always insisted that my staff be fair and reasonable in registration and licensing matters and tough on fraud enforcement matters. In other words, reasonable regulation and tough enforcement.

Madam Chairman, thank you for enduring my remarks. This is the home of the filibuster. I am looking forward to hearing from Mr. Levitt and others on the ways we can improve our protection of our investors. Thank you very much.

Senator COLLINS. Thank you very much, Senator.

[The prepared statement of Senator Cleland follows:]

Senator COLLINS. Our first witness this afternoon will be the Hon. Arthur Levitt, the distinguished Chairman of the Securities and Exchange Commission. Prior to becoming Chairman of the SEC in July of 1993, Mr. Levitt served as the Chairman of the New York City Economic Development Corporation from 1989 to 1993 and the Chairman of the American Stock Exchange from 1978 to 1989. Prior to that, Chairman Levitt worked on Wall Street for 18 years. I would also note that Chairman Levitt was once the owner of a publication very well known here on Capitol Hill, the newspaper *Roll Call*: so he is truly a man of diverse talents.

We are truly fortunate that the Chairman could join us this afternoon and I look forward to his testimony. Because of time constraints, I am going to ask Mr. Levitt to limit his oral testimony to no more than 15 minutes. We will have lights to give you a sign of when you are getting low on time. In any case, your prepared testimony will be made part of the record.

Pursuant to Rule 6 of the Subcommittee, all witnesses who testify are required to be sworn, so at this time, I am going to ask Mr. Levitt to please stand and raise your right hand.

Do you swear that the testimony that you will give before the Subcommittee will be the truth, the whole truth, and nothing but the truth, so help you, God?

Mr. LEVITT. I do.

Senator COLLINS. Thank you. Mr. Levitt, you may proceed.

**TESTIMONY OF ARTHUR LEVITT, JR.,¹ CHAIRMAN, U.S.
SECURITIES AND EXCHANGE COMMISSION**

Mr. LEVITT. Chairman Collins, Senator Cleland, thank you for this opportunity to appear on behalf of the Securities and Exchange Commission before the Permanent Subcommittee on Investigations. The foremost mission of the SEC is to protect investors, and so we are especially grateful for the spotlight you have brought to bear on this important issue.

It is an unfortunate irony of history that the best markets bring out the worst elements. The higher the market, the greater investor optimism, the more opportunities for outright and outrageous fraud. The Chicago Tribune wrote that an aging bull market always brings the sleazier elements out of Wall Street's woodwork, and that was a year ago. As the market continues to soar to new

¹ The prepared statement of Mr. Levitt appears in the Appendix on page 112.

levels, each day brings us new challenges in fighting fraud, especially in the micro-cap and penny stock market.

These hearings are focusing on a matter of paramount importance to the investing public, and they could not come at a more opportune time. I commend you for bringing to these hearings the defrauded investors who sit with us today, because there is nothing worse for the integrity of our markets, there is nothing worse for the process of capital formation, which depends so extensively on trust and confidence in those markets, than the dishonesty, the distortions created by greed.

I think that even in the days since the printed version of my testimony was completed and submitted to the Subcommittee, our Commission's law enforcement efforts have pursued some of the most audacious frauds conceivable. I would like to give you a few quick examples.

Just last Tuesday, September 16, the Commission obtained emergency judicial relief from a Federal judge in California in the form of a temporary restraining order and an asset freeze against the Geneva Group and Nicholas Garcia. We charged the defendants with a classic pattern of micro-cap fraud, where a shell company with no apparent business operations was being sold to investors through high-pressure sales practices, pretending it was a legitimate company with wide-ranging business operations.

The following day, September 17, the Commission filed a securities fraud action in Federal court in California against five defendants, charging them with involvement in a fraudulent stock leasing scheme. The complaint alleges that the defendants acquired large blocks of restricted stock of 18 public companies, promising the companies that they would pay large monthly rental fees. After holding the stock for 1 year, the defendants promised to return the stock to the companies. The defendants then tried to sell the stock for property, money, or credit. The purchasers of the stock have suffered losses of at least \$9.5 million.

Finally, just last Thursday, in a tale frighteningly similar to a Hollywood movie script, the U.S. Attorney for the District of Nevada filed a detention motion against a penny stock promoter who is the target of an ongoing securities and bank fraud and money laundering investigation. This individual was arrested after recorded telephone conversations revealed a plot to arrange an accident for an accountant who was slated to testify against him at an upcoming trial.

Allegations of this nature, once relegated to what we used to call "street crime," send a shiver through our markets. This is not behavior that investors expect from market professionals, from corporate executives. It is not behavior that this Commission will tolerate.

I cite these recent cases because they are an indication of some of the problems facing both civil and criminal law enforcement agencies every single day, not to mention investors. The remarkable efficiency, credibility, and success of our capital markets today has attracted more and more con men and criminals. Our securities markets are still the most efficient and fairest markets in the world, and while we must be careful not to be unduly alarmist, the actions that we have already taken, coupled with the program I

will outline today, demonstrate the Commission's resolve to step up our regulatory and enforcement efforts in this area.

As these cases suggest, fraud among low-capitalization stocks frequently involves two different but related problems. The first is aggressive and often fraudulent sales practices, such as lying to customers or unauthorized trading in their accounts.

The second problem involves manipulation of micro-cap stocks by brokers, issuers, or promoters. These stocks are often traded in markets where there are no listing standards; and, in fact, often the issuer does not file financial reports with the Commission because it is so small.

The Commission is responding to fraud in the micro-cap market with a wide-ranging campaign focused on three strategies: prevention, enforcement, and regulatory initiatives. I will discuss each briefly in turn.

In terms of prevention, the Commission believes it is better to prevent fraud before the life savings of investors are destroyed than to simply punish the perpetrators after they have done their damage. To achieve this, we have conducted aggressive broker-dealer inspections as well as market and Internet surveillance.

It is not enough, however, for regulators alone to protect investors. We also have to give investors the tools to protect themselves. The best tool, in my judgment, is investor education, and that is why in recent years the Commission has developed an incredibly aggressive investor education program. We have created a Web site that offers SEC press releases, investor alerts, litigation releases, tips on avoiding fraud, and our huge EDGAR database of corporate information.

We have held 20 town meetings in cities all over America where thousands of investors come out and for 2 hours sit there and ask questions about their investments. We had nearly 6,000 investors in Los Angeles. We have had 2,000 investors near Hamden, Connecticut. All over the country, to see investors come and ask questions that they were embarrassed or ashamed to ask their brokers, truly tells you what is going on out there.

We have created a toll-free SEC hotline. We have developed a series of investor education brochures, and I am pleased to announce to you today the release of the latest such brochure, entitled "Cold Calling:"¹ It is going to be distributed to investors nationwide by the SEC and the North American Securities Administrators Association. We also have brochures on how to buy municipal bonds, how to buy a mutual fund, and how to pick a broker.

One other vital defensive tool for investors is the broker disciplinary database known as the CRD. We are going to do everything we can to help NASDR head Mary Shapiro fulfill her pledge to improve the CRD and make it available through the Internet.

We have stepped up both our civil and our criminal enforcement efforts. We are working with criminal authorities as never before, not merely to kick brokers who steal from innocent investors out of the business temporarily or permanently but to put them behind bars where they belong. We are sharing intelligence, pooling re-

¹ Exhibit 1 appears in the Appendix on page 269.

sources, and coordinating cases with our fellow law enforcement agencies.

In the last year alone, for example, we charged or prosecuted more than 80 individuals in a coordinated effort with the Department of Justice. We have also worked closely with the self-regulatory organizations, or SROs, State regulators, local prosecutors, and our foreign counterparts to maximize our resources and stop micro-cap fraud at its earliest stages.

Finally, we have undertaken a series of regulatory initiatives. Over the last several months, the Commission staff has worked with the New York Stock Exchange and the NASD to develop rules that address problems in this sector of the market. For example, we think that clearing firms should be more responsive to customer complaints and should provide more information about the conduct of firms whose trades they process. We are now considering a New York Stock Exchange rule that will address these concerns.

We are going to ask market makers trading and broker-dealers selling securities on the NASD's over-the-counter bulletin board and the National Quotation Bureau's pink sheets to obtain more up-to-date information about the issuer before they are allowed to quote or recommend a stock. We will also be asking the NASD to evaluate once again standards for securities of companies quoted on the Bulletin Board.¹

The SEC itself is taking a series of dramatic steps to combat micro-cap fraud and rogue brokers. We are putting the rules governing the micro-cap market under a magnifying glass to examine how well they have worked, how to plug the loopholes, and how to make them work even better. We are focusing greater attention not only on rogue brokers but on rogue firms, because boiler rooms belong in power plants, not in professional brokerage firms.

The keystone of this initiative is the creation of a special Commission-wide working group which will bring together SEC divisions and offices to find better ways to attack these frauds early on, before they have taken their toll on investors. If our Office of Compliance Inspections and Examinations finds a pattern of abuse of one of our small business exemptions, for example, they will immediately work with their counterpart from our Office of Small Business Policy to determine whether we should change that rule.

The SEC can do a lot, but, especially in this market, we cannot do it alone. That is why this morning I met with Dick Grasso, the head of the New York Stock Exchange, Frank Zarb of the NASD, and the head of the NASAA to ask for their support, as well. In meeting with them today, they each pledged their commitment to minimize abuses in the micro-cap market through joint initiatives with the Commission, the industry, and the States.

There is one other critical challenge presented by micro-cap stock fraud. We need to control the fraud without damaging the market for securities of legitimate small businesses. I have always been a fierce advocate of the interests of small business. I want to assure Senator Collins and the Subcommittee that I am not about to stop now. We are going to weigh the needs of small businesses very

¹ See Exhibit 19 describing subsequent NASD action taken on the Bulletin Board which appears in the Appendix on page 553.

carefully as we attempt to close some of the loopholes that have created these problems.

Madam Chairman, as I noted earlier, in a market like this, parasites crowd in to feast on the bull's success. While we are aware of the problem and actively addressing it, we are deeply, deeply grateful for your interest in focusing public attention on an issue so important. You have truly shown great leadership.

I look forward to working with you, not just today but in the future, and with your colleagues, to eliminate any of the abuses that you and Senator Cleland have mentioned and others that exist in the market today. Thank you for this opportunity.

Senator COLLINS. Thank you very much, Chairman Levitt.

In reading your written testimony and listening to your comments, it struck me that many of the practices that you describe, whether it is market manipulation or the high-pressure cold calls or unauthorized transactions or no net sales policies, sound very much like the practices of a decade ago when I was a cabinet official in the State of Maine with responsibility for a department that included securities regulation. Indeed, to give my friend from Georgia yet another quote, it does remind me of that old Yogi Berra line that it sounds like *deja vu* all over again.

This leads me to wonder whether the remedies that we have tried—whether it be greater disclosure requirements or electronic monitoring of trades—can only take us so far, since the business comes down essentially to how brokers treat their customers. So is it almost impossible to get control of these problems unless we raise the minimum competency levels and the ethical standards of the brokerage community.

I want to emphasize that the vast majority of individuals working in this field are ethical and are looking out for their investors' best interests; but we have had a continuing problem that does not seem to go away no matter how much we enact new administrative or regulatory or legal reforms.

So starting first with the competency issue, we have no minimum educational requirements and it has been suggested to me that passing the entry-level NASD exams can largely be a matter of just cramming and taking the test often enough. Indeed, when I harken back to my regulatory days at the State level, it truly was more difficult in the State of Maine to get a license as a cosmetologist than as a broker, even though one could argue that recovering from a bad hairdo is far easier than recovering from bad investment advice.

But in all seriousness, with brokers engaged in the business of advising people on what to do, in many cases with their life savings, where mistakes can have just absolutely devastating consequences, as we are going to hear from some of our witnesses later today, do you believe that competency requirements for brokers are sufficiently demanding?

Mr. LEVITT. Senator, you know, I was a stockbroker for a number of years, and I ran a branch office, and I managed thousands of brokers, and I have enormous respect for the profession. I think they have done remarkably well, and the vast, vast majority of the brokers in America today are extremely competent and the most

professional in the world. They account for the low cost structure in our process of capital formation.

I would say that today's brokers are better trained and better equipped than they have been at any other time in history. They not only have to take the qualifying examination to begin with, but through an initiative that was embarked upon jointly among the Commission, the Securities Industry Association, and the SROs, we imposed additional requirements for training and retraining in products that brokers sell—because today, it is not just stocks and bonds. It is options and derivative instruments and real estate and insurance and a host of other products, and those brokers have to be trained on a regular basis in both products and regulations.

I do not believe that the problem is a lack of training. I think there is some problem in terms of incentives that the firms give to brokers, which have up to now been largely quantitative, that is, the more the broker trades, the more he gets paid. That issue, too, has been addressed by the industry through the recommendations of the Tully Committee to create other kinds of incentives and to do away with some of the clear conflicts of interest, such as product-specific contests at various firms where a broker gets sent to Honolulu by selling more of a particular underwriting. They rarely exist any longer today. Very few brokerage firms offer incentives to brokers to sell the home-grown product any longer. But I think more work has to be done in this area. The Commission does not intend to legislate compensation, but we certainly intend to focus public attention upon it.

I do not think that the competency levels have to be raised. I think that the problem is not with the bulk of the brokers. The problem is with the really bad actors, that no matter what the competency levels were, these are dishonest, crooked people. We have got to kick them out of the industry and keep them out. We have to send them to jail. We have to work with the Justice Department, and this Commission for the first time has conducted joint efforts, and is presently conducting a joint and public effort with the Justice Department, to take brokers who have stolen vast amounts of money from their customers, and not merely to push them out of the industry but to have them wearing striped suits. That is where the effort has to be made, in my judgment.

Senator COLLINS. I really applaud the efforts that you are making to work with the Department of Justice and the State Attorneys General to bring more criminal prosecutions. But let me follow up on what you just said and ask your opinion on the whole issue of ethical standards.

It seems to me that as long as we tolerate a sales as opposed to a "fiduciary" mentality in segments of this industry, we are going to have problems. In addition, high ethical standards tend to result as much from tradition as from rules and that is difficult to change overnight.

But I do have one specific approach that I want to get your reaction to. Why not take a page out of the book of one of your fellow New Yorkers and institute a zero tolerance policy, making it known that one serious breach of the rules and you are out of the industry? As the Chairman of the SEC, you could send out the word that if you turn an account, you are out of the industry. If you know-

ingly execute an unauthorized transaction, you are gone for at least, say, 2 years.

If we are going to allow aggressive selling, the consequences of exceeding the limits should be severe and known to all in the industry. So why not announce a zero tolerance policy and then follow through with it? It strikes me that what has worked on the streets of New York might well work in its offices.

Mr. LEVITT. Well, I applaud the concern and interest that underlies that thought. This particular Commission has included among the foremost initiatives that we have pursued over the last 4 years, our efforts to drive rogue brokers out of the industry and to raise the standards of professionalism that are part of the industry.

I believe that a broker's impact on a person's life is every bit as great as a lawyer's, as his accountant's, and maybe in some instances as his physician's, so that I regard this with the same seriousness as you do.

The Commission has been approaching this in a number of new ways. We have made a major issue of supervision. Every broker who gets kicked out of the industry or gets suspended and who then comes back into the industry, represents a responsibility for a supervisor. If that broker becomes a recidivist and gets kicked out again, this Commission wants to hold his supervisor responsible. We have brought more supervisory actions than any Commission in history.

Now, the way we get at this issue is through a cooperative effort. Because of our limited resources, we can't do it by ourselves. Nor should we. Because we are talking about a culture, and that culture can be approached best, in my judgment, with a consensus approach with State regulators, who are the cops on the beat in the localities, which is terribly, terribly important, and with the SROs in the form of the NASD and the New York and the American Stock Exchanges. And they know that this Commission cares enormously about their level of tolerance of bad practices.

The committee that I have formed today is going to meet within the next 2 weeks to talk about tightening up on the practices. I do not know that it will decide to go to zero tolerance because I am not certain as to which offense or offenses should trigger that. While I think that churning is a heinous offense, I think there are others that are even worse.

But I assure you that the industry, working collectively and in the best fashion to change a culture, will bring about stronger penalties, stronger methods for getting at this problem. And the Commission will be absolutely relentless in terms of pressuring the industry to raise the standards to see to it that bad brokers do not enter, and no less can stay, in the industry. And we will move in the direction of zero tolerance. Whether we arrive there in one fell swoop is a different question.

Senator COLLINS. I really believe that is key, because every time we try to tighten up on the regulatory scheme through increased information or more monitoring, we are not really getting at the underlying problem. It seems to me that the SEC more than anyone, perhaps, has the ability to force the change in culture that you

have just described, and I applaud you for your willingness to send that message very clearly.

In a recent speech, or perhaps it was a newspaper, when you were talking about the role of the SEC and State regulators, you made what I thought was a very good point. You said that investors would be better protected if our response were triggered by complaints and not by job changes. Do we not need a system that will trigger action at the time that a disciplinary action is taken against a broker rather than when the broker changes jobs? For example, you could have an unethical broker stay with the same firm for a very long time. Then he or she is unlikely to come to the attention of regulators. The scrutiny comes when there is the job change and the relicensing process takes place.

I know that the CRD improvements offer some hope in this area, but could you elaborate on that?

Mr. LEVITT. Sure. The CRD is the Central Registration Depository. I am going to sound a little bit like a Ross Perot imitation here because I think it is important to get this out to investors. The telephone number for the CRD is 800-289-9999. This is a crucial part of our investor education effort.

Mary Shapiro, the head of the NASDR and a former Commissioner, made a courageous decision to discard the old system and design a new one. We are going to have full Internet access in 1998, and I want the entire project done by the end of 1999. By that time, I want 100,000 calls that we now get each year to increase to over a million. I want this to be one of the best-known 800 numbers and Web sites in America, 1-800-289-9999.

Senator COLLINS. Let me follow up on that point. When I was meeting with the investors, the victimized investors who will testify next, it occurred to me that one way we could help people who believe they are being ripped off or encountering problems is to require the account statements that are sent out to have a telephone number such as the one you have just described or perhaps the name, address, and phone number of one of the regulators or the NASD so investors know where to turn for help. Is that something that you would consider?

Mr. LEVITT. Yes. I think that is a good idea, and that is one of the notions that we talked about with the self-regulating organizations. How can we get information out to the public that tells them that you have got to be careful of this firm, that you have got to watch this broker, or here is the number that you should call, and please call it before you do business with a new broker that you have never met.

Now, I urge in every way, in every forum I get, that an investor who does business with a broker over the telephone that he or she has never met before is just making a terrible mistake. I encourage that linkage between a customer and a broker. Know your broker. Call up and find out whether he or she has had a regulatory problem, and do you really want to entrust your life's savings to someone who has been kicked out of the industry or disciplined or has been the object of hundreds of investor complaints?

That is what we have got to get investors to begin to do. The information is there. We are committed to making that information more visible, more available, more usable, and the form that you

suggest, I think, is a good one; and we are going to consider it. Whether the confirmation slip is already too jumbled to be meaningful, whether we are talking about a mailing that would go with the confirmation, I am not sure, but it is that concept of revealing to investors brokers who have a problem, is one that is high on our list of priorities.

Senator COLLINS. Let me ask you just one more question before turning to my colleague, Senator Cleland. Your new brochure is excellent. I was leafing through it as you were describing it, and I think it would, in fact, help investors to be very cautious. But I wonder how many investors are actually going to see this brochure. Would there be merit in requiring a broker or a brokerage firm which is doing a great deal of cold calling to be required to send this information out to people who are opening new accounts?

I am trying to think of a way to make sure that it gets to the people who need to read it. It is very good. It would certainly warn people of the dangers of responding to a cold call pitch. But if investors do not get it, if it does not reach them, then it is of little value. So what would you think of actually requiring investor education materials to be included with account statements or in some way distributed by firms that do a great deal of cold calling?

Mr. LEVITT. I think a phone in the hand of these cold callers is as dangerous to the public as a car in the hands of drunk drivers. Just the other day, a friend of mine told me of a cold call that he got at 7:15 in the morning, and he said, "How dare you wake me up at this hour." The broker said, "It is the early bird that gets the worm." It is that kind of cavalier approach that, I think, bears on a culture that has got to be discouraged.

We certainly are going to encourage wide distribution of that cold calling brochure. We are going to encourage it without forcing it. I think, again, the strategy of the Commission has been to mobilize the best instincts of the industry, which is mindful of these perceptual problems. The bulk of the firms in America today would have nothing to do with brokers who abuse the cold calling privilege, in effect, and it is only firms that are really outlaw firms that cast a reputational stigma upon the industry.

I think we have got to bring and encourage the NASD and the New York Stock Exchange to bring cases against violators of the cold calling culture. Cold calling is a function of American business, and I would not dare say no calling should take place. It should. It has an appropriate place.

Now, I think it is wrong, however, to have a battery of cold callers who may be kids in high school or in college who are not trained, who do not have to pass any of the tests that a broker has to pass, out there cold calling and turning the account over to a broker they work for or, indeed, illegally making the sale themselves. That we are going to nip in the bud. We are going to encourage cold callers to follow standards. A cold caller must be experienced, must know what kinds of clients qualify for a call and what kinds of representations to make.

So my long-winded answer to your question is, you bet we are going to encourage the broadest distribution by the firms and others of this kind of information. We are not going to regulate it, but we are going to encourage it in the strongest way we possibly can.

We are going to use our town meetings to do it. We are going to use our Web site to do it.

We are going to talk about it continually, because the one question that I ask in town meetings which gets the greatest response is when I ask for a show of hands: "How many of you have been awakened in the morning or late at night by an abusive caller who does not seem to know the word no?" I would say 75 percent of the hands shoot up. That tells us something. So you are clearly onto something, and we intend to follow up on it.

Senator COLLINS. Thank you, Chairman Levitt.

Senator Cleland.

Senator CLELAND. Thank you, Madam Chairman.

Mr. Chairman, thank you for being with us today. When you mentioned putting the con artists in the striped suits, you meant broad stripes, right, not small stripes?

Mr. LEVITT. Right.

Senator CLELAND. I am wearing a striped suit today. I just wanted to make sure. [Laughter.]

Senator CLELAND. Thanks for being with us. I understand the importance of injunctions and consent decrees and receivers and trustees and other types of administrative and civil sanctions that can be applied against violators. The media is full of stories about the major frauds perpetrated on our citizens. It is my opinion that the only sanction, quite frankly, as you have indicated by your comment, that most of the serious violators will understand as a successful deterrence is jail time and the completion of a successful criminal prosecution. Do you have any idea why more of the major fraud cases do not end up in the criminal courts?

Mr. LEVITT. Well, I think it is a question of calendars that are so full and commitments that are so great, and these are cases that are difficult cases to bring and to prove. It is only in the most egregious instances that we get to criminal actions. We find that there are very few districts of our Federal courts that are experienced at bringing securities cases. Some of them, such as New York and California and some large areas, do have that experience and recognize it as a major area for their involvement. Others simply would rather go after bank robbers than they would going through the difficult process of trying to prove what a securities fraud is.

Senator CLELAND. Thank you. How about your enforcement staff? Do you have enough people to do your job well?

Mr. LEVITT. Probably not. With our markets exploding, with many times more investors in the market today than ever before in history, with mutual funds taking up more investors' resources than all the combined deposits in our banks in America today, our resources are severely strained, particularly in the enforcement area. We, like every other agency in government, are mindful of restrictions on government; and, for the past 3 years, we have operated pretty much on a flat budget.

I am under no illusion that we can ever wipe out totally all fraud in America. And I would emphasize again that, while the number of scamsters out there is probably greater today than any time before, relative to the number of investors in the market and the dollar volume of new issues coming on the market, we are no worse than we have been for years.

Nevertheless, my answer to your question is we are straining, and we have to leverage our resources by working more closely with State regulators, by getting our self-regulating organizations to assume more of the burden of responsibility.

Senator CLELAND. I would like to just follow up on that. Where do you see the role of the States here, particularly in terms of enforcement?

Mr. LEVITT. I think it is critically important that the States maintain their licensing abilities. States really need to understand who is applying for a license and what is going on. Senator Collins mentioned before the fact that, if a broker stays at the same firm for a number of years, the focus of the State tends to be on other things and does not come down until a broker transfers from one State to another.

I think that has got to change. I think the State regulators have to take cognizance of the fact that the States are a vital linkage here, particularly since the passage of a law last year which mandates the States to take on the responsibilities for small investment advisers. That is a critical problem.

I think it is essential that the SEC work closely with State regulators. We may not see things exactly the same way, because, from the standpoint of the firms and the standpoint of the system, 50 different State regulators with different kinds of regulation within the States can create redundancies and costs that really make the system unworkable.

So we have tried very hard to persuade the States to try to standardize their practices in a way which enables us to deal with one system rather than 50 systems; and, until that happens, we can never harmonize the role between the Federal Government and the States. But I believe the States are moving in that direction and they have taken recent actions. They recognize the greatest danger that they face is moving into too many different directions. They will earn the animus of the brokerage firms, of the industry, of the self-regulators, and the Commission by doing that, but, by harmonizing and working together, I think we create a strong regulatory presence that is the best way to get at fraud.

Senator CLELAND. When I was Secretary of State in Georgia and responsible for securities regulation, we worked closely with the SEC just to do that very thing. One of the things that has surprised me is the incredible dollar value now of the whole penny stock market and its impact on illegal impact on the economy, siphoning off legitimate investment to very, very high-risk investment.

I notice that the Wall Street Journal recently estimated that investor losses resulting from penny stock fraud has risen from, say, \$2 billion a year in the late 1980's to an incredible some \$6 billion today. Does that sound about right to you?

Mr. LEVITT. It is difficult to tell. I think that that estimate was probably based upon a study done by the State regulators some years ago and factored into that the growth of the market, and assumed that the growth of fraud ran along parallel lines. I am not sure whether that is so or not. I have not seen a study which I would call reliable. But my anecdotal experience tells me, as markets rise, as numbers of investors proliferate, as numbers of bro-

kers proliferate, as numbers of new issues proliferate, there is no question but that fraud will go right along with it.

Willie Sutton used to say that he robbed banks because that is where the money is. Well, I think the scamsters and the brokerage industry probably do the same thing. Again, the percentage is small, but the scamsters that are out there do incalculable harm to the system. To have these three investors up here on national television testifying to how they were violated does more to hurt our process of capital formation than anything else I can imagine. I think it is an unfortunate consequence which, I think, all of us have to resolve to give the maximum exposure to and to try to make the penalties so onerous that this will not be necessary in the future.

Senator CLELAND. I appreciate that point of view. I am concerned that Congress seems determined to continue on a course of chipping away at investor protections and remedies as a means of encouraging economic expansion. I am certainly interested in a robust economy, but experience is our best teacher here. We know that if we tip the scales too far in the direction of promoting capital formation, fraud flourishes. Our challenge, it seems to me, is in keeping the scales of capital formation and investor protection in balance. Would you like to comment on that?

Mr. LEVITT. I think you are absolutely right, that while the Commission has two initiatives: capital formation, nurturing it, encouraging it, and investor protection—as far as I am concerned, the primary initiative of this Commission or any Commission must be protection of investors. There can be no capital formation in a system that cannot be trusted.

The numbers that investors depend upon must be reliable. You have read about a great deal of controversy involving the FASB, the independent mechanism for establishing accounting standards and their efforts to call for the accounting for derivatives, which take up billions of dollars in our marketplace today. We oversee the FASB, and I believe that the business community and the regulatory community must support efforts to see to it that the numbers that investors rely upon are accurate. So I believe that public confidence comes first in our scheme of things. There can be no markets, none, without public confidence in the reliability of those markets and the people who run them.

Senator CLELAND. I could not agree more.

Madam Chairman, just to maybe wind up with a Yogi Berra quote that I heard the other day for the first time, that 90 percent of baseball is mental and the other 50 percent is physical—
[Laughter.]

Senator CLELAND [continuing]. I think your point has been well taken, Mr. Chairman, that 90 percent of this securities investment game is confidence in those who play the game and the other 50 percent is financial.

Thank you very much, Madam Chairman. Let me just recognize Jeff Robbins, our Minority Chief Counsel who has done a lot of work with our team today. Thank you very much.

Senator COLLINS. Thank you, Mr. Chairman. I know that all of us have additional questions that we will submit for the record.¹

I would ask that you give careful consideration to my suggestion for the zero tolerance policy and work with us to see if we can come up with something that would assure due process, if limited to serious breeches, but nonetheless sends the message of zero tolerance.

Mr. LEVITT. I promise you that I will. Thank you.

Senator COLLINS. Thank you.

The next panel of witnesses will please come forward. The second panel includes Emile Murnan, Helen Sprecher, and Louis Poggi. These are three investors who will tell the Subcommittee about their recent experiences investing in the micro-capital markets.

We are going to first hear from Mr. Murnan, who is a resident of St. Louis, Missouri, who retired several years ago as a salesman of industrial woodworking machinery.

We then will hear from Mrs. Helen Sprecher, a longtime resident of Philadelphia. Mrs. Sprecher and her husband owned a grocery store, I think for some 30 years——

Mrs. SPRECHER. Thirty-seven years.

Senator COLLINS. Thirty-seven years. Mrs. Sprecher is accompanied by her attorney, Mr. Henry Pass.

Finally, we are going to hear from Mr. Louis Poggi, a resident of Pembroke, New Hampshire. He is a father of five children and is employed by Federal Express.

We are looking forward to hearing from you and I want to give each of you a special thank you for being willing to come before the panel today and share your experience. What you are doing is going to help others be better informed investors, and I really thank you because I know this is difficult, to come forward and talk about your own experiences.

I am going to ask each of you to limit your comments to 10 minutes. This green light will go on at the beginning. The yellow will come on when you have 2 minutes left so that it will allow you to wrap up. We will make any prepared testimony that you have part of the record.

As I mentioned previously, pursuant to Subcommittee Rule 6, all witnesses are required to be sworn in, so I am going to ask you all to stand and raise your right hand.

Do you swear that the testimony that you are about to give to the Subcommittee will be the truth, the whole truth, and nothing but the truth, so help you, God?

Mr. MURNAN. I do.

Mrs. SPRECHER. I do.

Mr. POGGI. I do.

Senator COLLINS. Thank you very much.

Mr. Murnan, we are going to start with you, please.

TESTIMONY OF EMILE O. MURNAN,² ST. LOUIS, MISSOURI

Mr. MURNAN. Madam Chairman and Members of the Subcommittee, my name is Emile Murnan and I am pleased to be here

¹ Exhibit 16 appears in the Appendix on page 432.

² The prepared statement of Mr. Murnan appears in the Appendix on page 145.

today to testify before you about my recent experience as a victim of fraud by a securities brokerage firm.

I am 78 years old and retired several years ago from a sales career. My home is in Ballwin, which is one of the many, many suburbs of St. Louis, Missouri, famous for the Gateway Arch and glib people. [Laughter.]

Mr. MURNAN. I do not receive a pension and, therefore, I try to be careful in management of my funds. It is apparent to me that control is needed to protect others from becoming unwitting victims of fraud by an industry entrusted by so many to conduct transactions which are critical to their financial security.

My story begins on January 16, 1997, when I received a telephone call from a Mr. Marlon Tropeano. He is with the L.T. Lawrence and Company in New York City. I had never done any business with him or his firm and I am not really sure how he came about having information on me. It seems that when you purchase a stock from a broker, especially in New York, they must put your name on a list and sell it to all the other brokers in town because I have had numerous telephone calls from different brokerages, all in New York, and they are all with this same type of thing, trying to get you to buy something you never heard of.

However, in my case, he wanted me to buy shares in Callaway Golf Company, and I was familiar with Callaway. I know it is a good company on the New York Exchange and so forth, and at this particular time, I had a few bucks to spend because a bond I had had matured. So I bought 200 shares of the Callaway Golf stock. I regarded this as a long-term investment, and on January 18, I paid for it in the amount of \$6,040.

The trouble began about 6 days later—exactly 6 days later, after the date of purchase, when he sold Callaway Golf for a total of \$6,308. That is a slight gain, but I did not know he had done it even. The same day that he sold that, he bought 1,000 shares of Medaphis Corporation stock for a total price of \$13,840. He has now established a margin account, without my permission, of \$7,530.

This thing gets worse. Six days after that, on January 28, he purchased 4,700 shares of QPQ stock for a total of \$12,940. This means he had now established a margin account of \$20,000. One thing I might add that I had some thoughts on is how ethical is it for a brokerage company to allow a firm to establish a \$20,000 margin account on an investment of \$6,000? It just does not seem to make any sense to me.

Anyway, on February 5, without my permission, he sold the 1,000 shares of Medaphis for \$13,109. This is a small loss of \$730, but it gets worse. On the same day, he sold 1,600 shares of QPQ, and on February 12, he sold 1,900 shares of QPQ, and finally on April 10, the account was closed and I received a check of \$292, for a loss of \$5,748 out of my original investment of \$6,040. It is only about a 94 percent loss.

On February 13, I returned from a trip to Florida and when I opened my mail, here were all these confirmations of buys and sells, which I just could not believe. I could not believe he had sold the Callaway Golf stock and bought two other stocks without my

permission at a substantial loss, because now I have the buys and the sells all in the same mail.

On February 21, I sent a letter to the Compliance Department of L.T. Lawrence and Company disputing these unauthorized trades and the loss of my money. On March 11, I was contacted by telephone by Mr. Andrew Basile, who stated he was Senior Vice President and head of the Compliance Department. He assured me that he would investigate my complaint, but nothing was ever done to resolve the issue of this lost money. I talked to him several times, plus others under him. Their attitude is, yes, so what? We lost your money. We are not going to do anything about it and we do not apologize. It is just tough luck.

So since I could not get anywhere with them, I took matters into my own hands and I wrote the NASD in New York City, the Securities and Exchange Commission in Chicago, and North American Securities Administration Association in Washington, D.C., as well as the Commissioner of Securities of the State of Missouri in Jefferson City, plus I retained the services of an attorney.

An examiner for the Missouri Securities Division later determined that L.T. Lawrence and Company had 15 customer complaints filed against Mr. Tropeano, 11 of these complaints prior to his solicitation to me.

Finally, on July 12, a settlement was reached and the losses were reimbursed through my attorney, minus his fee. This whole affair has been an extremely troublesome experience for me and has caused me considerable expense and made me very unhappy. It seems that in this age of technology, these renegade fraudulent activities should no longer be possible by companies who are entrusted with the key elements of our financial security.

This concludes my statement, Madam Chairman, and I would be pleased to answer any questions.

Senator COLLINS. Thank you very much, Mr. Murnan. I appreciate so much your sharing your experience with us. We are going to hear from the other two witnesses first and then we will be asking you questions.

Mrs. Sprecher.

**TESTIMONY OF HELEN SPRECHER,¹ PHILADELPHIA,
PENNSYLVANIA; ACCOMPANIED BY HENRY IAN PASS, ESQ.**

Mrs. SPRECHER. It is hardly necessary for me to say I consider it a great honor to be here today. My name is Mrs. Helen Sprecher and I reside in Philadelphia, Pennsylvania. My husband, Harry Sprecher, is unable to attend this hearing due to his declining health.

My husband and I are both 85 years old. Before our retirement in 1988, we owned a small neighborhood grocery store. We worked very hard, 7 days a week for 31 years, and we were able to save about \$100,000 for our retirement. But as a result of the devious and deceptive practices of unscrupulous stockbrokers and their firms, nearly every penny was lost.

I am appearing before you today and making this statement in the hope that what happened to my husband and me can be pre-

¹ The prepared statement of Mrs. Sprecher appears in the Appendix on page 147.

vented in the future. I am telling my story so that other elderly and other vulnerable citizens might be spared the suffering, the financial loss, and the emotional trauma that we have had to endure.

Our problems with stock brokerage firms began in the fall of 1990, when we were contacted by a stockbroker named John Baratta. At that time, we were led to believe that Mr. Baratta was affiliated with the prestigious Wall Street brokerage firm of Morgan Stanley. Mr. Baratta persuaded us to open a brokerage account with him and he started to purchase stock for us shortly after the account was opened.

While Mr. Baratta was our stockbroker, we periodically received account statements from Morgan Stanley showing the status of our account. The account statements indicated that Morgan Stanley had been introduced to us through a company called Manchester Rhone Securities. However, I do not recall Mr. Baratta ever telling us that he worked for Manchester Rhone Securities. During this time, we always thought that we were dealing with the firm of Morgan Stanley.

It was not until I recently consulted with attorney Henry Pass that I found out that Mr. Baratta actually worked for Manchester Rhone Securities, a very small brokerage firm that has since gone out of business. Had we known Mr. Baratta was not affiliated with Morgan Stanley, we would probably not have done business with him.

During that time, Mr. Baratta said that Morgan Stanley was looking at a company called Wave Tech, a waste disposal firm in Canada. Morgan Stanley took Mr. Baratta and some other brokers to look over the operation. He was so impressed, he purchased 20,500 shares at \$1.25 a share for our account. Sometime during the fall of 1991, Mr. Baratta informed me that he had switched brokerage firms and was now working for S.D. Cohn, a company on Wall Street in New York City. At that time, he also told me that Morgan Stanley was no longer doing business with small investors such as me and my husband. We then agreed to have the stock in our Morgan Stanley account transferred to a new account at S.D. Cohn by Mr. Baratta. When we switched brokerage firms, our account was worth approximately \$98,000.

Mr. Baratta continued to be our stockbroker until February or March of 1993. Around that time, we learned that Mr. Baratta was no longer affiliated with S.D. Cohn and that a stockbroker named Donald Lou Spitzer had taken over our account. Although I had never met Mr. Spitzer, he seemed nice on the telephone and persuaded us to let him handle our account in the future. He said his mother was 92 years old and he took care of her accounts and he would be very careful with my portfolio.

Both my husband and I were having health problems. My husband had three very serious operations, a double bypass, an operation on the esophagus, and one on the colon. I was also having health problems, so I was in no condition to make any decisions. Mr. Spitzer was well aware of my condition. He promised to make good on my losses.

He purchased 25,000 warrants in American Track System, expecting the shares to come on the market at \$5 or \$6 a share. Mr.

Spitzer sent me a beautiful brochure of the company and its prospects. I felt I could not leave Mr. Spitzer or the company he was with because his promise of restitution, it would just be dropped.

In August of 1994, Mr. Spitzer sold Wave Tech at 3/32, which is a little more than a dime. The following week or so, the company was taken over by someone else for a little over \$1 a share, so that was a loss of over \$20,000 right there.

Around September of 1994, Mr. Spitzer informed me by telephone that he had left the S.D. Cohn brokerage firm and had joined a new firm called Investors Associates. We allowed Mr. Spitzer to transfer our account to Investors Associates. We continued to deal with him until June of 1995.

Around that time, a gentleman named Keith Bleich telephoned me and identified himself as a broker for Investors Associates. He said that he was calling to inform me that Donald Spitzer had been discharged from Investors Associates because of unethical practices. Mr. Bleich then told me that our account had been transferred to him and that he intended to give our account his personal attention. He also assured me that because of our age, he would make sure that we would never lose any money. Unfortunately, I believed him. He said he was going to be a father for the first time and was very considerate and worried and sort of got me into that event, worrying about he and his new baby coming on. He talked about that endlessly.

About a month later, Mr. Bleich called again and asked if I had any other securities that were not in our account with Investors Associates. At the time, I had in my personal possession 440 shares of RJR Nabisco stock. Mr. Bleich said it would be to our advantage to have everything in one place. I suppose if I was deceased, my heirs, it would be nice for them to have everything in one place. He told me he would send Federal Express to pick up my stock certificates for delivery to his office, which should have been some kind of a clue. He was so glib and persuasive that I agreed to send him my stock.

Because the RJR Nabisco stock paid a nice dividend which supplemented our Social Security benefits, I told Mr. Bleich that the stock was not to be sold and he promised not to do so. Over the next several days, he called me three or four times a day, trying to convince me to buy stock in a company called Electronics Communications. He told me that the company was new and that the stock was about to skyrocket. I had never heard of the company, so I would not commit myself. I told him it was a very difficult time for me, since I was recuperating from surgery for the aneurism of the aorta which had left me very weak and unable to think straight and he was putting a lot of pressure on me.

Sometime in August of 1995, a statement arrived from Investors Associates. To my utter shock and surprise, most of the stock in our portfolio had been sold without my permission, including the RJR Nabisco stock from which we had been relying on. The statement also indicated that we now owned 3,000 shares of Electronic Communications and 1,500 shares of Air Methods, Incorporated. Both of these stocks were purchased by Mr. Bleich without my permission. I later learned that Investors Associates was an active market maker in these securities.

Shortly thereafter, the value of both stocks started to plummet and our margin obligation went from \$950 to almost \$5,000. Margin calls were coming in two or three times a week, so I frantically called Mr. Bleich. He insisted that the stocks were going to make a lot of money. Margin calls continued to come in two or three times a week, calls that I could not meet.

Although I continued to call Mr. Bleich, it became obvious to me that my calls to him were seen as a nuisance. Whenever I would call, I would always be told that he was in a meeting or out of the office. Eventually, the 1,500 shares of Electronic Communications had to be sold off to partially satisfy the margin calls and we sent him \$3,000 to satisfy some of the calls.

In July of 1996, I informed NASD about my problems with Investors Associates and Mr. Bleich. When Mr. Bleich heard about this, he called to tell me that everything that had been in our portfolio when he took over the account had been put back and that we no longer owned any of the stock that he had purchased without my permission. I later learned that this was not true because the statements I continued to receive from Investors Associates did not show the changes in our account that Mr. Bleich had assured me had taken place.

In the meantime, margin calls against our account were still coming in. When I phoned Mr. Bleich, he insisted the changes had, in fact, been made and everything would be fine. During one of my last telephone conversations with Mr. Bleich, he brought another gentleman on the line who claimed to be an attorney for Investors Associates, a David Sayed. David Sayed, or whoever answered the telephone, verified that the changes in our account had been made. However, I continued getting margin calls and our account statements from Investors Associates indicated that they were still charging me interest on stocks that I was not supposed to own in the first place.

In February of this year, I consulted an attorney, Mr. Henry Pass, to see what legal recourse we had as a result of the unscrupulous handling of our stock brokerage account. After Mr. Pass reviewed our records, I learned about the losses my husband and I had incurred since the time we first opened our account through Morgan Stanley in 1990 until the time that we closed the account with Investors Associates in April of this year.

Due to the declining health of my husband and myself, I had not been able to keep track of all the activity in the account. During this period, I had been recuperating from the surgery related to the aortic aneurism. My husband had also undergone surgery, as well as chemotherapy for cancer of the colon and the esophagus and a lot of my time was spent caring for him. I, therefore, was not aware of all the churning and other improprieties that occurred during this time.

In December of 1990—I am sorry.

Senator COLLINS. You can conclude your statement. Take a little bit longer.

Mrs. SPRECHER. When we entrusted our retirement savings with John Baratta through Manchester Rhone Securities and Morgan Stanley, our account was worth approximately \$96,000 [sic]. However, when we closed our account with Investors Associates in

March of this year, our account was worth \$2,300. The stress of the situation has greatly affected my health, both physically and emotionally. I have been experiencing anxiety attacks, nausea, loss of appetite, and inability to sleep. The distress and anguish are sometimes unbearable and have caused me to lose over 15 pounds.

Shall I stop?

Senator COLLINS. If you have more you want to say to us—

Mrs. SPRECHER. There is another page.

Senator COLLINS. Please continue.

Mrs. SPRECHER. Until I was referred to attorney Henry Pass, I did not know that there are laws on both the State and Federal levels that are supposed to protect my husband and me from the unscrupulous and illegal practices that we experienced. Unfortunately for us and for so many others, these laws did not prevent the firms and stockbrokers with which we dealt from engaging in the practices that caused us to lose so much money and to experience so much grief and misery.

Mr. Pass has instituted lawsuits against the companies and individuals involved and I am hopeful that my husband and I will be able to recover at least some of the money that we have lost over the years. I only hope that something can be done by the government to prevent retirees, such as myself, from becoming victims of the unsavory, unethical practices of investment firms and stockbrokers that seek us out. Something must be done to protect all of us from the kind of people who preyed on my husband and me, caused me to lose most of our retirement savings, inflicted on us such terrible anguish and distress in our twilight years.

Thank you for inviting me to share my story with you.

Senator COLLINS. Thank you very much, Mrs. Sprecher. Your story is the reason we are here today. What happened to you is absolutely outrageous, and it is our commitment to try to change the system in a way to prevent that.

Mrs. SPRECHER. Yes, so I heard from Mr. Levitt.

Senator COLLINS. Exactly.

Mr. Poggi.

TESTIMONY OF LOUIS POGGI,¹ PEMBROKE, NEW HAMPSHIRE

Mr. POGGI. Madam Chairman and Members of the Subcommittee, my name is Louis Poggi and it is a pleasure for me to be here today to tell you my personal story of being defrauded by a stock brokerage firm.

I am employed as a truck driver by Federal Express. I live in Pembroke, New Hampshire, and am the father of five children. My life is hectic, to say the least, and the story I am about to tell you was a devastating experience for me and my family. I sincerely hope that this hearing will lead to new regulations of the securities industry which will prevent others from such unnecessary suffering.

My experience with this scam started in June 1995, when I received a telephone call out of the blue from Pat Boyce. Mr. Boyce identified himself as a broker for Investors Associates, Inc., of Mel-

¹ The prepared statement of Mr. Poggi appears in the Appendix on page 154.

ville, New York. I am not sure how Mr. Boyce obtained my telephone number or identified me as a potential customer.

During this initial conversation, Pat Boyce solicited me to purchase stock in Cheyenne Software, Inc. His sales pitch was overwhelming and he tried very hard to convince me that the price of this stock was going to rise very quickly, which would result in a huge profit for me. I became tired of Mr. Boyce's relentless solicitation and told him, sure, go ahead, buy the stocks. It did not mean a thing to me. He was just a guy on the phone from New York.

I told him, sure, go ahead and buy the stock, but I thought it was a joke. I did not realize what I was doing because Mr. Boyce told me at a later date that I had actually bought stock in Cheyenne Software. As a result of this initial conversation, I learned later that the trade date of this purchase was June 30, 1995, for 1,000 shares of Cheyenne Software at a total cost of \$18,216.75.

Mr. Boyce called me a few weeks after our initial phone conversation. He informed me that the price of Cheyenne Software stock was rising and that I had already made a profit of \$3,000. I was astounded to have gained such a profit on an investment that I had not really made, or I thought I made. A sudden profit of \$3,000 was like a major windfall to me.

I told Mr. Boyce that I now wanted to sell my shares in Cheyenne Software in order to receive my \$3,000 profit. Mr. Boyce told me that I must send Investors Associates \$18,216.75 to cover the purchase price of the stock. I replied that I was not able to do that, but if I owned the stock, why could I not just sell it and you send me the profit of \$3,000. Please note that at this point, I had not submitted any money to Investors Associates.

Mr. Boyce stated that I must send him a check for the initial purchase and then I would own the stock, so I could then turn it in to sell it. I did not understand the stock market business and this situation was confusing to me, but I was intent upon getting my \$3,000. That was quite a bit of money to me. I was going to make that profit, even if it meant coming up with the \$18,216.75.

It happens that my father lives about 20 minutes from Investors Associates office in New York. I routinely visit my parents, so I decided to make a trip there to check out the Investors Associates office. I wanted to see if it was a real company or just some guy calling me from his kitchen. I went to Investors Associates office and it appeared to be a legitimate company in a normal office building, actually, a luxurious office building.

This visit gave me confidence in Investors Associates, so I told them I would purchase the Cheyenne Software stock with my credit card. They told me that I could not do that. At this point, I felt that all I had to do to get the \$3,000 profit was to obtain \$1,216.75 which would be quickly returned to me because I intended to sell the stock as soon as the purchase was confirmed. In fact, I was led to believe that I could quickly sell the stock to make back the \$18,216.75 plus the additional \$3,000 gain.

That same day, on or about June 30, 1995, I obtained cash advances from my credit cards and purchased the 1,000 shares of Cheyenne Software. I told Investors Associates that I wanted to sell my 1,000 shares of Cheyenne Software as soon as possible in

order to receive my \$3,000 profit and get my initial investment back to pay off the credit card debt, and they did say "fine".

It was my understanding that the stock would be sold and my money from the sale would be placed in an account with Investors Associates. I waited approximately 10 days and still did not receive the money or any confirmation of the trade. I called Pat Boyce, who told me he had made money for me once and that now he knew of another stock, Universal Self Care, and that I should buy it. I told Pat Boyce that I wanted to close out my account because I needed the money to pay back the cash advances on my credit cards.

Pat Boyce gave me a strong sales pitch about Universal Self Care stock. I told him that I did not want to purchase Universal Self Care and he became very upset with me. Boyce said that he had made money for me on the Cheyenne Software stock and he could not understand why I would want to close out my account.

Boyce told me the Universal Self Care stock was guaranteed to rise in price because Investors Associates is on the board of directors and they would be able to control the stock. I told Boyce that the profit in Cheyenne Software was just a fluke and that I really did not know anything about Universal Self Care. I informed Boyce that I would not buy this stock over the phone, that I needed time to research it. Boyce did not seem to hear me, because he said, "Mr. Poggi, do you want me to put that order in now?"

The conversation ended with the agreement that we would watch Universal Self Care stock until the end of the day but no purchase would be made without my authorization. It seemed to me that Pat Boyce was reading from some type of script during this conversation because he would not take no for an answer.

I immediately called Waterhouse Securities, who I have done business with previously, to determine the price of Universal Self Care stock. The stock was quoted as selling at \$.25 less a share than the quote from Pat Boyce. I was outraged, so I called Pat Boyce back and told him that he is charging me \$.25 more per share than Waterhouse Securities, which is outrageous. I would like to note here that that came out to an \$800 profit commission to him out of this transaction, which was very generous on his part, to pay himself \$800, I would say.

I informed him that I did not want anything to do with Universal Self Care stock. Boyce told me it was too late because he had already bought 5,000 shares of Universal Self Care with the money in my account from the Cheyenne Software trade. He said that the \$.25 extra per share was his commission. He told me that he had to make a living, too, and that is why he did charge me an extra \$.25 per share.

The first trade on Cheyenne Software was a \$35 commission charge, so I would say there was something unbalanced there, to say the least.

I told Boyce that I did not authorize his purchase and just wanted my money back. I was, to say the least, extremely upset. I now owned a stock that I knew nothing about which was purchased with money from my credit card cash advances. I called Boyce again that day and told him to immediately sell the stock in Uni-

versal Self Care. He told me that he was not in a position to sell the stock.

I called Boyce back again a few days later, which he told me that I have no worries because the price of Universal Self Care is going to be pushed up and he will sell it. I continued to insist that Boyce sell my shares in Universal Self Care, even though he had almost convinced me that the stock was going to be profitable. Boyce then transferred my call to Vince Grecco, who told me that he was the owner of Investors Associates. Grecco said that he would sell the stock in Universal Self Care, but he snidely told me to enjoy retiring on Social Security. He said that his company could have made me a fortune. I told him just to sell the stock and send me the money.

A few days later, I received a notice that I had bought 5,000 shares of Universal Self Care at a net cost of \$17,360.50. I thought this was just a mistake and that I would be receiving my funds in the near future from Investors Associates, basically taking him on his word that he was sending me the money.

About 10 more days passed and I called Pat Boyce, who told me that Universal Self Care stock was not sold from my account. I told Boyce that Grecco had ensured me that the stock would be sold. Boyce stated that my account had been closed and the stock certificates were being forwarded to me. He said I should receive the stock certificates in 6 to 10 weeks, at which point I could then have the shares sold by a brokerage of my choice.

I broke down at this point in the conversation and became very emotional. I was hysterical and Boyce hung up on me. I composed myself and called Investors Associates a short time later. This time, my call was transferred to Vince Grecco. He told me that I had instructed him to close my account and that it is standard procedure with this company to send investors the stock certificates of their shares when they close an account. I told Grecco that I wanted the shares in Universal Self Care to be sold. I did not want the stock certificates. Grecco told me that it was too late to sell because the account had been closed and the stock certificates were in the system.

Shortly after this conversation with Grecco, I went on vacation with my family, but I called Grecco every day trying to resolve this matter. Grecco told me that there was nothing he could do and that he was sorry I did not understand the jargon of the industry. Grecco repeatedly told me that he just was following my orders to close the account.

The clearinghouse for Investors Associates on my account was Prudential Securities. I finally decided to call the local office of Prudential Securities to try to determine the status of my stock certificates. I do not remember the name of the person I spoke with at Prudential, but he assured me that the stock certificates would be forwarded to me as soon as possible. The stock certificates for Universal Self Care were subsequently received on or about August 22, 1995, in the mail by my sister on Long Island. I instructed her to take the certificates to the local Waterhouse Securities office and have them sold. The 5,000 shares in Universal Self Care were sold on or about August 25, 1995, for \$14,437.50.

Subsequently, I filed a complaint with the National Association of Securities Dealers, NASD, in New York. A couple of months passed before the NASD conveyed to me that I should pass on my complaint to New Hampshire authorities. I then filed a complaint with the State of New Hampshire Bureau of Securities Regulation. This complaint was finally settled on April 23, 1997, with Pat Boyce being ordered to make restitution to me in the amount of \$2,925 and Investors Associates assessed a penalty of \$25,000.

This concludes my story, which obviously has been a terrible experience that will affect me in many ways for the rest of my life. I thank you for allowing me to share this information with you and I would be pleased to answer any questions.

Senator COLLINS. I want to thank you, Mr. Poggi, for sharing your story with us.

I want to thank all three witnesses again before we go to questions. What you have done today is put the human face on what happens when an individual is ripped off by an unscrupulous broker. We hear all the statistics and the amount of money that is lost, but your testimony does more than anything else to make people understand the human consequences when this kind of unethical and illegal behavior occurs, and in that sense, you have provided an invaluable service not only to this Committee but to the public, as well. So I thank you for coming forward.

I do want to ask you just a few questions. When each of you ran into trouble, did you know to whom to turn for help? Was it difficult to figure out where to go, whether to contact Federal officials or State officials or the firm itself? Mr. Poggi, we will start with you and go right across the panel.

Mr. POGGI. Well, to say the least, I was confused and I immediately did not know where to turn. But just a little bit of research, I figured out the NASD was based in New York City and I called them and they told me to just handwrite something and get the ball rolling. I did not realize about the Securities and Exchange Department in New Hampshire or I probably would have went right to them, because that is where I got my best results. I just want to make a note—

Senator COLLINS. At the State level?

Mr. POGGI. Yes, at the State level, New Hampshire. As soon as this happened, it probably was within days that I went on vacation, and here I am spending quality time that I should be enjoying my children, I am ready to have a nervous breakdown, because as you know, all my money was tied up in cash advances on my credit card, so it was not a fun vacation and how do you put a dollar value on that? I should be enjoying my children. As a matter of fact, I was vacationing in Maine.

Senator COLLINS. Good judgment. [Laughter.]

Mr. POGGI. Right, on the coast of Maine, which is a very gorgeous place. I recommend everybody go there.

Senator COLLINS. I tell Senator Gregg that all the time.

Mr. POGGI. Oh, yes. It is beautiful. Here I am, instead of enjoying the scenery and my children, I am writing letters and talking to Vince Grecco on the phone. It was a nightmare.

Senator COLLINS. Mr. Murnan, was it obvious to you where you could go for help or was that a difficult thing to figure out?

Mr. MURNAN. It was not obvious, but it was not really too difficult. I know a couple brokers in St. Louis and I called them and told them what had happened and they gave me names and addresses. Then some of the agencies, when they sent me information, they would also suggest that I contact this agency or that agency, which I did. So eventually, I had, I think, just about all the agencies alerted and on the case.

The first thing after I made my initial contact with the NASD, I received a call from the L.T. Lawrence and Company complaining that I had gone and alerted the authorities of their actions. They put this broker on the phone and he started screaming at me and he says, you are affecting my ability to make a living by doing this, and I said, well, you have affected mine, too, by losing all my money. I had conversation after conversation with him and I saw it was never going to get anywhere, so finally I enlisted the services of all the other agencies that I mentioned plus my attorney. The NASAA and the State agency were most helpful.

Senator COLLINS. Mrs. Sprecher, before you hired a private attorney to help you sort through this maze that you were going through, did you know where to turn for help?

Mrs. SPRECHER. I did not know I had any other recourse. I sent for a book that was advertised. It was called "Legal Problem Solver" and I was thumbing through this book and I came across stocks, and lo and behold, I read about the Pennsylvania Security Commission and the NASAA, so I wrote to the Pennsylvania Security Commission and they responded right away. They also said I should contact the others, like the NASAA, so I also wrote them.

Senator COLLINS. One of my suggestions which I am going to be pursuing is it seems to me that the account statements received by investors, should include the name, address and the phone number of a regulator who could help an investor. Investors would then not have to research, would not have to wonder where to go. Do you think that would be helpful, if I could just get pretty brief responses?

Mrs. SPRECHER. If I was aware of what a regulator was. At that time, I probably would have seen "regulator" and thought, well, that is just something to do with the stock. I would not have known to call that number or anything.

Senator COLLINS. So it is going to be——

Mrs. SPRECHER. It has to be in plainer language than just "regulator".

Senator COLLINS. Right. What I am suggesting is, for example, if it said on the bottom of the account statement, if you are having difficulties——

Mrs. SPRECHER. That would be better.

Senator COLLINS. OK. Mr. Murnan, would that kind of change be helpful, if on the account statement it had the name, address and the phone number of someone you could call if you ran into the kind of trouble——

Mr. MURNAN. That would be most helpful, and also, I believe this would be a deterrent to these people doing it in the first place, because now you easily know what to do. I think the way they operate——

Mrs. SPRECHER. Yes. I think that would be good.

Mr. MURNAN [continuing]. They feel that the average individual is not going to know what to do and a lawyer will not take it because it is too small, perhaps, so they wind up, a lot of them just do nothing and accept the loss. I was so incensed when this happened to me, I was mad. I felt like I had been robbed. He could not do it much worse with a gun. I just was not going to put up with it. I was going to try to get some results from it, which, finally, I did, but I was still out half—

Senator COLLINS. Still at a loss, though. Mr. Poggi, would that have been helpful in your case?

Mr. POGGI. Madam Chairman, I think that would have been most helpful.

Senator COLLINS. Thank you. I have just a couple of specific questions. Mr. Murnan, did Mr. Tropeano, is that how you say it?

Mr. MURNAN. Tropeano.

Senator COLLINS [continuing]. Tropeano ever discuss with you Medaphis Corporation or QPQ Corporation prior to the trading of the stock? Did you ever get a prospectus?

Mr. MURNAN. He did not, and for months, I did not know what they were, even. A broker in St. Louis, I told him about it and he said he would do some research, which he did, and he sent me information.

Senator COLLINS. What did you find out about QPQ?

Mr. MURNAN. He sent me some data that they had. You know, they have data on all companies. He sent me this data and it showed that the all-time high for QPQ was \$2.25 per share. He charged me \$2.75 a share, \$4,700, which right away is a loss of \$2,350. It was not too much longer after that that he apparently started selling it. This all happened within less than 2 months, the buying and all the selling and all the loss.

Senator COLLINS. Was that the company that owns pizza parlors in Poland?

Mr. MURNAN. Yes. That is what I learned. The company had two pizza parlors—

Senator COLLINS. And you found that out through your own research?

Mr. MURNAN. They are doing millions of dollars worth of stock. This data I received also said that there was much, much insider trading, buying and selling of this stock before they hooked me with it.

Senator COLLINS. Thank you. Mr. Poggi, did your broker ever discuss with you the risks of investing in Cheyenne Software or ever provide you with a prospectus or other written information about the company?

Mr. POGGI. No. There was no written information about any company or any prospectus. The only thing he ever said was that the stocks were going to go up and there was no discussion of any risk whatsoever.

Senator COLLINS. My final question is for Mrs. Sprecher. Mrs. Sprecher, it sounds like you were under the impression that you were doing business with Morgan Stanley, a well-known, reputable firm.

Mrs. SPRECHER. That is right.

Senator COLLINS. Is that correct?

Mrs. SPRECHER. That is correct.

Senator COLLINS. If you had known that——

Mrs. SPRECHER. No, I would not have ever accepted a company that was that weak. Before that, I had been dealing with Bache and Company, another great big company.

Senator COLLINS. So if you had realized that you were not doing business with Morgan Stanley but rather with Manchester Rhone——

Mrs. SPRECHER. This was taken over by Prudential, another very well-known company. I would not have ever dealt with those other companies.

Senator COLLINS. So you feel that you were misled not only because of the unauthorized trades, but you were not even doing business with whom you thought you were doing business, is that correct?

Mrs. SPRECHER. That is right. And when Mr. Baratta told me that Morgan Stanley was actually taking them by helicopter to look at something they were interested in in Canada, I was sure I was dealing with Morgan Stanley.

Senator COLLINS. I want to again thank all three of you. I feel bad for the experience you have. Senator Cleland has some questions, but Mr. Poggi, did you have something you wanted to add?

Mr. POGGI. I did not know if we were wrapping it up, but I was thinking, when we have something this outrageous, I mean, why cannot these young kids which a lot of these brokerage houses hire to make these cold calls, to get swifter results in investigating, why can they not be suspended upon investigation and get them right out of that, get them away from that phone and computer and let them sit home wondering if they are going to collect unemployment or where their next move is going to be, especially if they know they have ripped people like us off?

Senator COLLINS. I think you raise a very good issue. I know that the NASD is here and the State regulators are here, but I am going to make sure that Chairman Levitt also gets a copy of your testimony, all three statements. I know he will be interested, because that is what I am pushing toward, is to have quicker, firmer, more severe penalties for brokers who engage in unethical behavior.

The problem we have now is it is relatively easy to get into the brokerage business, to get into the industry. There are no educational requirements, as we discussed earlier. There is an exam, but if you study enough and cram and take it enough times, you are probably going to pass. So really, the broker does not have much of an investment in this case. He can just, even if he gets out of the business, he has made the profit and that is why I think we need a much more severe approach in the zero-tolerance policy about which I talked with Chairman Levitt.

Senator Cleland.

Senator CLELAND. Thank you, Madam Chairman.

We are just all delighted that you had the courage to come and visit with us today. Maybe it will do some good for thousands of people out there like you who are, indeed, ripped off, unfortunately, just like you, with these shameful, dishonest people.

Let me just say, I would like to hear again how much each of you lost, starting with Mr. Poggi.

Mr. POGGI. Well, I gained \$3,000 and then I lost that \$3,000 on the unauthorized trade and probably about another \$3,500 of my money from my cash advances on the credit cards.

Senator CLELAND. So you lost a total of, what, about \$3,500?

Mr. POGGI. Right, out of my own pocket, but that \$3,000, as far as I was concerned, I earned that and that was mine, too.

Senator CLELAND. You certainly have gone through enough pain. You sure have.

Mr. Murnan, how much money did you lose?

Mr. MURNAN. My investment was \$6,040 and I lost \$5,748 of that, so all but \$292, I lost.

Senator CLELAND. Not to count the suffering and the emotional turmoil that you went through.

Mr. MURNAN. Yes, that is for sure, the phone calls and letter writing and so forth.

Senator CLELAND. Mrs. Sprecher.

Mrs. SPRECHER. About \$96,000.

Senator CLELAND. About \$96,000?

Mrs. SPRECHER. Yes. I would like to know if the broker houses would not have to send—say if you were going to buy a stock, they would have to send you like a buy permit that you would have to sign and send back to them, especially for the elderly people. Say they have to return it within 5 days. That would give them 5 days to think about it, whatever somebody wanted to sell them.

If a broker would ask a person's age and they were of retirement age—I do not mean anybody as old as I am, anybody, say, 70 or older, they want to buy a stock, unless they are very influential and they have dealt and they have made money with the company. If you are dealing with another company, a small company, if they want to sell you a stock, they could get someone on the telephone who would not even be aware of what they were selling them and maybe buy it. If they had time to send it to them and look at it, maybe a prospectus, maybe tell them what the company did and what the earnings were in the last few years, if the person still wanted to buy it, they would have to sign a buy certificate and send it back. That would give the person, say, 5 days' time to think about it and also send them a check for it or whatever way they deal with it.

Senator CLELAND. Mr. Murnan, you had a comment?

Mr. MURNAN. I had a question. It would be interesting to know how these brokerage houses get your name, your phone number, your address, and maybe a Social Security number before they ever call you. This practice should be checked into, I think.

Mrs. SPRECHER. Everybody sells names.

Senator CLELAND. One of the things that I have learned in dealing with securities fraud is, first of all, just deal with somebody you know.

Secondly, unfortunately, Mrs. Sprecher and Mr. Murnan, the people who want to rip people off do focus on those most vulnerable—

Mrs. SPRECHER. I know. I found that out.

Senator CLELAND [continuing]. And unfortunately, they are the elderly and the retired who do have some small amount of disposable income and then are able to, unfortunately, answer the phone.

Then many people are gullible to go ahead and send people money that they do not know. That is part of the problem.

What are some of the steps that you might suggest in terms of, say, public education, maybe that the SEC ought to think about or the State regulators ought to think about? Mr. Murnan.

Mrs. SPRECHER. I did write it down. Now I do not know what I did with it.

Mr. MURNAN. I forgot what I was going to say.

Mrs. SPRECHER. I think I just said what I thought they should do.

Mr. MURNAN. I have been asked, well, why would you buy a stock from somebody that you do not know, and my answer was, well, he was good enough to call me at the right time. He came up with a good stock that I knew about, felt was a good investment. I figured that this business is so well regulated—in fact, I never had thought about it, getting ripped off. This is so well regulated that it does not matter where you buy it. Callaway Golf stock is Callaway Golf stock, if you buy it in New York or Chicago, but that proved not to be the case.

Senator CLELAND. Because, unfortunately, there are unprincipled people out there—

Mr. MURNAN. I know that.

Senator CLELAND [continuing]. Who are determined to rip people off.

Mr. Poggi, what do you think might have prevented your experience in terms of, say, investor information or regulatory authority that might have helped?

Mr. MURNAN. Do not answer the phone.

Mr. POGGI. Well, I feel that I should have done a little bit more investigating than just going down to their office. They had a nice front, and I was going to get in and out real fast and make my \$3,000. But had I probably sent in or made a phone call to the NASD and found out what kind of blemishes they did have on their company, that might have been enough right there, and really, that is all you have to do, is it is all public knowledge, any broker or any company, and it really is up to us to do our homework and find out who we are dealing with. It is available. All we have to do is call the NASD.

So if we have the phone number on a bill or something, or like they said before, maybe send them—I think you said before, before they could call, send you a piece of literature with phone numbers and who you are and everything and that ought to eliminate a lot of riff-raff. Then you have those numbers. It is like, hey, here is a number. Check me out. Call the NASD and find out who I am, or whatever. If they do not, then that red flag goes up and watch out. But it is available.

Senator CLELAND. In terms of my experience in Georgia, we always advised people to just ask the first question, that was, are you licensed by the Secretary of State in Georgia? That usually ended the conversation on these kind of matters.

Secondly, Madam Chairman, did not the Chairman of the SEC put forward a 1-800 number of some kind that he wanted to get out?

Senator COLLINS. He did, indeed.

Senator CLELAND. He wanted to receive more and more calls there from investors that might have a problem or might want some information about investing.

Correct me if I am wrong. Did I hear that all three of you were positive, basically, in terms of your dealing with State regulators? You got either a phone call returned or quick response or some help or something? Is that right, Mr. Poggi?

Mr. POGGI. Yes, that is correct. When I contacted the NASD right after Pat Boyce had purchased my stock, or the stock that I did not authorize, I got right on the phone and I was handwriting a letter. I mean, literally, you just have to document something. But I figured, now my stock certificates were going to be sent to me and Vince Grecco said that that was going to be up to 10 weeks. It actually was about 4 to 5 weeks, and NASD did not do anything. I think they are inundated with all kinds of problems. I was pretty much on a list.

So it was not until after I had received my stock certificates and sold them that I went to the New Hampshire Securities and Exchange and then we really began the fight to get my money back and try and get these guys thrown out of business.

Senator CLELAND. Mr. Murnan, what was your experience with State regulators?

Mr. MURNAN. Mine?

Senator CLELAND. Yes, sir.

Mr. MURNAN. They were most helpful. In fact, they were instrumental in me going to New York, where the District Attorney had a similar program to this and the news media was there. In fact, they went into this L.T. Lawrence and Company and went through the records and found they had had about 300 complaints, and on this particular Tropeano man, they had 15 complaints on him. Those were not all in Missouri, I guess, but none of them were reported. They just all went unknown.

Senator CLELAND. Mrs. Sprecher, what was your experience with State regulators?

Mrs. SPRECHER. With who?

Senator CLELAND. State regulators, your State?

Mrs. SPRECHER. Positive. I thought they had sent letters to Investors Associates and really pushed them. They are out of business now.

Senator CLELAND. OK.

Mrs. SPRECHER. But they just changed their name, as far as I know, and they are back in business.

Senator CLELAND. Madam Chairman, I will just wrap up my part of the program here by just saying that when I was growing up in Georgia as a young boy, I used to watch something called the "Ted Mack Original Amateur Hour" and they used to say, "The number in New York to call is . . ." In this case, we have the Chairman of the SEC giving us a 1-800 number for investor protection, anybody interested in calling it, 1-800-289-9999. We are not dealing with amateurs here. These are professional rip-off people. Thank you very much.

Senator COLLINS. Thank you, Senator.

I want to echo the Senator's comments that I think it is highly significant that each of these consumers found that when they

called State officials, that they got some help. You and I both have experience in that area and know what important roles State regulators play, as well.

I want to thank you so much for sharing your experiences with us today. I know that they have been very painful experiences and I really feel bad that you have had to go through this. But through your bad experience, I believe we can bring about some improvements in the system, so thank you very much and good luck to all of you.

Mr. Murnan.

Mr. MURNAN. Could I just tell you one more little thing?

Senator COLLINS. Sure.

Mr. MURNAN. To add irony to the end of this, if he had not sold my Callaway Golf stock, it would now be a paper profit of \$1,000.

Senator COLLINS. Is that not awful. Thank you very much.

Senator CLELAND. Thank you all.

Senator COLLINS. Our final panel of witnesses this afternoon includes Joseph Borg, the Director of the Alabama Securities Commission and member of the North American Securities Administrators Association, and Barry R. Goldsmith, the Executive Vice President of NASD Regulation. We are very fortunate to have this panel with us today. They represent the States and, obviously, NASD and will be able to provide the Subcommittee with an overview of their respective enforcement missions.

As the witnesses are getting settled, I will continue the introductions. The first witness is going to be Joseph Borg. He is, as I mentioned, Director of the Alabama Securities Commission. He is responsible for the direction and supervision of the Statewide agency involving the registration of securities dealers, agents, investment advisors, and investment advisor representatives, as well as the enforcement of civil and criminal statutes under the Alabama Securities Commission. He has considerable investigative and litigation experience and played a leading role in putting out of business one infamous firm, Stratton Oakmont.

We will also be hearing today from Barry Goldsmith, the Executive Vice President of NASD Regulation. In that capacity, Mr. Goldsmith is responsible for formulating the enforcement policy of the NASD and its over 500,000 individual registered representatives. The creation of this new subsidiary was one of the several major new recommendations made by the Select Committee on Structure and Governance, headed by former New Hampshire Senator Warren Rudman.

As I mentioned, all of our witnesses are sworn, pursuant to Rule 6 of the Subcommittee, so if you would please stand as I administer the oath.

Do you swear that the testimony you are about to give before the Subcommittee will be the truth, the whole truth, and nothing but the truth, so help you, God?

Mr. BORG. I do.

Mr. GOLDSMITH. I do.

Senator COLLINS. Thank you.

Mr. Borg, we will start with you, now that we have had all these accolades to State regulation.

TESTIMONY OF JOSEPH P. BORG,¹ DIRECTOR, ALABAMA SECURITIES COMMISSION, AND MEMBER, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC. (NASAA)

Mr. BORG. Thank you, Madam Chairman and Senator Cleland. I am Joe Borg, Director of the Alabama Securities Commission, and I do, on behalf of NASAA, welcome the opportunity to participate in your oversight hearings on the growing problem of fraud in the sale of small company stocks.

I am representing NASAA, which has led numerous enforcement efforts in this area, and I commend you for the timeliness in holding a hearing on this important subject. As mentioned by Chairman Levitt and Senator Cleland earlier, I believe, over one in three households now are investing in the capital markets, up from 1 in 17 in 1980. Securities fraud has a profound impact on a great number of working families. That has been demonstrated here just a few moments ago.

I have been involved in the securities markets for about 15 years as a partner in a law firm, as a State securities regulator, and as an actual investor. I am here today to discuss the very serious and growing problem of fraud in what has been termed the micro-cap market. Daily, it threatens investors across the United States with losses of millions of dollars.

Moreover, in my opinion, this threat casts a shadow on every financial institution in our markets today. One of the unreported costs of this problem is the millions of dollars intended to seed new businesses that end up in the pockets of swindlers rather than creating new jobs, and its consequences are also increased distrust of the markets by the grassroots Americans that support the entire market.

I am actually speaking about the efforts of small unscrupulous firms who use sophisticated scripts and an army of cold calling solicitors and brokers to sell micro-cap stocks to investors by any means, including false and fraudulent misrepresentations, dishonest and unethical sales practices, and I would agree with Senator Cleland, as the neighboring State, we call it like you call it. It is lying, cheating, and stealing.

On May 29, 1997, at a news conference with the New York and New Jersey Attorneys General, NASAA announced that 20 State securities agencies had filed 37 actions against 14 of these firms. That announcement was phase one of what is going to be and will continue to be the biggest nationwide crackdown ever by the States aimed at brokers fraudulent selling stocks over the phone.

That announcement resulted from a directive from the NASAA office that created a strike force represented by 12 States. In February, audit teams comprised of examiners from these States struck five preselected firms in the New York metropolitan area. Concurrently, other States conducted similar investigations, and ultimately, 20 States participated in the actions, with NASAA serving as the coordinating council for this nationwide crackdown.

One of the targets, the brokerage firm of Investors Associates, was subject to 15 State actions. To date, Alabama, California, Indiana, Massachusetts, New Hampshire, Oklahoma, South Carolina,

¹ The prepared statement of Mr. Borg appears in the Appendix on page 158.

and Texas have revoked the license of Investors Associates and Ohio recently denied its application for a license.

State securities examiners confirmed that employees of the targeted firms pressure their victims into buying stock in unknown companies by reading from scripts. The brokers and cold callers know little or nothing about the companies they are paid to hype. I would like to add at this point that these cold callers are unregulated, unlicensed.

Here is an excerpt from one of the scripts taken from a trash can at a brokerage house on Long Island. It is the sale of micro-caps that is a planned and choreographed production. In fact, the script begins with the stage instruction to "speak slowly and nonchalantly". Here is what they say.

"Two or three times a year, we at Investors Associates get our preferred clients involved with a niche area of the market where we can potentially turn a 6, 7-figure profit within the course of a few trading hours, more specifically, what we call initial public offerings." Now, after providing a little detail about a particular stock, which is generally hype, the script goes on to say, "In other words, a return of 100 percent in 20 minutes perhaps sounds a bit unrealistic, but that is exactly how our IPOs work. We did three deals last year, yielding collectively 34 points within the first 10 days of trading and that is a fact." That is out of the script.

Of course, once enough shares are sold and the price is driven high enough, insiders sell the stock, creating a price slide, making fortunes for themselves and wiping out the savings of innocent investors. In the vernacular of the industry, this is called the pump and dump. Although the unknown companies being peddled are small, it is not their size that is dangerous but the dishonest way that their stock is represented and sold.

In the course of NASAA's sweep, State examiners discovered four systemic abuses by the targeted firms. These include, first, trading abuses, and you have heard this today. Our examiners found an army of unlicensed solicitors who are accused of falsifying records, conducting unauthorized trades, and failing to complete trades. These are the tools of stock manipulation and securities fraud.

Second, failure to report investor complaints. State examiners found hundreds of unreported investor complaints. Most of the offices audited failed to have centralized procedures for handling and reporting customer complaints, as required by regulation. The consumer complaints were just gathering dust in some corner or on some shelf, totally ignored.

Third, evasion of broker-dealer registration requirements through the use of third-party franchise agreements. Rather than acting as a legitimate branch of a broker-dealer, these franchises operate independently with no central compliance, no supervisory procedures, no oversight, as is generally the industry practice. While they operate independently, they do not have independent capital nor independent bonding upon which the investing public can rely. When a broker-dealer or its satellite offices are not properly registered, that is a sure sign that something is terribly wrong.

Fourth, abusive cold calling practices. Most of the firms and branches relied on high-pressure scripted telephone cold calling techniques that include falsifying experience and performance as

well as other outright lies. This is the key to the scheme. Without the high-pressure cold calling, the rest of the illegal scheme would never succeed.

Again, we are talking about a small segment, a very small segment, of the broker-dealer industry. However, the dollars are phenomenal.

Unquestionably, as you heard from one of the witnesses earlier, the use by unscrupulous broker-dealers and their agents of a prestigious type New York, Wall Street-type name and address still tends to create an air of legitimacy and the promise of a golden opportunity, not only for the unwary or inexperienced investor but, in my experience, in many cases also for more well-educated and more sophisticated investors. This is especially true when the lesser-known brokerage firm markets a recognizable clearing firm name as a way to impress investors and gain their confidence. This is a confidence game.

I am confident, Madam Chairman, that these hearings will uncover numerous examples of high-pressure boiler room sales practices, misrepresentations, unsuitable sales, failure to execute trades, trading in accounts without authorization, and in a number of cases, out and out threats.

But I do not want to focus on more problems of the victims and what type of problems they incur, but I would like to take a moment to go through a specific detailed study to show how the manipulation occurs and also to present for your consideration indications of generational networking among these firms. We are going to talk a little about a history and progression of networking that continues unchecked today.

Looking at the Steve Madden chart—now, Steve Madden is the name of a shoe company that was brought public by IPO—there was a big group of States, including a major player from Senator Cleland's State of Georgia, that worked on this project. Looking at this chart, you will notice, for example, that the time line shows the creation of 10 million shares of stock from 200. Now, this is all prior to public offering and before the public gets involved, 10 million shares from 200. At the same time, a \$100,000 bridge loan was made by three individuals who are the principals of Stratton Oakmont, or were the principals.

As we go through the chart, a plan and scheme of bridge loans and transitional shares, inside purchasers—the first initial shares were sold to 16 purchasers, 12 of whom were Stratton Oakmont insiders. The bottom line is, the stock went from less than \$.50 a share to an offering price over \$5 to the public, with the insiders making a profit. What is not shown at the IPO level, when it goes out to the public, there was \$5.1 million of promissory notes still owed to the principals of Stratton Oakmont.

What came to my attention this morning is that those principals are now trying to collect on that \$5.1 million. I am not sure what effect that will have. I did notice that last Thursday, there was a filing with the SEC for Mr. Jordan Belfort, the former principal of Stratton Oakmont who has now been barred from the industry, to acquire almost 900,000 shares more. The cost or source of funds was undisclosed. I do suspect it is those promissory notes that are now showing up at this late date.

If we could change the chart, I would like to point out that of the Steve Madden initial public offering of \$12,500,000, 52.3 percent went to insiders and friends of the insiders. I suspect that most investors, if they knew that almost \$.52 of their dollar was going to the pockets of investors, would have a second thought about investing in that company.

What that first chart does not indicate is the effect of that \$5.1 million, that if it gets collected, if it has to be paid from Steve Madden assets, the proceeds to the company will decrease from 52.3 to 11.3 percent. We are talking, out of \$12 million, only \$1.5 million getting to the company, supposedly to increase the company's earning capacity and make a return for the investors.

If we can go to the next chart, I would like to point out this chart here is a generational networking analysis. Under Stratton Oakmont, I have three individuals, the first of which is Jordan Belfort. Mr. Belfort came from Investors Center. The idea behind this chart is, if you track agents, starting at First Jersey and working all the way down, First Jersey being the Robert Brennan notorious penny stock promoter, and going all the way down, agents become principals, get barred from the industry after making, in Mr. Jordan Belfort's case, about \$84 million, and move on to their agents, who become sales professionals and then form their own companies, and it continues on and on and on.

The conclusions are obvious and inescapable. You cannot ignore them. The abuse in this area continues to grow. As regulators pursue and shut down one firm, another or even several emerge to take its place. The lying, cheating, and stealing, as Senator Cleland stated earlier, continues unabated.

Thankfully, Stratton is gone. Belfort is out of business, and so is the other principal, Danny Porush. However, this does not solve the problem, and it is said that those who do not learn from history tend to repeat it. I think we have been repeating history.

These losses are unacceptable, and unless regulators are given necessary enforcement tools and resources to strike at the individual agents with both civil and criminal sanctions, the infestation in our markets will continue. We must discourage rogue broker entrepreneurs by bringing criminal cases. Prosecute the trainer. Let it be known that the cost of business just went up.

Rogue brokers of firms will agree to pay a civil fine of \$100,000 or even \$1 million as the cost of doing business as long as they can continue to bilk the investors of tens of millions of dollars. Again, this is just unacceptable.

We have heard that \$6 billion is lost through these fraudulent practices. Whether that is high or low is immaterial. Those kind of losses of any type of amount is unacceptable.

We would recommend three phases. Front-end protections, for example, would be important. We recommend that the SEC consider adopting the use of State enforcement actions to disqualify persons based on those State orders by interpreting the language in Section 3(a)(39), which States basically that the Commission can utilize "other appropriate regulatory agency information". That could mean State security agencies. If the State has issued an order against a broker-dealer or a broker-dealer-agent, I see no rea-

son why that cannot be used by Federal prosecutors or Federal agencies or the NASD as a disqualifier.

The continuation of State licensing procedures is absolutely important. It is the first barrier against entry of fraudulent brokers and broker-dealer-agents into the market. This is absolutely critical, I think, and I commend Chairman Levitt for recognizing the importance of State licensing authority.

Ongoing protections, we would recommend that the role of the clearing firms be examined. It is important that clearing firms have some responsibility to the industry and the investors for whom they clear. Also, a disturbing trend has been in the area of omnibus clearing arrangements, which are so generalized as even the clearing arrangements do not know who they are clearing for. We are very seriously concerned about this trend.

Also, books and records. There is a proposed rule for books and records requirements for broker-dealers under the Securities Exchange Act of 1934, which was originally released October 22, 1996. The SEC, in my opinion, has recognized the importance of books and records for use by the States in regulatory and enforcement actions. We believe the time is ripe for SEC adoption of a meaningful and agreeable Federal books and records rule that closely tracks the October 1996 release.

Lastly, after the fact. SIPC is 27 years old. It is time for a review. This Act has not been amended since 1970 and the question is, is the protection still sufficient coverage for the investors? Should consideration be given to raising the payment levels, and should actions other than a firm's financial failure be the cause to trigger coverage?

Lastly, I am pleased by Chairman Levitt's comments recognizing the value of State licensing powers, which authority is on the forefront of protecting our markets and investors, and I am ecstatic that the Chairman today announced a new drive to combat this insidious problem. I can assure Chairman Levitt and this Committee of my and my colleagues at NASAA's commitment to assist in the war to protect the markets and the investors because these markets and these investors have served our great country so well. Thank you.

Senator COLLINS. Thank you, Mr. Borg.
Mr. Goldsmith.

**TESTIMONY OF BARRY R. GOLDSMITH,¹ EXECUTIVE VICE
PRESIDENT, NASD REGULATION, INC.**

Mr. GOLDSMITH. Thank you, Chairman Collins. I am very pleased to be here and thank you and the rest of the Subcommittee and Senator Cleland for the opportunity to testify about the micro-cap fraud problem in U.S. markets and our efforts to address it.

Sitting here today listening to the three investor witnesses who preceded me has done more to convince me than anything I have heard at this hearing that we, as regulators, need to do more. We have to look at fresh approaches at addressing this problem.

I readily acknowledge that there are some dishonest individuals and firms in the securities business today. However, let me also

¹ The prepared statement of Mr. Goldsmith appears in the Appendix on page 252.

say that the overwhelming majority of securities professionals and individuals in the industry today are honest and ethical and treat their obligation to comply with the law seriously, and as they should, put the individual investor's interest first.

The problem firms that we have heard about today represent a tiny portion of the more than 5,500 securities firms in this country and are, for the most part, firms that concentrate their activities in the securities of thinly-capitalized micro-cap companies. While many of these smaller companies offer good investment opportunities for public investors, sales of securities of these companies are also susceptible to the abusive practices that we have heard so much about today. We see too much in the way of misrepresentation, manipulation, phony guarantees, phony promises and unauthorized trades. It is in this area, of micro-cap thinly-traded securities, that we see the greatest growth in fraudulent activity today.

I would like to spend a moment talking about NASD Regulation's enforcement record. As these hearings demonstrate, we have to redouble everything we have been doing in the past. NASD Regulation has already begun to do so, with major investments and new staff and surveillance systems being made now and budgeted for in the future. These enhancements have increased both the numbers and impact of our enforcement actions, as well as the effectiveness of the sanctions we have obtained.

I have described some of our recent enforcement actions in my written testimony. We have sanctions guidelines that are now under review and are going to be totally revamped. Last year, we brought 1,200 disciplinary actions, threw nearly 400 brokers out of the business. This year, we are running about 18 percent ahead of that in terms of barring individuals from the business.

The priority in every case that we bring against offending firms and individuals is to make restitution to injured investors. In two recent micro-cap cases that we brought just last month, D.H. Blair and GKN Securities, more than 4,300 investors in 48 States will receive more than \$3.8 million in restitution and interest.

Stratton Oakmont, a firm that we heard so much about today, was thrown out of the business by NASD Regulation in December. This is a prime example of how the States and the SROs and the SEC can work together. The NASD decision expelling Stratton Oakmont specifically made reference to securities actions brought by 19 States, including the State of Alabama. I am against regulatory duplication, but in certain cases, a little duplication is not a bad thing.

The Subcommittee has expressed particular interest in how we assure that past offenders do not repeat their violations. We accomplish this by giving regulators and investors information on past violations, punishing repeat violators more heavily, closely monitoring the firms that hire past violators, and requiring heightened supervision of any brokers with a significant disciplinary history.

Our sanctions guidelines already provide for significant escalating sanctions against recidivists. Where we see barred brokers reappear on the fringes of our industry as unsavory stock promoters and people who are beyond our jurisdiction, we refer those cases to the SEC and to criminal law enforcement authorities.

We cannot arrest people. We cannot put people behind bars. But the NASD has the manpower and the technical expertise to assist criminal prosecutors around the country to do their jobs. Recently, we have noticed increased interest by State and local criminal prosecutors in tackling these cases. With appropriate training and help from the regulators, we believe they can do just that and these cases are going to be brought.

We have made micro-cap a prime focus of our regulatory program, but we have to do more. The NASD is actively studying this market, particularly the over-the-counter bulletin board, where many of the securities that we heard about today are traded. We are going to make the changes that are necessary to address the problems we see.

While the bulletin board provides a marketplace with real time price and volume information, investors need to have access to more accurate and current information about the companies whose shares trade there. Too often, the only information investors have is the misinformation and hype posted on a stock promoter's Web page or the pie-in-the-sky promises made by brash cold calling brokers.

We are going to propose a number of initiatives in that area. First, we must take a hard look at whether there should be higher threshold standards for including a stock in the over-the-counter bulletin board. We will look closely at whether a company that is either unwilling or unable to provide full and timely disclosure of information to the public and to regulators should be given quotation visibility on this electronic medium. Such a proposal could limit quotation on the OTC bulletin board to companies providing and filing periodic reports with the SEC and other financial regulators.

Second, we are going to work with the SEC to strengthen the tools that we have to keep the shares of bogus companies from being traded in the over-the-counter market in the first place. This can be accomplished by toughening and clarifying the rules we have to prevent broker-dealers from initiating or continuing to quote an OTC security when they do not have current, reliable financial and other information about the issuer.

Third, we are also considering a rule to prohibit a broker from recommending an OTC security unless he or she also has first reviewed the issuer's current financial statements and believes that they are accurate.

Fourth, we are considering rule changes that would place tough new requirements on brokers, beyond the existing suitability requirements, to confirm with their customers that purchases of these types of speculative over-the-counter securities are suitable, given the customer's age, experience, and investment objectives. We are looking at requiring brokers to disclose to their customers specific information about these types of investments and explain to them the differences between the over-the-counter market and the Nasdaq stock market. We will determine if there is an increased need for regulation on the operation of the bulletin board, such as to give the NASD the authority to halt trading or halt quotes of securities under certain circumstances.

Finally, we must be more proactive in educating investors on the specific and unique characteristics of the OTC equities market. We have already begun a program to educate investors about the OTC bulletin board, the pink sheets, and other quotation media.

I would like to talk about some of the new rules that we have initiated and those that we are proposing and have under consideration. We feel that these rules will have a very strong impact on investor protection in this marketplace. First of all, with respect to clearing firms, a focus of these hearings, and we have heard testimony today about how one of these brokers used Morgan Stanley's name in order to attract Mrs. Sprecher to invest. The focus of these hearings has been the increasing responsibility of clearing firms for notifying regulators of problems with introducing firms.

We are working closely with the SEC and the New York Stock Exchange, to impose new reporting responsibilities on brokers that clear trades for these smaller firms. These proposals would require clearing firms to provide information that will allow self-regulators to better monitor the smaller firms for which they clear trades—the introducing firms.

Our boards will soon be considering proposals to require clearing firms to report to their designated examining authority, either the NASD or the New York Stock Exchange, the written complaints that they receive on introducing firms and to forward these complaints to the introducing firms, as well. This will help get at the problem that Mr. Borg identified of complaints that are being deep-sixed and put on shelves that nobody sees. This is a double check and additional information that we need.

I would like to talk about taping. Taping has a salutary effect. When we succeed in putting a recidivist firm out of business, we think that our job is not over. We have heard testimony today about principals of firms who we expel turning around and forming new firms under a different name, or other times the firms move en masse to a branch office of an existing firm. When a large number of brokers like these become employed at another broker-dealer, this raises a real risk that their new firm will have significant sales staff who may not yet have forgotten their old bad habits.

In addition to our other enforcement efforts against repeat offenders, the NASD board this month sent to the SEC for its review, and hopefully approval, a rule that would require brokerage firms to tape all customer sales calls for 2 years if a specified percentage of the firm's brokers worked for firms that have been expelled for telemarketing fraud or sales practice abuse.

Cold calls, telemarketing, we have heard stories today that turn my spine cold about cold calling. These tactics are often used to induce investors to purchase stock over the telephone from a broker they do not know and probably would not want to know if they met him or her. We have adopted telemarketing rules, and in a related initiative, we now have out for comment to our members a rule that for the first time would require all persons who make cold calls to be registered security sales representatives.

Right now, as I speak, there are firms who are using unregistered staff, people who do not have to pass NASD examinations or undergo the education that is required to make calls to investors.

The proposed rule will assure that those making the cold calls are aware of our rules and subject to our regulation and sanctions.

We are also developing a new Internet search engine that will help combat Internet fraud, and obviously we are working on new initiatives to give investors more information that they want. One of the comments that Chairman Collins made about putting phone numbers on brokerage statements is something that I definitely want to consider. Right now, we are talking to a number of major utilities on the East and West Coasts to use envelope stuffers to put this kind of information in the hands of the type of audience we must reach. We need to be marketers. We need to be effective. Publishing an 800 number that nobody remembers is not enough. We need to do more.

I would be happy to respond to any questions you might have.

Senator COLLINS. Thank you very much, Mr. Goldsmith.

I commend you for the steps that the NASD is taking to further regulate the bulletin board, to look at that issue, since I think a lot of people, given the bulletin board's link to Nasdaq, assume that it provides the same kind of stability in terms of disclosure and listing requirements as the other NASD markets. I also commend you for the other rule changes that you have just described to us that are under consideration involving among other clearing firms and cold calling.

But as I said to Chairman Levitt, in the end, I think this comes down to an issue of the confidence and the ethics of the people in the industry. As I said in my opening comments, the vast majority of brokers, and you have underscored that, are ethical. We do have, however, a persistent minority that no matter what we seem to do from a regulatory or legislative perspective just keep popping up and that is why I want to pursue with you the questions that I asked Mr. Levitt.

I am not kidding when I say that in the State of Maine, it is easier to get a license to be a stockbroker than it is to become a cosmetologist. A cosmetologist has to have a high school education, has to have undergone specialized training, has to take both a written exam and a practical exam, has continuing education requirements every 2 years, and yet, obviously, the consequences of someone who is a licensed broker for an unwitting, unsophisticated investor who is given bad investment advice are so much more severe.

Do you think that the competency levels for brokers are sufficient? Is entry into the industry too easy?

Mr. GOLDSMITH. I really do not think that the problem rests with how difficult the exam is. In fact, we brought cases, I believe, against 52 individuals who felt that it was too difficult and they got somebody who they paid to take the exam for them. That is something that, hopefully, will not happen again.

But I think what we need to do, I agree with your comment about increasing sanctions for the bad apples. We see too many cases where firms, as a cost of doing business, will pay \$1 million fines and go on to, in a sense, rob Peter to pay Paul. Even in cases where arbitration systems are set up, we sometimes find that these firms are paying old investors 10 cents on the dollar with new investors' money.

I do not think, though, that toughening the exams will necessarily stop that problem. I think you hit it on the head, that these are really ethics we are talking about and we have a lot of very smart crooks in the business who would be able to pass just about any reasonable exam that could be taken.

So I think we need to concentrate on getting the bad people out, educating investors, and looking hard at cases and saying, is this a firm or is this an individual that we want to, in a sense, live another day with other investors, or are we going to draw the line here and try to get them out of the business? Sometimes with numbers of cases and burdens, it is something you have to look back on and make the decision to bite the bullet.

Senator COLLINS. I think that is a critical issue. I think the NASAA issued a report that was quoted in the House report accompanying the 1990 penny stock legislation that said in one study, something like 83 percent of the people who were working for firms with trouble had a previous history of violations of securities laws. That again raises the concern to me of whether we are tough enough and whether we should have a zero tolerance policy. For example, if there is a serious breach of ethics, you are out, or you are at least out of the industry for a significant period of time. What is your reaction to that?

Mr. GOLDSMITH. I think, as I said, our sanctions guidelines are being reviewed from top to bottom. We have a committee made up of staff members, industry members, and committee members, looking at our guidelines. I think there has been an appreciation that we have ratcheted up our sanctions.

We have also, as part of the joint regulatory sales practice sweep that the SEC, NASAA, and the NASD did last year, issued a notice to members requiring heightened supervision of brokers with disciplinary histories. And one thing we are doing that I think has a very beneficial effect, particularly now as CRD is going to become more investor-friendly and enable investors to get information on brokers, is bringing cases and drilling down to low levels in terms of brokers. We are not just suing the top two or three people in the firm.

A.R. Baron is a case that we have heard a lot about. There have been indictments by the Manhattan District Attorney's office and we have sued 23 brokers there. GKN, a case I mentioned, 29 brokers. H.J. Meyers, which I think is right there on Mr. Borg's chart, more than 35 brokers. What we want to do is tag these brokers, and these may not be brokers who have committed capital offenses, but tag them with disciplinary histories so when they go from firm to firm, that is known to their new firms. When investors get a call and want to check out the broker, they will see that this is a broker who has been disciplined. That is something, I think, that is going to have an effect.

Senator COLLINS. Let me follow up on that very point. You just mentioned A.R. Baron, and in your testimony you mentioned enforcement actions taken against Hibbard Brown. These are firms that, it is my understanding, are no longer in business, is that correct?

Mr. GOLDSMITH. Yes.

Senator COLLINS. With respect to each of those firms, do you know how many brokers worked for the firm and how many of those brokers are still in the industry? You mentioned that you are suing further down, but are a lot of the people who worked for those two firms still in the business and are they subject to any sort of special ongoing scrutiny by either NASD or their new firms, if they are still in business?

Mr. GOLDSMITH. A firm that we expel, our taping rule, if it is approved, will come into effect. And one thing that we do, we have an examination program and we had over 2,400 main office exams last year and cause exams based on customer complaints, 5,200. When our examiners go into firms, we are aware of the brokers who are there and we are aware of their past affiliations and those are red flags for us, as well.

So we do keep track of where brokers go. I think you will find that in many of these firms, particularly some of the younger brokers end up going into the used car business when their firms go out of business. Also there are a fair number that just scatter. But sometimes we hear that there is a nucleus of brokers going to firm XYZ. We will go into that firm and we will look around. It is a piece of regulatory intelligence that I think is very important and one that we use.

Senator COLLINS. Mr. Borg, earlier today, and I know you were here for the testimony of our consumer witnesses, we heard two of the witnesses, Mrs. Sprecher and Mr. Poggi, were the victims allegedly of outrageous conduct by a firm called Investors Associates. I wondered if you are familiar with the firm, whether or not you know what its status is now and whether there was a sufficient regulatory response, in your judgment.

Mr. BORG. Investors Associates was suspended, their license revoked in Alabama, I believe either December of 1996 or January of 1997. It is my understanding that Investors Associates still maintains its NASD license. Its license has been revoked in at least 10, perhaps 12, States, and some of the people of Investors Associates have moved on to other firms, including some of the folks that were mentioned today.

I would point out, as I was listening to the testimony today, I recognized a number of these names, these individuals, such as Mr. Baratta, who came from Investors Center, which is on the chart, and Mr. Bleich, who came from Duke Associates, and Mr. Tropeano, who came from Continental Brokers, which is on a subsequent chart in the submitted materials. Mr. Grecco is well known. He is both from Investors Center and Stratton Oakmont. So this, I think, proves the point. Mr. Spitzer was also mentioned as one who took over the Sprecher account. He is formerly with GKN. So I think this shows the pattern that goes on.

Has there been sufficient response? That is a tough question. I do not believe—I would prefer a stronger response, and I think, as this program of working together on the micro-cap attack, as Chairman Levitt mentioned today, including joining with the NASD, perhaps the State concerns on the extent of the regulatory attack can be increased, especially if there are some other indications, such as cold callers who have to be registered.

If they are not registered, they are not on the CRD. If they are not on the CRD, I do not know about them and there is nothing I can do except bring a criminal action. I cannot revoke the registration or suspend it; they are not licensed. So I am pleased to hear Mr. Goldsmith today talk about enforcing a regulation or proposing a regulation to that extent.

I do think that regulatory actions by the SEC, the NASD, and the States—we fall into this category, as well—in the past have concentrated on the principals and the firms. I do not think that, historically, any of the regulatory agencies really recognized the progression, as you will, or the generational networking that existed until recently.

I do believe that there has to be greater response up front prior to the time, for example, that Mr. Belfort and Mr. Greene, who are on their yachts now, have taken several hundred million dollars and are now out of the business. It is a little late.

Senator COLLINS. It is incredible to me—and your tracing the patterns of employment of these individuals just underscores the point—it is incredible to me that these rogue brokers can just keep popping up over and over again and that we are not taking action to bar them from the industry. I am just perplexed by that, because you know that they are going to go on to victimize other people, similar to the people we have heard from today.

Mr. BORG. And that is why I recommended that if the NASD and the SEC could utilize a State order, to the extent that it could utilize orders between NASD and SEC, to prevent these brokers from continuing in the industry or at least suspend their operations until such time as a full review could be made, I think that would go a long way to preventing the further transfer from place to place.

Unfortunately, the CRD system does not trigger our notice at the State level until there is a firm transfer, and if it is a mass transfer, then that means we have to go through one by one, and we try to do that, but the States do have limited resources.

That is why it is so important, and I heard Chairman Levitt state today that they have all this information, but it is hard to prosecute. Well, it is easier for the States to prosecute, but I do not have the resources and information he does. It is a combination of the SEC and the NASD, with their resources and their information and their expertise and our ability to get into State court in a quicker manner, perhaps, than the U.S. Attorney's Office or the Department of Justice, but a combination of all these factors is what it is going to take to drive these people out of business.

Senator COLLINS. Thank you.

Senator Cleland.

Senator CLELAND. Mr. Borg, it is good to see you.

Mr. BORG. Thank you, sir.

Senator CLELAND. Mr. Goldsmith, thank you very much.

Let me just follow up on that point. I think you really hit the nail on the head there. I mean, what we have here is a troika with the SEC and then the NASD and then the States, three levels, certainly two levels of government and one involving the private sector there, all having to work hand-in-glove to track down and nail

and prosecute and put in striped suits—broad stripes—bad guys or bad gals. They are pretty elusive.

I can remember being Secretary of State in Georgia. We put together a 6-State task force to crack down on some boiler rooms out in Orange County, California. You just referred to a 20-State effort—was it not 20 States?

Mr. BORG. Yes, sir, the May sweep.

Senator CLELAND. Yes. I think that is quite incredible.

I just want to come back to the role of the States. Obviously, you have some defenders here who think the role of the States ought to be a strong one, but you just mentioned right there at the end your ability to get into State court quickly if you had some help from others, NASD or the SEC in terms of information. Is that correct?

Mr. BORG. Yes, sir, I believe so. My State brings a number of actions every year. I think last year, we brought 30 criminal actions. I have something like 36 or 38 defendants awaiting trial right now on charges, not necessarily micro-cap but general securities fraud, whether they are non-existent stock or investment advisors who have ripped off pension accounts.

But the thing is, on this micro-cap, because of the time and effort it takes—you may recall that time line on the Steve Madden chart with the creation of the bridge units and the selling of the private placements. This is information that is the expertise of the NASD. If that could be combined with getting the complaints to us quicker, because sometimes they do end up at the NASD as opposed to the States, we would like to facilitate a greater exchange of that information, and I think we are doing it. It has started on a district level.

Then if the NASD would refer to us those complaints as soon as they hit and if we can find sufficient basis in our State law, I think the Attorney Generals or the District Attorneys, or in our agency case, we prosecute our own cases most times with the assistance of the DAs and the AGs, we could get into court a lot quicker on a good criminal case.

In some cases, the determination may be there is not quite enough to meet the burden of a criminal case, because as you know, it is a much higher burden than revoking a license or suspending them from business, and that is a decision that is going to have to be made on a case-by-case basis.

But with the information from the SEC and the NASD, combined with the cop on the beat, as Arthur Levitt has referred to the States, abilities to get into court, I think you would see an increase in criminal prosecution. I think you would also see a speeding up of the process of revocations of licenses and suspensions, and if the SEC and the NASD would honor those suspensions of licenses, I think you would see a quicker response.

Senator CLELAND. Do you think criminal prosecution is the ultimate deterrent?

Mr. BORG. Yes, sir. If I can give you a quick example of what I think happens, and I was not a personal witness to this, but one of the people we interviewed with regard to the Stratton case indicated that at one point in time, one of the principals in the boiler room, which is a big board room where they had 250 to 300 people

making cold calls, which, by the way, Senator, they made a million calls a month. We took 18 months of their records——

Senator CLELAND. That is more than I raised in soft money. [Laughter.]

Senator CLELAND. Strike that from the record. I am kidding.

Mr. BORG. But at one point in time, there was a fine levied or there was an action brought and one of the principals got up on the table to announce that one of the regulators had taken this action or had fined them a certain amount and the report goes that everyone, "Awww." And then he announced, "But, in the same 30 days, we made \$10 million," and everybody went, "Yay." So, no, there is no sufficient response in a civil proceeding if they can pay you \$1 million and steal \$5 million. It is a cost of doing business. Therefore, I think the proper response would be a criminal action, and you have to get past the principals to the agents to deter new agents if they think there is a possibility of going to jail.

Senator CLELAND. What do you think about this concept of zero tolerance the Chairman mentioned and Mr. Goldsmith is interested in and made a comment to the New York Attorney General in terms of zero tolerance? Should we be thinking about that?

Mr. BORG. I am very interested in zero tolerance. I would like to be able to work with NASD and the SEC on developing guidelines toward zero tolerance. I think it is something that can be discussed.

If I might digress just for a second, the idea of putting the numbers on the account statements, I think, is an excellent idea. However, I would recommend one change to that. In Mr. Poggi's case, the number on the account statement would have been too late because the account statement he got was after the trades had been made, within that 30 days, and the statement will not drop, chances are, until sometime at the end of the month.

I would recommend that either at the initial application stage, prior to any trade, that that information be delivered, either as part of the client form to allow them to do business or a separate mailing that gives that information up front, because, as I said, in Mr. Poggi's case, I think had it been on the account statement, he would not have seen it for 45 days and it was too late in his case.

Senator CLELAND. You mentioned about the effectiveness or the ability to go into State court quickly. The Private Securities Litigation Reform Act placed certain restrictions on the ability of defrauded investors to seek redress in class action lawsuits. Should the new Act be amended to preclude investors from bringing actions in State courts?

Mr. BORG. I think the issue is different. I am not up on the Private Litigation Reform Act, per se. I am sure my general counsel at the Commission is. But what I am talking about here is the enforcement of the anti-fraud authority and the criminal violations under a criminal act. The State is not precluded, as I understand it, from bringing any actions under private litigation reform, and that is for class action type lawsuits, and that would be a civil redress. Therefore, I am not qualified to speak to that, Senator.

But I would say that on the criminal side, that that would be a police power to the State and I think the State, if it has a violation of its statute or a violation of a Federal statute or Federal regula-

tion that they are required to meet at the State level, then I think the States can act on that.

Senator CLELAND. Mr. Goldsmith, talk to us a little bit about zero tolerance and how you see that in your line of work.

Mr. GOLDSMITH. Let me take an easier question first and then I will answer that one. I think it is clear, I think we all agree that we need to increase the sanctions, and I am not talking about by \$500 or \$1,000. When we are dealing with people who should not be dealing with investors, we ought to get them out of the industry.

I think any kind of zero tolerance, just as I think in the three strikes and you are out, in any court system, you have to recognize that you are dealing with firms with limited resources. If you have a zero tolerance that runs from a technical violation all the way up, you are going to have people litigating and prosecuting and appealing to the SEC and the court of appeals.

Our disciplinary process moves quite quickly at the NASD, but people have the right, as they should, to appeal that. It then goes to the Commission. It could then go to the court of appeals. If you are trying to throw people out of the business for violations that may not warrant that, that could be a problem and it is going to hurt your enforcement down the road.

But a carefully articulated policy with guidelines that, with respect to certain types of violations of certain magnitudes, would warrant expulsion, and we have that and we are looking at toughening those, I think is something worth looking at. Again, we are revamping our entire sanctions guidelines to that end and we are toughening up. We have thrown out more firms. We have expelled more individuals, and I think we still need some further toughening.

Senator CLELAND. Madam Chairman, that is the end of my questioning. I would just like to thank some key people on my staff. Wayne Howell, who is the former head of the North American Association of Securities Administrators, now my Administrative Assistant, has put a lot of work in on this hearing and will be helping me on other hearings, as well as Kevin Franks on my staff and Jeff Robbins, minority counsel. Thank you, Madam Chairman.

Senator COLLINS. Thank you, Senator, and I want to thank you for your personal leadership in this area. I know we are going to continue to work together on it and I look forward to that.

I want to thank our witnesses. The hearing record will remain open for 30 days and it is possible that our counsels, as well as other Senators on the panel, will have additional questions to submit in writing and we hope that you will assist us on our ongoing investigations.¹

I, too, want to thank my staff people who worked very hard on this, Ian Simmons, Tim Shea, Dennis McCarthy, Mary Robertson, Lindsey Ledwin. As you can see, when you are in the majority, you get more people to thank. [Laughter.]

I want to acknowledge Jeff Robbins's assistance also as the minority counsel, and I particularly want to have a special thank you to my legislative counsel who is also a former State securities administrator, Steve Diamond.

¹ Exhibits 16, 17, and 18 appear in the Appendix on pages 432, 466, and 475 respectively.

Thank you very much for helping us explore this issue and the hearing is now adjourned.

[Whereupon, at 4:46 p.m., the Subcommittee was adjourned.]

A P P E N D I X

**OPENING STATEMENT
OF
SENATOR SUSAN M. COLLINS
CHAIRMAN
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
Hearing On
Fraud In The Micro-Capital Markets,
Including Penny Stock Fraud
September 22, 1997**

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Today we launch an investigation into securities fraud in what is known as the micro-capital markets. For those unfamiliar with the arcane terminology of Wall Street, the microcap segment of the markets includes small companies with relatively low market values. It includes, but is not limited to, penny stocks.

These hearings are both the continuation of a tradition and a look to the future. They are the continuation of a tradition because of our Committee's long history of investigating securities scams aimed at small investors. They are a look to the future cause we will be examining new and growing abuses in our capital markets.

These hearings are very timely. Last fall, Federal prosecutors charged 46 individuals with stock fraud in New York. In May of this year, a 20-State task force acted to shut down some of the worst of the firms engaged in stock manipulation. And less than three weeks ago, on September 4, *The Wall Street Journal* published a lengthy story entitled "Despite Reforms, Penny-Stock Fraud is Roaring Back." That story noted the very disturbing fact that investors may lose more than \$6 billion annually due to penny stock fraud - more than "triple the 1980s peak."

We conduct these hearings against the backdrop of a booming stock market and a new generation of unseasoned investors. Hidden beneath the rising tide of the market, micro-cap fraud represents a pernicious undercurrent that potentially affects thousands of American families. Many of these families are, for the first time, investing their hard-earned money to save for skyrocketing tuition costs, unforeseen medical expenses, and lengthier retirements. While we have the safest and most successful capital markets in the world, the irony is that public confidence in our markets actually creates opportunities for con artists to exploit the unwary.

Microcap fraud not only harms small investors, but it has the potential to harm small companies. As this type of fraud increases, the willingness to invest in emerging enterprises decreases, and legitimate companies are denied the capital which is the life blood of our free enterprise system.

How do these scams work?

Unscrupulous brokerage firms, often operating through intermediaries, purchase large amounts of stock in a small company. The stock is virtually worthless or of very limited value, but the brokers drive its price higher by aggressively cold-calling thousands of unsuspecting individuals, many of whom have little or no prior investment experience. In repeated cold-calls, the scam artists hammer away at the investor on the telephone, promising glowing returns and emphasizing the need for immediate action. The inevitable effect of these aggressive sales tactics is to push the stock price higher, at which point the brokerage firms' insiders dump their shares, leaving the public with worthless securities and the brokers with millions in ill-gotten gains.

Scratch the surface of a stock manipulation scheme and you will inevitably find false or exaggerated information. If you doubt the potentially tremendous impact of false information, consider the \$6 billion dollar Bre-X scam. In that instance, phony reports about the gold content of the company's mines drove the price of the stock from a few pennies to \$240 per share, until the fraud was exposed and the stock fell back down to earth. As you can imagine, the unsophisticated investors who rode the stock down hit the ground with a thud.

Coercive cold-calling and spreading false information are not the only tactics used by boiler rooms engaged in stock manipulation. Other practices which I expect to emerge from our investigation include: making unauthorized purchases in customers' accounts; refusing to execute sell orders to maintain a stock's upward momentum; using unlicensed persons who are paid under the table for making sales; and bribing brokers to recommend the stock being manipulated to their unsuspecting customers.

One particularly troubling problem that we will hear about today is the difficulty regulators have in driving unethical brokers out of the industry. When a boiler room operation is closed down, often after lengthy proceedings, it is unfortunately common for the employees to show up in a host of new firms. Not unlike a grade-B science fiction movie, killing one of the monsters only seems to create a new army of them. Our regulatory system must ensure that when a broker participates in this type of fraud, he or she is not allowed to remain in the industry and again pick the pockets of unwitting investors.

There are a number of other regulatory questions that we must consider. For example, should the large Wall Street clearing houses that process transactions for penny stock brokerage firms have more of a role in stopping fraud and manipulation in the microcap market? How effective has the 1990 penny stock legislation been in limiting abusive practices? More specifically, since that legislation applies only to stocks selling for \$5 or less, has the fraudulent activity simply moved to higher-priced stocks also traded in the microcap market? What more should be done to police the "Bulletin Board" market?

While we are confronted with complex issues, we are fortunate to have an outstanding set of witnesses who are well qualified to address those issues. We will first hear from the Honorable Arthur Levitt, Jr., the distinguished Chairman of the United States Securities and Exchange Commission.

We will then hear from three individual investors who were victimized by fraudulent practices and who have kindly agreed to share their experiences with us.

Finally, we will hear from two other regulators: Mr. Barry Goldsmith, the Executive Vice President for Enforcement of NASD-Regulation, the regulatory arm of the NASDAQ market, and Mr. Joseph Borg, the Director of the Alabama Securities Commission, who will present the State perspective.

As we proceed with today's hearing, as well as with future sessions on securities fraud, we should remember that this Subcommittee has a dual role. Mindful of Justice Brandeis' observation that "sunlight is the best disinfectant," we have a responsibility to expose abusive practices so that the American people can be on guard against them. We also have the obligation to determine whether our current regulatory scheme affords adequate protection to an ever growing investing public. As I noted earlier, this Subcommittee has a proud tradition of looking out for the interests of small investors, and I am determined to continue that tradition under my chairmanship.

In carrying out our responsibilities, we are fortunate to have the participation of my colleague from Georgia, Senator Cleland. As the Secretary of State, Senator Cleland oversaw securities regulation in Georgia, a state that was in the forefront of the battle against penny stock fraud. His experience and leadership in this area will be an invaluable asset to the Subcommittee.

I am also delighted to be working with the Ranking Minority Member of the Subcommittee, the distinguished Senator from Ohio, John Glenn. I know that Senator Glenn shares my commitment to exposing abusive and unethical practices in the sale of securities, and I will now recognize him for any statement he may wish to make.

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**UNITED STATES SENATE
Permanent Subcommittee on Investigations
Committee on Governmental Affairs**

**EMERGING SECURITIES FRAUD:
FRAUD IN THE MICRO-CAPITAL MARKETS**

Statement of:

**MAX CLELAND
United States Senator
State of Georgia**

Washington, D.C.

September 22, 1997

**GOVERNMENTAL AFFAIRS COMMITTEE
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS**

Emerging Securities Fraud: Fraud in the Micro-Capital Markets

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Madame Chairman and Members of the Subcommittee. It is a pleasure for me to be here today seeking information, and hopefully, solutions, to a major problem that has faced our country for years.

Secretary of State

I served as Georgia's Secretary of State and Commissioner of Securities¹ for many years. I was responsible for administering Georgia's securities laws² and providing investor protection for Georgia residents.

Securities Markets

The securities markets are an integral part of our nation's economy and we have experienced tremendous growth in these markets. In fact, this year alone the markets have reached an all-time record. Unfortunately, these successes have led to a tremendous increase in fraud and abuse.

In 1990, only 17.8% of all Americans were invested in equities. Today, I understand that 31% of all Americans are now investing in equities and that one in three households now own securities.³ In 1992, the daily share volume for the New York Stock Exchange and NASDAQ was

¹The Secretary of State is designated as the Commissioner of Securities and is responsible for administering the Georgia Securities Act of 1973, as amended.

²O.C.G.A. §10-5-1 *et seq.* (The Georgia Securities Act of 1973, as amended).

³Investment Company Institute, *1997 Mutual Fund Fact Book*, (Investment Company Institute, Washington, D.C.) Mar. 1997, ch 5 at 3.

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only about 200 million shares a day. Today, the New York Stock Exchange and the NASDAQ Market consistently trade in excess of 500 million shares.⁴ At the end of 1996, the market capitalization of NASDAQ was over \$1.5 trillion dollars — more than a three fold increase from \$508 billion at the end of 1991.⁵

Confidence and Integrity

The securities markets would not exist without public confidence in the integrity of the professionals who work in and manage these markets. I salute these professionals, and commend them for their efforts in promoting and encouraging a strong securities market that provides the capital to make our country grow and provide economic security for our citizens.

While there are justifiable criticisms of the markets, the purpose of these hearings is to deal with the few bad apples, and not force regulatory changes that would be burdensome and a hindrance to legitimate capital formation. The success of our markets is shown by the billions of dollars that change hands each day, either from a telephone call, head nod or a hand shake, which clearly reflect the trust and confidence we have placed in their integrity. Should this integrity be replaced with mistrust, our confidence would erode and the markets, as well as the American economy, would ultimately suffer. We now have, beyond any doubt, the best securities markets in the world, and it is very important that we strive to keep this market strong and the playing field level, in order to give all investors an opportunity to be successful in the market.

Regulatory Structure

⁴Suzanne Wooley, *The Booming BigBoard*, BUS.WK, August 4, 1997 at 60; National Association of Securities Dealers; NASDAQ, NYSE and AMEX Comparisons (Internet - 9/2/97 - www.nasd.com).

⁵NASDAQ Investor Research & Analysis (9/3/97).

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The confidence in our securities markets results, in part, because of the excellent cooperation that has existed between state⁶ and federal government regulators and self-regulatory organizations. This regulatory partnership has proven to be one of the most efficient and effective regulatory collaborations in the country.

Substantive securities regulation in this country began at the state level. In 1911, the State of Kansas enacted the nation's first Blue Sky Law. Other states quickly adopted their own version of such legislation. And in 1929, as a result of the stock market crash, Congress began a series of legislative efforts that encompass the body of law known today as the federal securities laws.

Regulatory Uniformity

In the 1970s, a major cooperative effort was initiated between the states, the SEC, the NASD and the stock exchanges. The results of this effort include:

- Uniform competency examinations that allow an individual to take one examination accepted by all the states.⁷
- Uniform registration forms that allow a firm or an individual to use the same forms for the states, the SEC and the self-regulatory organizations.⁸

⁶The term "states" used herein refers to the agency or officer of a particular state charged with administering and enforcing the respective state law regulating the offer and sale of securities within or from that state.

⁷The individual states under the auspices of the North American Securities Administrators Association, Inc. ("NASAA") worked with the NASD and adopted the use of Series 63, the uniform state law examination. The examination is administered through the NASD.

⁸Form U-4 is the form used by representatives seeking registration with the individual states and the NASD. Form U-5 is the uniform termination form used when a representative terminates their employment. Form BD is used for applications to be registered as a broker-dealer. Form ADV is used for applications for registered investment advisers.

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- Central Registration Depository (CRD) that allows for an automated one-stop registration filing system.⁹

This registration and licensing process provides an efficient and uniform process that complements the fundamental purpose of state and federal securities laws to provide investor protection and foster the confidence that will encourage the investments necessary for capital formation, economic growth and job creation.

Efforts of the Private Bar

For a regulatory program to be successful you must have vigorous enforcement. When the securities laws were framed in the 1930s and 1940s, Congress wisely realized that there would never be enough "cops on the beat" in the form of government-paid securities regulators, but that it would be necessary for the private bar to enforce the law on behalf of defrauded citizens. It is these attorneys who, in the words of SEC Chairman Arthur Levitt, "serve a crucial role as a deterrent and are a vital supplement to the Commission's enforcement resources." In testimony before Congress and in court documents, the SEC has repeatedly emphasized the critical role of the private lawsuit. However, despite the best efforts of the SEC, the 50 state securities agencies, and the SROs, there continues to be an unacceptably high level of fraud and abuse in today's capital markets.

Fraud

Recently, top securities watchdogs in the United States have warned investors that the

⁹The Central Registration Depository (CRD) is an automated registration system operated under an agreement between the NASD and NASAA. The system was designed in the late 1970s and came online in the early 1980s. An applicant files forms with the CRD seeking registration, the system tests the form for completeness and certain other edits, the form is then communicated to terminals in the individual states for final approval. Disciplinary data is captured and made available, on demand, to the regulators.

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explosion in the stock market has brought a sharp rise in securities sales fraud and stock price manipulation. At a town meeting in Los Angeles, SEC Chairman Levitt cautioned that investors are "more vulnerable than ever to fraud." This concern has been echoed by others who point to a disturbing rise in the level of securities fraud and allege that organized crime is seeking a foothold in certain sectors of the marketplace.

What is unusual about the increasing evidence of wrongdoing in the stock market is that shady practices tend to go unnoticed in the days of a strong bull market. Usually, the misconduct is uncovered only after a sharp sustained market drop similar to that of 1987. This has the regulatory community wary about what it would face should the stock market collapse.

In the past five years, the number of stockbrokers doing business in the United States has grown by 50 % to 650,000. However, during the same time period, the regulatory staffs of the Securities and Exchange Commission and National Association of Securities Dealers grew just 18 %.

Let us all understand who suffers in cases of securities fraud — it is retirees living on fixed incomes, young families struggling to make ends meet and save for their children's education, teachers, factory workers, and bankers.¹⁰ Each day, devastating cases are brought to the attention of securities regulators, law enforcement officers, and the private bar. Indeed, I am convinced that financial fraud is a serious and growing problem.

Micro-Cap Fraud (Penny Stock)

Today's hearing will focus on "micro-cap fraud." This is a new and modern term — we are

¹⁰See attached news articles relating to investment fraud.

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famous for these here in Washington — for what we have known for years as "penny stock fraud".¹¹ In Georgia talk, we call it cheating and stealing.

In the late 1980s as Secretary of State, I directed a series of public hearings to focus on the penny stock fraud taking place in Georgia.¹² We heard substantial evidence about serious securities violations involving misrepresentations, omissions to state material — enough about legalities — what they were doing was lying, cheating, and stealing and swindling our citizens out of their hard earned money. Of course, not to provide capital for economic growth, but to line their own pockets with ill-gotten gain.

This led me to recommend a series of changes to strengthen Georgia's securities laws.¹³ These recommendations were unanimously enacted as amendments to the Georgia Securities Act and gave my staff more tools to effectively deal with penny stock fraud

In 1990, the SEC recommended, and Congress enacted, Penny Stock Reform. The resulting reforms, both state and federal, were effective for a few years. However, these crooks are clever, they accumulate their wealth by stealing — not with a gun — but with a telephone and a fast line, and often through threats and intimidations. It did not take long for them to figure out how to avoid the reform requirements. Now we see the micro-cap frauds being perpetrated by rogue brokers making cold calls all over the country promising people that they can get rich quick in today's

¹¹In September, 1989 NASAA estimated that \$2 billion of investors' funds were lost to penny stock fraud and abuse annually and that during 1988 a survey showed that penny stock complaints were reported in 49 of the 50 states.

¹²Testimony and documentary evidence was provided by penny stock dealers, traditional securities dealers, state regulators, federal regulators, NASD, trade associations, brokers, and defrauded investors.

¹³These changes established significant disclosure requirements for those dealers offering and selling penny stocks within or from the State of Georgia. See O.C.G.A. §§10-5-2(a)9,10,11 and 10-5-12(i) and (o).

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growing market. They use the success of the legitimate market to demonstrate the misrepresented potential portrayed in their presentations. They say whatever it takes to "close the sale". They take advantage of honest hard-working people, trying to live the American dream, who make honest money in the market.

Private Securities Litigation Reform Act

I recognize the right of investors to seek legal remedies against those persons selling fraudulent securities. I have supported an investor's right to seek redress through mediation, arbitration and civil litigation. While I worked to streamline the regulatory process in Georgia¹⁴, I opposed amendments to federal regulations that would have impaired the ability of a state to protect its investors.

However, in 1995, as Secretary of State and Commissioner of Securities in Georgia, I opposed S.240, the Private Securities Litigation Reform Act.¹⁵ It appears that we are now seeing a move to preempt existing state securities laws by extending the Private Securities Litigation Reform Act of 1995 ("PSLRA") to the states. It is not yet clear whether this Act will provide sufficient protection to defrauded investors. The main concern here is if the courts ultimately interpret it in a way that makes recoveries under federal law impossible, state remedies will be the only means for defrauded investors to redress their injuries.

In the 19 months since its passage, the new Act has barely been tested, with no trials, no

¹⁴Georgia has a disclosure based registration system that requires the disclosure of material matters relating to the issuer of the securities (O.C.G.A. §10-5-12) and has a coordinated filing system for all issuers with an effective registration filed with the Securities and Exchange Commission (O.C.G.A. §10-5-9(5)).

¹⁵See my attached letters to Senators Sam Nunn and Paul Coverdell, dated June 27, 1995.

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appellate decisions on substantive provisions, no summary judgments, and few decisions on any of its provisions. It will take more time to adequately assess the PSLRA's impact as the courts struggle to interpret its provisions.

National Securities Market Reform Act of 1996

The Congress did an excellent job of balancing competing interests in the adoption of the National Securities Market Reform Act of 1996.¹⁶ I have always favored improvements in the regulatory system that do not curtail enforcement efforts to protect investors. The current efforts by some industry segments to preempt the state's role in the registration and licensing of broker-dealers and sales representatives would seriously impede the authority of the states to protect their residents from unscrupulous firms and brokers. I am confident that the SEC will find in its report¹⁷ that the states are an integral part of the regulatory process, and that it would be a mistake to hamper our state regulators by removing their jurisdictional authority over broker dealers.

Where do we go from here?

I have several suggestions as to where to go from here.

- **Investor Education.** I am interested in new and innovative ways to educate the public about the securities markets and the risks associated with investment opportunities. A program of this type must be fully supported by the regulators and the industry.
- **The CRD System.** Modernization of the Central Registration Depository should be one of the highest priorities of regulators. Quality information made promptly available to regulators

¹⁶Pub. L. No. 104-290, 110 Stat. 3416 (1996).

¹⁷Pub. L. No. 104-290, 110 Stat. 3451, Sec 510, (d) (1996).

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is often the key to a successful investigation and prosecution of violators. The CRD must be able to deliver both data and analytical reports in order for it to be successful as a regulatory tool. I encourage regulators to continue support for a viable customer complaint database that will provide information that could be useful in multi-state investigations.

- **The Administrative Process.** The administrative process provides regulators with the most effective tools to investigate misconduct and to discipline those firms and individuals who commit violations. However, regulators must not misuse or abuse the administrative process, and the process must not be viewed as the ultimate weapon to deter fraud in the securities business.
- **Civil Actions.** The filing of civil actions against firms and individuals who commit violations appears to have been the remedy of choice for the SEC. I think it is time to study the effectiveness of the civil process in dealing with serious fraudulent conduct by such firms and individuals.
- **Criminal Prosecution.** The filing of criminal complaints and the seeking of indictments against rogue brokers and con artists will be the most effective tool to deter this type of criminal activity. I strongly encourage regulators to work with local, state and federal prosecutors in developing coordinated investigations and prosecutions. Also, state and federal task forces could also provide a powerful tool in demonstrating to criminals that justice will prevail.
- **Taping of Sales Presentations.** I commend the NASD for its recent recommendation¹⁸ to

¹⁸See attached NASD Press Release dated August 7, 1997.

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- require certain firms to tape sales presentations by certain brokers. The taping of these potential problem brokers is a positive step toward better investor protection.
- **Cold Call Practices.** I also commend the regulators for their efforts to place limitations and restrictions on cold calls.¹⁹ I encourage further monitoring and study regarding the use and control of cold calls.
 - **Clearing Firms.** I question how many investors have been improperly influenced to purchase high risk and speculative securities by using the name of a prominent firm that is merely acting as their clearing agent.
 - **Disclosure.** Disclosure has always been the foundation for investors in making investment decisions. Regulators have done a good job requiring proper disclosure of material facts in registered offerings. In fact, some might say that the quantity of disclosure today may be a deterrent to real, meaningful disclosure. Disclosure in the secondary markets, even by market makers, has not been effective. I realize that the use of the telephone and market volatility require prompt decisions. However, we must be sure to find a way for regulators to require that investors in the public markets be provided with sufficient information prior to making their investment decision.
 - **The Internet.** It is imperative that our regulators have access to modern technology and provide programs to monitor investment activities on the Internet. Cyberspace fraud will be the wave of the future.
 - **The Future of State Regulation of Securities.** I support strong enforcement of our

¹⁹SEC Rule 15c2(4).

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securities laws and I am confident that the states must play a major role in these enforcement efforts. I want to encourage the states to be more flexible in licensing and registration procedures. I believe in using registration as an enforcement tool, but I do not think that states should place unreasonable burdens on firms and individuals attempting, in good faith, to become registered in their jurisdictions. I have been informed of many such unreasonable and inappropriate tactics. In Georgia I always insisted that my staff be fair and reasonable in registration and licensing matters and tough on fraud and enforcement matters. In other words - "reasonable regulation and tough enforcement."

Madame Chairman thank you for enduring my remarks. I am looking forward to hearing from the experts regarding ways that we can better protect our investors.

* THURSDAY, SEPTEMBER 19, 1996

LOS ANGELES TIMES

Comparator to Get Off Lightly, Sources Say

■ **Securities:** They say settlement in stock scandal will neither impose a fine nor require admission of wrongdoing.

By GREG MILLER
TIMES STAFF WRITER

Comparator Systems Corp., the Newport Beach company that was at the center of a major stock market scandal, has reached a settlement with government regulators in which it will pay no fines and can continue to operate, sources said Wednesday.

Under the terms of the agreement, two of the company's top executives—Chief Executive Robert Reed Rogers and Vice President Gregory Armijo—have agreed to no longer serve as officers or directors of any public company, sources said. The men also agreed to sever any employment ties with Comparator after a period of time, and they need not admit any wrongdoing.

But Rogers, 67, has already resigned, and neither executive will be required to pay any fines. Comparator itself faces no penalties, sources said, other than to agree to abide by securities laws.

One source said that the company will have to restate its balance sheet and get Securities and Exchange Commission approval before it can issue any new stock.

That means the controversial maker of electronic fingerprint scanners is free to continue to operate even though the SEC had accused Comparator in a civil suit of

Please see SETTLE, D13

SETTLE

Continued from D1

being an outright fraud that lied about its finances, stole its technology and bilked investors out of millions of dollars by issuing mountains of worthless stock.

"We're pleased to be able to have the matter resolved so that the company is not involved with any further time or expense in this matter," said Gerald E. Bolz, an attorney who represented the company and the two executives. He declined to discuss specifics of the settlement.

The settlement is believed to have been signed by Judge Lourdes Baird in U.S. District Court in Los Angeles on Tuesday, but the settlement documents were not yet available to the public. SEC officials declined to comment on the case.

The company still faces lawsuits filed by stockholders. Still, the settlement of the SEC case caps a bizarre and complex chain of events that attracted national media attention and thrust the virtually unknown company under the microscope of stock market regulators.

The SEC zeroed in on Comparator after its stock shattered trading records and soared thirtyfold in value on the Nasdaq Stock Market

in early May. Investigators soon found themselves confronting a case that involved stock-touting on the Internet, allegations of theft of a fingerprint scanning device from a professor in Scotland and the critical testimony of a former Comparator corporate secretary who was accused by the company of embezzlement and had gone on to appear in a pornographic film.

Comparator had never posted a profit in its 17 years as a public

company, and its sales had usually been dismal. But the company survived by issuing hundreds of millions of shares of stock. The company used the stock to pay employees' salaries, for legal services and even dental work.

By the time Comparator appeared on regulators' radar, the company had issued more than 610 million shares of stock, more than such giants as Microsoft or IBM.

The rapid rise and subsequent

fall of the stock on three days in early May became an embarrassment to regulators. Shortly thereafter, the National Assn. of Securities Dealers, which oversees the Nasdaq market, launched an extensive review of its trading requirements.

The company was removed from the Nasdaq market in June, and since then, its stock has traded for pennies in private, off-market transactions.

No Major Fine for Comparator, SEC Says

■ **Securities Agency says there's no money to recover from Newport Batch firm involved in scandal.**

By GREG MILLER
Times Staff Writer

The Securities and Exchange Commission on Thursday said it nixed out no fines or major penalties against Comparator Systems Corp., the Newport-based firm involved in the major stock market scandal last spring, because there was no money left to recover and no stronger punishment to pursue.

"What we have obtained here is all the relief we could get," said Chris Mixer, the SEC's lead attorney in the case. "I don't think there was a firmer resolution to be had."

Newport Beach-based Comparator was dealt only a minor penalty in settlement of an SEC lawsuit that accused the company of fraud and theft.

Under the terms of the agreement, two of the company's top executives, Chief Executive Robert Reed Rogers and Vice President Gregory Arnijo, agreed never to serve as officers or

directors of any public company. But the two are allowed to continue to serve temporarily as consultants to Comparator, a maker of electronic fingerprint-scanning devices.

The settlement surprised many, given that the SEC had moved so swiftly and aggressively against the company after it set three trading floors on the Nasdaq stock market and soared to a peak of \$1.5 billion in market value before imploding under the scrutiny of market regulators.

Mixer said Comparator's meager financial resources left little chance of recovering investors' losses and acknowledged that the SEC's enforcement authority is limited.

"We don't have criminal authority and so what we can get are injunctions and money penalties," Mixer said. "The company effectively had no assets and there is nothing to suggest the company is in a position to pay any meaningful penalty."

The SEC is able to refer cases to the U.S. attorney's office, which can pursue criminal charges. Mixer declined to say whether the agency had taken that step.

He pointed out that the settlement leaves open the possibility that Rogers and Arnijo—whose assets remain frozen—could still face fines. But the executives' attorney said that

possibility is remote. "We will be submitting financial information which will show their inability to pay," said attorney Gerald E. Boitz.

The SEC also said Thursday that it has issued an order barring Comparator's former auditor, Eli Buchhalter Accountancy Corp. of Los Angeles, from ever serving as an auditor for any public company. Buchhalter had routinely approved Comparator's wildly inflated stock price.

The SEC said it was forewarned and informed after the company's stock run-up. In a sweeping lawsuit, the SEC accused Comparator of lying about its finances to protect its Nasdaq stock listing, stealing its technology from a Scottish professor and cheating investors by issuing hundreds of millions of shares of worthless stock.

Indeed, Comparator had never posted a profit in its 17 years as a public company, but by May the 30-employee firm had issued 610 million shares of stock, more than corporate giants such as General Corp.

Some of the company's stock price run-up was fueled by trading on the Internet. The company has since been delisted by the Nasdaq market. Today, its stock still trades for pennies per share in private, off-market transactions.

LAW

SEC Plans Assault on Small-Stock Fraud

By MICHAEL SCHROEDER

WASHINGTON — Securities and Exchange Commission Chairman Arthur Levitt is launching a drive to combat the growing problem of small-company stock fraud.

Mr. Levitt is expected to outline proposed rule changes as well as stepped-up enforcement and investor-education initiatives in Senate testimony today. A state regulator and a National Association of Securities Dealers' senior enforcement official will also discuss new fraud-fighting efforts.

"The subcommittee has information that penny stock fraud is roaring back," said Sen. Susan Collins (R., Maine), chairman of the Senate Permanent Subcommittee on Investigations. "We intend to fully investigate this new wave of fraud, as well as the regulatory response to it, to determine whether more must be done to protect the investing public."

Mr. Levitt, recognizing that civil fines and sanctions are not a deterrent to chronic violators, is expected to tell the panel that he will direct his enforcement division to assist the Department of Justice and state attorneys general in bringing more criminal stock fraud cases.

The SEC plans to work with the NASD and stock exchanges to find ways to put bad brokers and firms out of business for good. The agency also plans to develop a better system for letting investors know if a broker has been sanctioned.

State regulators estimate that penny stock abuses cost investors at least \$6 billion a year, triple the amount during the 1980s. Although new rules curbed stock fraud in the early 1990s, unscrupulous stock promoters and brokerages are now exploiting loopholes.

Mr. Levitt wants the SEC staff to explore tightening rules and closing loopholes, especially several exemptions small companies invoke to avoid registering stock offerings with the agency. He also wants to see the SEC improve its education of unsophisticated investors. To that end, more public education forums and better use of the SEC Internet site are under discussion.

Another witness, Joseph Borg, director of the Alabama Securities Commission, plans to testify about the need for increased criminal prosecutions of brokers and more cooperative investigations involving the SEC, states and federal prosecutors. For many boiler-room operations, he said, civil fines of even several million

dollars are merely considered a cost of doing business.

"If we're going to deter stock fraud, people have got to know that they'll not just be fined. There has to be a threat of jail," Mr. Borg said.

Many of the same brokerage officials who bilked customers in the 1980s are at it again, he said. Mr. Borg, who is representing the North American Securities Administrators Association at the hearing, plans to bring along a chart showing that employees from two notorious former penny stock firms, First Jersey Securities Inc. and Investors Center, have formed at least 14 other firms, including Stratton Oakmont Inc., which was forced out of business by NASD regulators last December after years of disciplinary complaints.

Barry Goldsmith, executive vice president of NASD's enforcement division, said the self-regulatory agency is, among other things, requiring brokerages to tape all sales calls if a certain percentage of their brokers worked for firms that have been expelled from the NASD for telemarketing fraud or stock sales abuses.

The NASD also is looking at a number of options to clean up abuses in the Nasdaq-operated OTC Bulletin Board, a market that handles relatively cheap, thinly traded stocks. It may increase the financial requirements to qualify for trading on the Bulletin Board, and may make filing financial reports with the SEC a condition for listing on the Bulletin Board. At least half the companies currently trading on the market file no financial reports with the SEC.

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A Lode of Lies: How Bre-X Fooled Everyone

Amid Tales of Gold, Investors and Regulators in U.S., Canada Didn't Dig Deep Enough

By Howard Schneider
Washington Post Foreign Service

TORONTO—As it progressed from stock exchange to stock exchange in North America, Alberta-based Bre-X Minerals Ltd. acquired fans among the elite of the continent's investment community, including Canada's Nesbitt Burns Ltd., to finance its activity and enrolling New York's J.P. Morgan Co. as a financial adviser.

Along the way, it cleared regulatory hurdles from Calgary to Washington, D.C., and made a claim that its claim about finding the world's biggest gold deposit, in the distant jungles of Indonesia, was sincere.

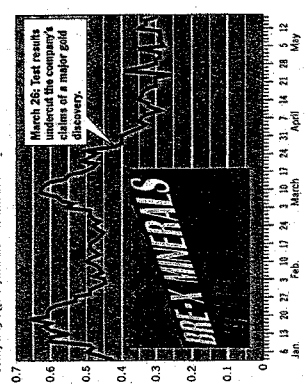
It wasn't, and billions of dollars in losses later, market regulators and analysts in Canada and the United States are wondering how such a claim could have been so convincing. Bre-X gold dust "sailed" into otherwise worthless chunks of junk, rock, according to an independent consultant—hoodwinked experts who are supposed to use their skepticism and insight to protect investors.

Toronto Stock Exchange President Rowland W. Fleming refers to Bre-X as a "comet," a once-in-a-lifetime scam that shows how even the most rigorous systems can be deceived by a big enough lie.

"If someone is simply lying, in a huge and suspicious fashion, we have no way of knowing whether all the disclosure rules in the world will not protect either the gullible investor or, it seems, even the most sophisticated one," Fleming said in

NO DEPOSIT, NO RETURN

Investors saw that Bre-X shares become nearly worthless when the company's gold-rod claims unraveled.



a speech to a conference of corporate officials last week.

The Bre-X saga also shows how the company's claims were not as adequate to protect investors as they seemed, and how the company can require little independent verification of company claims.

The Bre-X scheme is the subject of criminal investigations in Canada and Indonesia, though no one has been charged or arrested. Its stock price has fallen from a peak of \$100 in January to around \$10 in May. Fleming, who was involved in its financing, said in a statement released from his Cayman Islands home that he was unaware of the tampering. There are calls for an overhaul of

1996, Polderhof sold \$26.5 million in Bre-X stock. Walsh sold \$5.5 million, and his wife, Jeanette, sold \$20.6 million, according to insider trading records.

A spokesman for Nesbitt Burns, whose gold analyst visited a Bre-X site in Indonesia and endorsed the company's claims, said the brokerage house is as much a victim as anyone else.

"Our analysts rely on publicly available information that is released by reputable companies but in this case there is fraud. Our experts are not experts in uncovering fraud," said the spokesman, a subsidiary of the Bank of Montreal. "Our industry and our clients have been victimized."

Because it relied mostly on private placements of stock, Bre-X's public disclosure requirements were less strict than those that would have been if the company sold its stock directly to the public. The only prospectus the company was required to file, for example, was an original one in 1995, the year Walsh listed the firm on the Alberta Stock Exchange to finance a hunt for gold in the remote, forested Territories. That document contains no mention of Bre-X's later efforts in Indonesia.

The investors who originally bought Bre-X's private placements ultimately began selling their shares on the open market. The difference between the price they paid and the price they received remained the same as there for the private offering. Meanwhile, the company was making increasingly optimistic statements, which

See BRE-X, B7, Col. 1

Bre-X Exploited Holes In Regulation of Markets

BRE-X, From H1

pushed the estimated size of the gold find from a few million ounces to more than 70 million ounces, the largest deposit ever.

Under Canadian law, company officers are not liable for the accuracy of such statements, as they would have been with projections included in a formal prospectus, said Brenda Eprile, executive director, of the Ontario Securities Commission. A recent report has recommended changes in those rules, recognizing that stocks initially sold through private placements eventually migrate to the public market.

"When a company like a Bre-X does not do public offerings, there is not the due diligence and not the liability associated with direct sales to the public, Eprile said. "Yet the company got up to \$6 billion in market capitalization as its stock circulated among both market-wise investors and less-experienced individuals who bet their savings on the presumed pot of gold.

Glossy Credentials

Bre-X's public statements and official filings frequently noted that estimates of the size of the find had been prepared by a respected engineering firm, Montreal-based SNC Lavalin. Not as publicized was the fact that the engineering company had been hired only to make its calculations based on samples of earth extracted and processed by Bre-X.

Bre-X's filing with the U.S. Securities and Exchange Commission, for example, includes several sections cautioning investors about the risks of mining in general and the risks of Indonesia particularly, but it also says the estimate of a gold find "in excess of 30 million ounces" had been "prepared, reviewed or verified by independent mining experts" without stating that the samples always were drawn and controlled by the company.

After those samples were doctored—probably, officials feel, at a riverside warehouse en route to an Indonesian testing lab—the engineers also thought they were looking at a sizable gold find.

"We were very downstream" from the company-controlled drill-

ing program, said Robert Racine, a spokesman for SNC Lavalin, whose Indonesian subsidiary, PT Kilborn, worked with Bre-X.

In fact, it was more than two years from Bre-X's initial public statements about a major gold find on the Indonesian island of Borneo before someone outside the company independently tested the site for gold.

When mining giant Freeport McMoRan Inc. conducted its own drilling as part of negotiations over a possible partnership with Bre-X, the scheme unraveled.

The Louisiana-based company found no gold at the site; a second independent drilling program, by Strathcona Mineral Services Ltd. of Toronto, went even further, declaring that Bre-X's claims were the product of a tampering operation "without precedent in the history of mining anywhere in the world."

Called to Freeport's field office to explain the discrepancy, Bre-X's chief geologist, Michael de Guzman, fell from a helicopter en route, an apparent suicide. In statements to the Canadian media, his family members insist that he, too, was a man of integrity who would not have participated in the salting scheme.

A Track Record

Before Freeport's testing, Bre-X was able to build a store of credibility that began with success on the Alberta Stock Exchange and continued with listings last year on the Toronto Stock Exchange and in the United States on the Nasdaq Stock Market, where a total of 111 million shares changed hands over 10 months beginning in August 1996.

From initial private offerings at 30 cents a share, Bre-X stock climbed to more than \$250 on the open market before a 10-for-1 split a year ago.

Institutional investors, including mutual fund companies, the Ontario Teachers' Pension Plan and Quebec's huge cooperative Caisse de Depot, flocked to the high returns, helping to inflate Bre-X's value. The cycle of support for Bre-X also included a press corps eager to tout what looked like a true Canadian worldbeater. The fact that Canadian prospectors had uncovered some stunning mineral finds in recent years added to the hype.

In the end, each investment decision, See BRE-X, H8, Col. 3

A Rush of Investors Helped the Bre-X Myth Snowball

BRE-X, FROM H7

each positive news story, each company statement gave Bre-X a tougher veneer of legitimacy and made it less likely for the next person in line to question the underlying facts, said Toronto Stock Exchange President Fleming and others involved in the company.

"As a general matter, the various participants in this saga acted with their normal professionalism, which by its very nature bestows credibility," Fleming said. "There was normal behavior on the part of professionals, and we now know it was all based on the most dreadful deceptions."

Warnings Unheeded

In hindsight, there were early warning signs, but the information either never got outside the company or was dismissed as irrelevant to the ongoing Bre-X boom.

Some industry procedures, for example, were ignored when Bre-X crushed the full contents of each drilling sample rather than splitting them in half and securing a portion for future partners or others to test. Studies by an Australian company as early as 1995 also included information that raised doubts about the find: The gold flakes exuded by Bre-X seemed to fall too easily from the rock and had a higher ratio of silver than gold leached from a river rather than volcanic gold leached from bedrock.

Even a January fire at Bre-X's field office, which destroyed many of the sampling records, should have caused more concern than it did, said John Woods, editor of the Vancouver, B.C., business and financial journal *Business Week*.

"Everything came together to sus-

tain the Bre-X myth, Woods said, not least the willing acceptance of investment press to accept what the company's management told them.

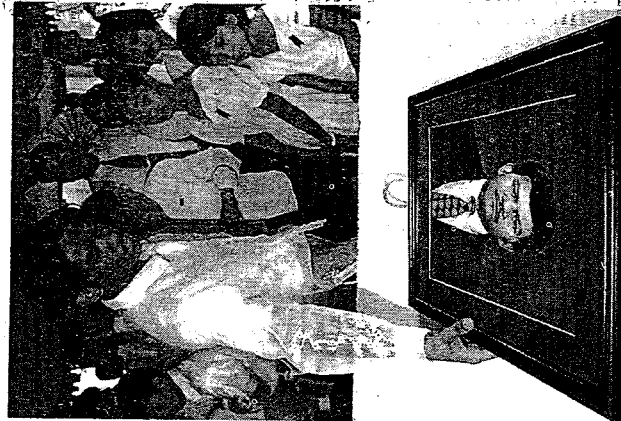
Along with years of litigation and the potential for criminal indictments, Bre-X will likely trigger some changes in Canada's market oversight and disclosure rules.

As for Nasdaq, "from our perspective, they passed the SEC's filing requirements," they passed the financial requirements," said spokesman Paul A. Walker. "There are no policy changes as a result of this case."

How extensive Canada's changes will be remains uncertain. Fleming and officials at the Alberta exchange say overreaction would kill what the market is there for—to help companies raise money. It would, for example, be difficult to force small, speculative mining firms to independently verify any finds because of the expense.

Christopher Armstrong, a historian at Toronto's York University who is finishing a book on Canada's financial markets, said the country's resource-driven economy goes through cycles of tougher and looser regulation, as it does the rest of the world. "Bre-X encourage a tougher attitude and concern about overregulation and lost profits pushes the pendulum back."

"Put yourself in a broker's shoes. Here is a stock that is going up like crazy... All the officials are eager to have it traded. That is their business," Armstrong said of Bre-X. "When we take a résumé and get one person to accept it, they go easier the next time around, and pretty soon you're a neurosurgeon performing surgery with a degree from the Garage University."



Paul de Gorman, son of Bre-X's chief geologist, holds his father's portrait at the funeral. Michael de Gorman plunged from a helicopter in an apparent suicide.

New York Times
May 6, 1997

For exchanges north of the border, Bre-X is just the latest scandal.

By FLOYD NORRIS

The Bre-X Minerals fraud, in which a gold find said to be worth billions of dollars turned out to have no gold worth mining, may turn out to be the most costly stock market fraud ever. But in one respect, it was a case of déjà vu. Once again, American investors had lost big by purchasing Canadian stocks.

The Canadian markets are hardly the only ones ever to be marred by fraud. The British had Robert Maxwell, the media baron whose companies were real but whose balance sheets were not; the American markets have contributed a long list of fraudsters, among them Barry Minkow, the teen-aged wonder whose carpet cleaning business, ZZZZ Best, was mostly fictitious, and Crazy Eddie Antar, the crooked electronics salesman.

But it seems like Canada produces more stock market fraud, at least per capita, than do other countries. And there may be good reasons for concern. Unlike other major industrial nations, Canada has no national regulatory agency for securities, but leaves the task to the provinces, which pursue oversight with varying degrees of enthusiasm. And efforts at reform have been incomplete.

Now, with Bre-X, Canadian stock fraud has hit a new peak, at least in terms of dollars. At its height last year, Bre-X was valued by the stock market at more than \$4 billion (United States). There have been other companies that gained large valuations without anything behind them, but never this large.

In one sense, Bre-X represents an unfortunate tradition, that of the junior mining company, for which the Vancouver and Alberta Stock Exchanges have been notorious since scandals involving phony Canadian uranium companies erupted four dec-

Continued on Page 21

Northern Exposure

Since the early 1950s, when American investors lost millions as flimsy Canadian mining companies cashed in on a mania for uranium shares, dubious stock promotions have been a common export across the United States' lightly-protected northern border.

DIANA B. HENRIQUES

GREAT SWEET GRASS OILS LTD. Nearly 3 million shares of this Canadian oil and gas promotion flooded into America through four high-pressure brokerage firms. Federal regulators said the price-manipulation scheme was "the archetype" of deals that cost American investors as much as \$22 million in 1956-57.

ST. STEPHEN NICKEL MINES LTD. From 1957 to 1960, this mining company was widely touted to Americans by a tiny Canadian brokerage firm that got a license from New Brunswick province — on the condition that it not sell stock in Canada. American investors ultimately lost as much as \$7 million when the company's assets proved largely worthless.

NEW CINCH URANIUM LTD. After this mining company claimed it had found a mother lode of gold in New Mexico, its stock soared from less than a dollar to nearly \$30 (Canadian). But the assay results had been doctored, and the gold wasn't there. The victim? Another gold company that paid nearly \$26 million to acquire New Cinch in 1981.

CHOPP COMPUTER CORPORATION Investors drove this stock from 17 cents to more than \$120 (Canadian) in 1985 when the company claimed it was building the world's fastest computer. There was no computer, and the stock collapsed, with investors losing at least \$6 million.

MTC ELECTRONICS Shares soared from \$5 to \$30 over four months in late 1992 on the strength of optimistic claims about MTC's stake in a cellular telephone network in Shanghai. When questions were raised about the system's actual value, the price plummeted, dealing big losses to American mutual funds. The stock now trades for pennies.

et Place

Canadian Exchanges, Bre-X Is Merely the Latest Scandal

Continued From First Business Page

go. The listing rules for junior companies, and there have been many complaints that the rules are too lax and too easy to get around.

But the rules are not the only problem. The listing rules are not the only problem. The listing rules are not the only problem. The listing rules are not the only problem. The listing rules are not the only problem.

By 1993, though, the company was excited about prospects far from Canada. It had hired John B. Felderhof, a geologist, to look for gold in the United States. Felderhof had been working for the Bushing project and had persuaded small but respected Canadian securities firm, Loewen, Ondaatje, McCutcheon, to raise money for the company by selling stock.

The share price, in Canadian dollars, had risen to \$1.50 in late 1991. By late 1993, it rose to \$3. In late 1993, the company's annual report highlighted Bushing, saying its chances were "excellent to become a major gold producer." Mr. Walsh said that the property could produce 500,000 ounces of gold a year. And a Bre-X director, Paul Kavanagh, added, "It has the potential to be one of the top-producing gold mines in the world."

By then, the stock price was zooming. It had risen to \$15. The company's annual report came out of Indonesia, the price kept rising — to \$50 in October, and then to more than \$100 in February 1996. At that point, there were reports to be 40 million shares of Bre-X stock.

Last April, the stock moved to the Toronto Stock Exchange, Canada's most prestigious

regulators concede that frauds do emerge in this country as well. Bre-X was able to gain a listing in the United States, on the Nasdaq national market, and Mr. Fleming said that even in retrospect he could not see any reason why the company should not have been listed.

For most of its life, Bre-X attracted little attention, inside or outside Canada. It was founded in 1988, with David Walsh as president, and listed on the Alberta Stock Exchange. Its early annual reports were full of details for a variety of projects, but none of them panned out.

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The share price was at more than \$200 by late May, when the shares were split 10 for 1, and by the time the price peaked, just after the split, Bre-X sold for \$28.18, the equivalent of \$281.80 in the old shares. An August listing on the Toronto Stock Exchange gave the stock more visibility.

By the time of the split, though, some insiders were starting to cash in. In April and May 1996, Mr. Felderhof took in \$28 million (Canadian dollars). Mr. Walsh realized another \$5 million. Mr. Walsh's wife, Mrs. Walsh, the company's secretary, took in \$28 million selling shares from April through November, according to CDA/Investnet, which monitors insider filings. At current exchange rates, in total, the three insiders have realized more than \$20 million. Mr. Felderhof and more than \$20 million for the Walshs.

It was around the time that the insiders were starting to sell that American institutions got interested. Filings with the Securities and Exchange Commission show no institutional buying until late 1995. By late 1995, the price was up to \$3. In April 1996, the company's annual report highlighted Bushing, saying its chances were "excellent to become a major gold producer."

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been no independent gathering of samples. Then in March, a Bre-X geologist fell to his death from a helicopter in Indonesia. In what was labeled a suicide. That scared some investors, but the price did not collapse until the end of the month, when Freepoint-McMoran reported that its own tests showed no significant gold.

Bre-X held out hope that new samples would show Freepoint-McMoran was wrong, but an independent evaluation, released over the weekend, included three samples no gold worth mining at Bre-X, Mr. Walsh said. The consultant, who conducted the study, concluded that the original Bre-X samples, on which the optimism was founded, had been faked. Just before the weekend report, Bre-X had sold for \$23.75 (United States) — the equivalent of \$237.50 on the pre-split shares — but they were not allowed to trade yesterday. There is almost certainly no value left in the shares.

Most of the money that American institutions — most of them bought the stock so after its peak, it is certain that they lost money. How much was lost is not clear, but it was substantial. Mr. Geller, the Ontario regulator, said that it was not clear how much money had been brought in by the Bre-X company and then taken up to the police, not his agency to investigate any securities violations to him, he would act. Mr. Fleming, the head of the Toronto exchange, said that the Bre-X company would come out of the scandal. "Maybe this will act as the much-needed stimulus to get Canada to have a national securities regulator," he said.

At the same time, it will not do anything to improve the image of Canada's markets.



By ANTHONY DePALMA

Instead, Strathcona concluded that "there is virtually no possibility of an economic gold deposit" on Bre-X's Busang

Continued on Page 21

Small Miner's Chronology: From Rags to Riches to Rags

Continued From First Business Page

site in Borneo. Furthermore, Strathcona confirmed the suspicion of many experts that drilling samples had been tampered with to inflate gold estimates. The report was released early today in Jakarta, late Sunday evening in New York.

The falsification of samples was done "on a scale and over a period of time and with a precision that to our knowledge is without precedent in the history of mining anywhere in the world," the Strathcona report said.

"The gold recovered in samples submitted by Bre-X has originated from a source other than the southeastern zone of the Busang property," it concluded.

"The report didn't say salted but that's just a nice way for them to avoid a lawsuit," said Sam Romberger, a professor of geology at the Colorado School of Mines. Sinking is the mining-industry phrase for faking drilling samples with particles of gold from a source other than where the drilling had taken place.

Professor Romberger said it appeared to have been a not very sophisticated attempt at fraud, in part because the gold used to salt the samples had characteristics clearly showing it came from someplace else.

One important question not addressed by Strathcona is specifically who is responsible for the actions that took in thousands of big and small investors.

To the groups of shareholders who have already filed several class-action suits against Bre-X, the answer seemed clear. "We've been pleading conspiracy to defraud all along," said Harvey T. Strosberg, a lawyer from Windsor, Ontario, representing

about 100 Canadian investors.

Suspicion is also being directed at one of Bre-X's chief geologists, Michael T. de Guzman, who worked most closely in gathering the hundreds of core samples on which Bre-X's rosy estimates were based. However, Mr. de Guzman died in a mysterious fall from a helicopter in March. Local police authorities said notes found in the helicopter indicate that Mr. de Guzman committed suicide because he was suffering from hepatitis B, something his family says it doubts.

Larry Waite, director of enforcement at the Ontario Securities Commission said, "The new developments are obviously of interest to many regulatory authorities, including us." And the commercial crime unit of the Royal Canadian Mounted Police is studying the Strathcona report to determine if a criminal investigation is warranted.

In Indonesia, the Minister of Mines and Energy, Ida Bagus Sudjana, told reporters that the Government would take legal action against Bre-X. "Every law breaker must be punished," he said.

While the accusations are being sorted out, trading in Bre-X shares have been suspended on every exchange where they are listed, including the Toronto Stock Exchange and Nasdaq, and there is no word yet on when trading will resume.

After Freeport raised doubts in March about the validity of Bre-X's glowing forecasts and the circumstances surrounding the death of Mr. de Guzman, the company's stock plummeted.

It once traded for more than \$20 a share in both Canadian and American dollars after a 10-for-1 stock split. Before the Freeport report, it was valued at \$15.50 on the Toronto exchange and \$11.375 on Nasdaq.

Last Friday, the stock dropped to \$3.23 in Toronto and \$2.375 on Nasdaq.

The company's chairman and chief promoter, David G. Walsh, was in Calgary today expressing shock and disappointment at the findings and promising to get down to the bottom of the mystery. His chief of exploration, John B. Felderhof, was at his beachside home in the Cayman Islands insisting that neither he nor anyone on his staff had been involved in fraud.

"I personally still believe that there are significant amounts of gold at Busang," he said in a statement faxed from the Cayman Islands.

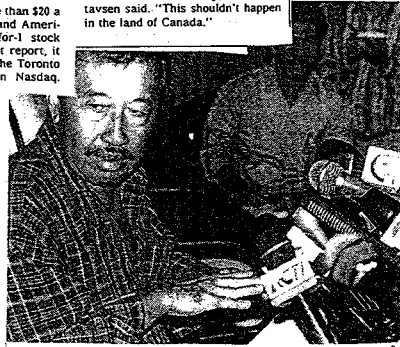
Mr. Walsh and Mr. Felderhof became millionaires as the gold fever pushed up the price of the Bre-X shares. They managed to keep tenuous control of the Busang property in spite of stiff competition from larger companies. They also survived the political intrigue that accompanies doing business in Indonesia.

Investors who bought into Bre-X early and sold before the problems emerged in March made millions of dollars, even though the company never turned a profit. However, stockholders who held their shares until Bre-X's drilling estimates were questioned lost more than \$3 billion in total.

"I guess I should have sold it all but I was a bit dumb," said Aksel Gustavsen, 79, a retired farmer now living in Calgary, who has been on the Bre-X roller coaster. He said that in the good times he made about \$150,000 buying and selling the company's stock. When Bre-X crashed in March, the value of his remaining shares lost about \$10,000 of their value in a few minutes.

"A lot of people have lost their bread-and-butter money," Mr. Gustavsen said. "This shouldn't happen in the land of Canada."

Y. MAY 6, 1997



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The New York Times

June 27, 1997, Friday, Late Edition - Final
SECTION: Section D; Page 2; Column 5; Business/Financial Desk
LENGTH: 652 words

HEADLINE: 4 at Syracuse Finance Firm Indicted in Pyramid Scheme
BYLINE: By BENJAMIN WEISER

BODY:

The Federal Government indicted the former chief financial officer of the Bennett Funding Group and three other men yesterday in what the Government called one of biggest securities fraud cases in American history and a large-scale attempt to cover it up.

In a 43-count indictment that brought to nine the number of defendants charged in the scandal, prosecutors accused the former executive, Patrick R. Bennett, of a fraud that cost more than 12,000 investors and 200 banks nearly three-quarters of a billion dollars.

The United States Attorney for the Southern District, Mary Jo White, called Mr. Bennett the "alleged architect" of the fraud, in which officials said many victims were elderly and lost their life savings. Prosecutors said the fraud extended to 46 states, with New York, New Jersey and Florida among the states with the largest number of victims.

According to Federal officials and the 100-page indictment, the fraud was possibly the largest pyramid scheme ever, in which Mr. Bennett and others sold investments in office equipment leasing contracts that were, in some cases, fictitious, and in other cases, already pledged to other investors or as collateral to institutions. In a pyramid, or Ponzi, scheme, early investors are paid off by later ones, while other money may be diverted to those running the scheme.

The Government also accused Mr. Bennett and others of engaging in sham financial transactions that were designed to give an inflated picture of the firm, which was then used in marketing to investors as well as in obtaining loans.

Some of the details in the indictment have been disclosed previously in court papers filed by prosecutors, as well as in a civil securities fraud complaint filed last year by the Securities and Exchange Commission. But the Federal indictment was notable for the sheer breadth of the fraud it described, the central role it ascribed to Mr. Bennett and the extent of the cover-up.

As part of the cover-up, prosecutors contended that Mr. Bennett and others gave fabricated and backdated documents as

well as perjured testimony to the S.E.C., and also sought to conceal assets from the bankruptcy proceedings involving his former firm. After the S.E.C. filed its fraud complaint, several companies controlled by Mr. Bennett filed for bankruptcy.

"In short, from beginning to end, these defendants are charged with committing every variety of crime, to carry out their fraud, to hide their fraud from regulators and investors, and, even after the scheme was unraveling, and after bankruptcy was filed, to try to conceal and divert from creditors and investigators what remaining assets there were," Ms. White said.

Mr. Bennett could not be reached for comment yesterday. His lawyer, Charles A. Stillman, said his client "expects that the full truth will show that the Bennett Companies were not a 'Ponzi scheme' and that the companies were not run for his personal enrichment."

"He deeply regrets that any investor has suffered any financial injury," Mr. Stillman added, "and as a former officer and director of the Bennett Companies accepts full responsibility for his actions."

The indictment charged Mr. Bennett with a total of 37 counts including conspiracy, bank fraud, money laundering, obstruction of justice, perjury and concealment of assets. The others charged in the case were Mr. Bennett's brother, Michael, the former deputy chief executive officer of the firm, which is based in Syracuse; Charles T. Genovese, an accountant; and Gary Peiffer, a lawyer and owner of a New Jersey investment firm. Each was charged with one count of conspiracy and one count of obstruction of justice.

The lawyer for Mr. Genovese, Rick Garcia, said his client was "innocent of all charges" and would fight the indictment. A lawyer for Michael Bennett declined to comment. And a lawyer for Mr. Peiffer could not be reached.

LANGUAGE: ENGLISH

LOAD-DATE: June 27, 1997

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USA TODAY

October 18, 1996, Friday, FINAL EDITION

SECTION: MONEY; Pg. 5B

LENGTH: 668 words

HEADLINE: PENNIES FROM HELL How to not get burned on low-price stocks

BYLINE: Sandra Block; Tom Lowry

BODY:

Like six-pack rings and old plastic cups, penny-stock con artists never seem to disappear, despite efforts by state and federal regulators to put them out of business.

The latest evidence: an FBI sting that led to charges against 46 stock promoters, brokers and company officials last week. The defendants were charged with scheming to manipulate the stock prices of dozens of small companies.

And regulators say the case represents only a tiny slice of an enormous pie. "We have a real problem here," says Mary Schapiro, head of the National Association of Securities Dealers Regulation, which participated in the sting. "A lot of unscrupulous people are recognizing the markets are flooded with money from first-time investors. That makes it an easy environment for these people to operate."

Make no mistake: Penny stocks -- low-priced stocks that usually sell for \$ 5 a share or less -- are risky. Because they are inexpensive and thinly traded, they are vulnerable to price manipulation. It takes only thousands of dollars to move the price of some small stocks, vs. millions to move the stocks of bigger companies.

Regulators say smooth-talking scam artists looking to unload worthless shares or profit by pushing up the price of a legitimate small-company stock have no shortage of victims.

Some reasons penny-stock scams continue to thrive:

-- The longest-ever bull market in stocks has given some investors a false sense of security. "The market has done so well over a period of years that I fear there may be a lack of realization by people that not every stock is going to go up," says William McLucas, head of enforcement at the Securities and Exchange Commission.

-- Many baby boomers are worried they won't have enough money

to retire. So they fall for promises of outrageously high' returns. "I think a lot of middle-age and older people are being induced into high-risk, high-return investments through scare tactics," says Donald Reis, head of securities regulation in Nevada.

-- Many people behind penny-stock scams operate on the fringes of the securities business, making them difficult to catch. At least seven defendants in the FBI case had been barred from the securities industry but continued to work. One of the defendants, stock promoter Edward Williamson, was convicted of murder in 1969, according to the NASD.

-- Previous sting operations have failed. In 1992, 11 defendants charged in what was called the "Pennycon" sting were acquitted of stock fraud charges in Denver. Defense attorneys discredited the government's star witness and raised questions about entrapment.

Even knowledgeable investors are sometimes tempted by penny stocks because they offer the prospect of big returns for a small investment. Earlier this year, for example, the stock of Comparator Systems shot up from pennies a share to \$ 1 in a three-day trading frenzy that pushed Comparator's market value to \$ 1 billion. Investors were led to believe Comparator had a revolutionary fingerprint identification technology. In June, the SEC charged Comparator with marketing a phony product just to sell stock.

Investors fall for scams because a stock that sells for \$ 1 "only has to go up a dollar to double my money," Reis says. "There's something about that idea that appeals to all of us."

Kevin Spring, a language instructor in Houston, bought 7,000 shares -- for less than \$ 1 a share -- in a company that recycles old tires after seeing an ad for the stock on television. His investment rose as high as \$ 2 1/2. But then the stock plunged well below \$ 1. Spring lost about \$ 2,000. It could have been worse: The shares are now trading for about 5 cents.

Of course, small-company stocks are risky even when no manipulation is involved. "In most cases, the lower-priced stocks represent smaller, less-tested companies," Reis says. "They're more volatile, more risky. Maybe we're not getting that story out."

GRAPHIC: PHOTO, B/W, Matt Mendelsohn, USA TODAY; Mary Schapiro, National Association of Securities Dealers

LANGUAGE: ENGLISH

LOAD-DATE: October 18, 1996

POLITICS & POLICY

Despite Reforms, Penny-Stock Fraud Is Roaring

By MICHAEL SCHROEDER

Staff Reporter of THE WALL STREET JOURNAL
WASHINGTON — When cleaning up after penny-stock scandals of the 1980s, federal regulators acted aggressively to stamp out rampant bilking of small investors that amounted to \$2 billion a year. By 1994, the Securities and Exchange Commission boasted "the current level of penny-stock trading is minimal."

But they're not saying that today. Fueled by the bull market, new technology and regulatory loopholes, penny-stock fraud has come roaring back—bolstered by some of the very remedies designed to prevent abuses. Regulators now estimate annual losses to investors at more than \$6 billion, triple the 1980s peak.

"Let me be blunt: there are significant problems in the [over-the-counter] market and a strong regulatory response is needed," says Barry Goldsmith, head of enforcement for the National Association of Securities Dealers. The NASD is owner and operator of the Nasdaq Stock Market and overseer of the "Bulletin Board" market, which handles relatively cheap, thinly traded "penny" stocks—in practice, those selling for \$5 a share or less.

The new NASD chairman, Frank Zarb, says one of his first initiatives is to clean up the Bulletin Board, an electronic stock listing created in 1990 to supplant the scandal-plagued "pink sheets" used in the 1980s. (That market was a primitive bid-and-ask trading system that printed quotes on flimsy sheets of pastel paper. The Bulletin Board gives brokers access to quotes by computer or phone.) The NASD and SEC may announce other revisions by year end.

However, earlier changes exacerbated the fraud problem by helping scam artists avoid scrutiny, government and industry officials say. In the case of the most visible reform, creating the electronic Bulletin Board, few regulatory requirements apply to companies that use it, and its link to Nasdaq gives its listings credibility with unwary investors. At the same time, on-line technology simplifies the marketing of these stocks.

Neither the SEC nor the NASD knows exactly how much fraud exists because few Bulletin Board companies must file public financial statements. But Harry Eisenberg, chairman of Walker & Manual LLC, a Lafayette, Calif., company that tracks small companies, estimates that no more than a quarter of the Bulletin Board's 6,716 stocks are solid and stable. Philip Feigin, Colorado's securities commissioner, says many are "absolute shells or bogus listings."

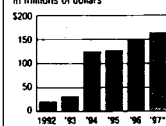
Policing Penny Stocks

Options that regulators are considering for stocks listed on the electronic Bulletin Board.

- **Hold market makers responsible** for verifying company financial information and require annual updates.
- **Make publicly available** the company information market makers file with the National Association of Securities Dealers.
- **Require all Bulletin Board companies** to file financial reports with the Securities and Exchange Commission.
- **Update the penny stock rule**, possibly raising the definition of a "penny stock" to \$10 or \$15 a share.
- **Give the NASD unilateral authority** to halt trading in stocks where fraud is suspected.
- **Revise the SEC's registration-exemption rules** to close loopholes.

Soaring Volume

Over the Counter Bulletin Board average daily dollar volume, in millions of dollars



NOTE: Includes both domestic and foreign stocks

*As of June 1997

Source: Over the Counter Bulletin Board

Problems in New York

This has made it a playground for the unscrupulous. Many problems arise in New York, which has no state securities-registration requirements and is home to many small companies specializing in cheap stocks. For example, prosecutors allege that loopholes allowed broker Michael Lipkin and associates to sell \$1 million of stock in Mugs Plus Inc., a purported souvenir maker—even after its only asset, a New Jersey warehouse, was gutted by fire and closed by its founders. Andrew Kandel, New York state's assistant attorney general in charge of securities, says such schemes will account for most of the 4,300 complaints his office expects this year.

Such cases help explain why the NASD is considering such revisions as seeking SEC authority to halt trading instantly whenever stock prices and volume shifts suggest fraud. Currently, that process can take weeks. It also may ask that all Bulletin Board companies be required to file financial statements for the benefit of both regulators and investors.

The SEC already monitors more than 13,000 traded companies and isn't eager to add nearly 7,000 from the Bulletin Board. However, SEC Chairman Arthur Levitt says, "If evidence shows that changes are needed, we won't hesitate to take quick action."

Penny-stock fraud exploded in the 1980s, when such stocks generally sold for less than \$1 a share, and in 1990 Congress ordered the SEC to stamp it out. These stocks let small investors ride the bull market cheaply. But unscrupulous brokers marketed by phone and the Internet

can push unsophisticated investors into buying shares in companies without real products or operations. Brokers pump up prices long enough to dump their own holdings, then move on to other shells—leaving investors with worthless paper.

The SEC's first move was to make brokers obtain signed releases from all new buyers of penny stocks before a transaction could be completed. That was supposed to make buyers realize they were choosing especially risky stocks.

Second, the SEC endorsed the Bulletin Board as a better-regulated and safer forum for thinly traded small stocks. Both brokers and regulators then could see real-time trading of the smallest companies on computer terminals. In theory, they could spot unusual volume or price spikes that might signal illegal activity.

Rule 504

In 1992, the SEC also promulgated "Rule 504 of Regulation D," which allows small companies to sell up to \$1 million of stock without an SEC registration. Designed to cut red tape for small business, this exemption has become a popular loophole for fraud, qualifying companies don't have to make financial disclosures to regulators and their shares can be traded immediately without restriction.

The reforms, coupled with efforts to purge wrongdoers from the brokerage business, helped for a while. In June 1994, officials said a survey of 129 brokerages found that their penny-stock trading accounted for less than 5% of total business, leaving only "traces" of past abuses. But others already were moving to exploit the Bulletin Board, where trading of U.S. stocks soared last year in \$18 billion

Back

Finance

INVESTIGATIONS

NOT EXACTLY GANGBUSTERS ON WALL STREET

The NASD forms a task force to root out the Mob—but more spine is needed

It was supposed to have been a routine speech. But when Mary L. Schapiro, chief regulator at the National Association of Securities Dealers, addressed a meeting of New York securities analysts on "Market Trends and Regulatory Responses" on Mar. 17, she dropped a bombshell. Schapiro announced the formation of a task force aimed at attacking Mob infiltration of brokerages. A day later, a longtime securities industry watchdog, Representative John D. Dingell (D-Mich.), released a letter from Schapiro saying that the NASD has "significant ongoing investigations" into all but one of the brokerages—and "many" of the companies—mentioned by BUSINESS WEEK in its cover story, "The Mob on Wall Street" (Dec. 16).

It seemed like an important, even historic, development. For the first time, the NASD, which oversees small-cap brokerages nationwide, seemed ready to take on the Mob presence in the market for microcap stocks. "The influence of organized crime in our markets is an issue that must be aggressively addressed," Schapiro told Dingell. As well as focusing on brokerages,

Schapiro said, the task force will examine a crucial but even thornier topic: "the finances and operating activities" of stock issuers. BUSINESS WEEK found that the Mob had exploited the initial public offerings of small companies.

But a number of questions remain unanswered. For one thing, where is the Securities & Exchange Commission? In a letter to Dingell on Feb. 25, SEC Chairman Arthur Levitt Jr. called the reports of Mob involvement cited by BUSINESS WEEK "disturbing"—and offered to discuss the matter privately. But in testimony before Congress on Mar. 19, Levitt said that organized crime's influence was restricted to a small number of firms and said

the Mob was "not as pervasive [on the Street] as may have been suggested."

That view is shared by NASD officials. In her Mar. 17 speech and another address the following day, Schapiro downplayed the Mob's significance on the Street, calling it "disturbing" but also "extremely limited." Indeed, NASD officials have said privately that there is not much of a problem for a task force to address. Two high NASD officials, interviewed by BUSINESS WEEK for the December article, said they were not aware of any Mob presence on Wall Street.

NO NEW TROOPS. Another NASD official, who asked that his name not be used, cast even more cold water on the view that the NASD is getting into the gang-busting business. No new personnel will be hired for the task force, he noted,



KNOW YOUR FELLOW INVESTOR

He's Alan Longo, an alleged member of the Genovese crime family in New York and a "selling shareholder" in Mayfair Homes and American Fuel

MAYFAIR HOMES CORP.

In its registration filing, Mayfair Homes listed shareholders who included Longo and Romilda Abramo, wife of Philip Abramo, an alleged capo in New Jersey's DeCavalcante crime family. Sources say Abramo controls brokerages specializing in small-cap stocks.

Name	Warrants Owned	%	Register for Res
Romilda Abramo	20,000	1.7	100.0
Alan L. Longo	20,000	1.7	100.0
[REDACTED]	50,000	4.1	250.0

Class B Warrant Holders	Number of Warrants
Alan Longo	100,000
[REDACTED]	100,000
Maraval & Associates, SA	100,000
[REDACTED]	100,000
Uniquity Holdings, SA	100,000
[REDACTED]	100,000

AMERICAN FUEL CORP.

Longo's name also shows up on American Fuel's filing, along with those of Uniquity Holdings, which Philip Abramo allegedly controls, and Maraval & Associates, which was involved in an Abramo-dominated IPO.

and he said it would merely "formalize what we have already been doing." Still, one veteran Mob investigator, now in the private sector, feels that the NASD and SEC may have no choice but to act on the Mob's Street connection because it endangers public confidence in the securities markets. "The FBI is committed, and the Manhattan District Attorney's Office has an open case. The question is," he adds, "are they [the NASD] serious?"

If the NASD's commitment is questionable, this much is clear: The Mob is committed. And if the NASD and SEC officials want to see just how much it is committed, they need look no further than their own files. They can look at documents filed in connection with two IPOs that never quite got off the ground—for Mayfair Homes Corp., a Georgia-based maker of mobile homes that is still trying to go public, and American Fuel Corp., a small New York company in the coal mining business whose IPO was withdrawn. Registration statements for both IPOs were reviewed by the SEC and NASDAQ at the time they were filed—and there was something that the agencies evidently did not notice.

The filings by these companies have an intriguing element in common: a "selling shareholder" by the name of Alan J. Longo. The 46-year-old Staten Island (N.Y.) resident has been described by law enforcement officials in court documents as a "soldier" in the Genovese crime family. Both companies identify him as a major owner of stock warrants who would cash out big once the companies go public and share prices climb nicely—as they usually do, at least for a while, in Mob-influenced offerings. American Fuel's chief executive, Robert Barra, says he doesn't know Longo and has no knowledge of any Mob involvement with the IPO. Calls to Mayfair execs were not returned.

In the filing for Mayfair, appearing on the list right beneath Longo is yet another eminent family name in Wall Street Mob circles. It is Romilda Abramo, wife of Philip C. Abramo, who has been described in an FBI court affidavit as a capo in the DeCavalcante crime family. Street sources describe him as the leading Mob power on the Street, owning or controlling brokerage houses that specialize in small stocks.

(Neither Longo nor Romilda Abramo could be reached for comment.) Phil Abramo is also alleged by Street sources to control Bahamian companies that were involved in the financing of another recent IPO, for SCAT International Inc. (BW—Mar. 24). SCAT officials have denied knowledge of Mob involvement in the financing of their company. Two of those Bahamian companies, Umbiquity Holdings and Maraval & As-



SCHAPIRO believes Mob stock operations are "extremely limited."

sociates, are listed as selling shareholders in the American Fuel deal.

The Abramo connection does not end there. The lead underwriter of both companies is R.T.G. Richards & Co., a Garden City (N.Y.) brokerage. According to sources who are familiar with the activities on the Street, of Abramo—now serving a one-year prison term for tax evasion—the alleged Mob capo controls Richards through confederates. Officials of Richards, which changed its name to Matrix Securities on Mar. 1, did not return phone calls. A man named Michael DeMayo who responded to a reporter's call to Matrix, said that he would relay a message to the president of the company, but added that he did not believe that gent would wish to discuss the two IPOs. DeMayo, also listed as a selling shareholder in the American Fuel deal, declined comment on the IPO and said he had no connection with Matrix.

Aside from Longo and Abramo, there are other familiar names in the Mayfair and American Fuel offering documents—hundreds of pages that were combed by SEC and NASDAQ officials. Co-manager of the American Fuel deal was Sovereign Equity Management Corp., which has also been described by Street sources as an Abramo-controlled firm. Sovereign officials have denied Abramo's involvement. And then there are the other investors in the

American Fuel deal—six pages of them, more than 200 names. One of them is Robert Catoggio, a veteran of the penny stock business. According to attorneys for the trustee of the bankrupt Adler Coleman clearing firm, Catoggio was a partner with Roy Ageloff in controlling the now defunct Hanover, Sterling & Co. penny stock house. Street sources have maintained that Ageloff is an associate of Longo and Alphonse "Allie

Shades" Malangone. Malangone has been described in court documents as a capo in the Genovese crime family. Malangone, Catoggio, and Ageloff were unreachable for comment.

Also included in the American Fuel filing is a slew of names that are little known to the public, but have achieved a distinction all their own in some circles. There is a Wall Street-Mob goon here, a cocaine dealer there, a Long Island loan shark—all on a lengthy list of names that includes, no doubt, many nice people.

If the regulators decide to peruse these documents—again—they won't have to dig too deep into their file cabinets. The American Fuel registration statement was filed last October. The Mayfair Homes filing, with Longo and Romilda Abramo appearing prominently on page 31, went to the SEC on Jan. 23—nearly two months after Longo was mentioned in BUSINESS WEEK.

EMERGENCY LOANS. So far, of course, the Mayfair and American Fuel deals have not generated any revenues for Longo. He is described as a heavy gambler who, according to a reference in one recent court decision, once had to borrow from loan sharks to pay off other loan sharks. But the Mob's Wall Street deals are no gamble. They are a sure thing—particularly when the regulators are nowhere to be seen.

A couple of weeks ago, Longo, Malangone, and other reputed Genovese mobsters were seen paying their respects at the funeral of a Genovese mobster named Peter Romano, who was believed by law enforcement to be a secret power in the Fulton Fish Market. It was a sad event. But the Mob has no reason to shed a tear. The only powers that can truly organize their funeral—on Wall Street, at least—are starting to make noise. But so far, at least, they haven't done a thing.

By Gary Weiss in New York

THE NEW YORK TIMES, FRIDAY, MAY 30, 1997

States Lead a Crackdown On Telemarketing Brokers

14 Firms, Most in New York Area, Involved

By LESLIE EATON

Americans who live west of the Hudson may have good reason to hate New York, based on evidence presented yesterday by securities regulators from 20 states who cracked down on stockbrokers pushing penny stocks by phone.

Led by Attorney General Dennis C. Vacco of New York, the regulators filed lawsuits and other enforcement actions against several individuals and 14 firms, almost all based in the New York metropolitan area.

"They operate in the shadow of Wall Street, which lends them an air of legitimacy," said Mark J. Griffin, director of Utah's securities division and head of the North American Securities Administrators Association, which coordinated the sweep. He estimated that there were probably 50 such telemarketing boiler rooms doing business around the country.

Four defrauded investors — none from New York — told of losing their savings to fast-talking, high-pressure stock salesmen who bought and sold shares without their permission and sometimes against their wishes. "They can convince you right away," said Billy Heliums of Roswell, N.M., who added, "Beware!"

Legal actions filed by the state regulators included dozens of scripts used by cold-callers, complete with such stage directions as "pause," "lower voice," "sincerely," and even "chuckle, chuckle." The scripts include lines for breaking down victims' defenses, including flattery ("You are rated as an A+ investor through Dun & Brad Street [sic]"), promises ("My prediction is in 20 minutes you will get a 100 percent return") and even insults ("I'm not asking the color of your underwear, I'm sure it's white").

Regulators say the problem has gotten worse recently. Mr. Vacco said complaints and inquiries to his office jumped by 40 percent since last year, to 3,100. One reason, he said, is that with the soaring stock market, "more investors are coming in, and the pitches are being well received, unfortunately."

The states' special enforcement effort came as Congress, under pressure from many large brokerage firms and mutual fund companies to reduce state regulation, has been attacking state actions. Recently, states lost jurisdiction over large investment advisers like mutual funds.

Now, the Securities and Exchange Commission is working on a report, ordered by Congress, on state licensing of individual brokers and firms, which are also governed on the Federal level by the S.E.C. and the National Association of Securities Dealers. Securities firms argue that state efforts duplicate Federal work and waste time and money.

In a response that the state regulators' association plans to file today, the state officials will argue that their procedures weed out rogue bro-

kers. New York, for example, has twice barred a felon who was convicted of first-degree robbery and attempted murder. Ohio recently barred a salesman, approved by the N.A.S.D., who faced Federal charges of securities fraud.

The N.A.S.D. can pull brokers' licenses for only very limited reasons, and cannot take into account state actions, regulators say. Moreover, the states respond to all customer complaints, no matter how small. "We're the local cops on the beat — when someone has a complaint, they may write the S.E.C. a letter, but they land up on our doorstep when we open our offices in the morning," Mr. Griffin of Utah said.

In addition to abusive sales practices, the states' regulatory sweep of small firms turned up what some regulators call an alarming new trend: franchise boiler rooms. Registered brokerage firms are said to be selling their names and licenses to "branches" that operate independ-

A bull market in complaints about pressure tactics over the phone.

ently, without supervision. The licensed firm may not have customer records or know about complaints.

One firm that engages in this practice, Investors Associates, was the target of 15 states' enforcement efforts. The firm is based in Hackensack, N.J., and has branches on Long Island and in Florida. New Jersey issued a cease-and-desist order against the firm and its principals; New York sued it in State Supreme Court, asking a judge to bar the firm and its employees from manipulating initial stock offerings, using unlicensed telemarketers and ignoring customer complaints.

Investors Associates said in a statement that it would cooperate with the state regulators to clear its name, adding that it "never condoned any improper sales practice and will take all necessary steps to rectify such inappropriate behavior, should it exist."

The other brokerage firms named by the regulators included First United Equities of Garden City, N.Y.; Kensington Wells Inc. of Syosset, N.Y.; L. T. Lawrence of Manhattan; Tobuca Pacific Securities, which has offices on Long Island, and in Florida and California; Meyers Pollock Robbins of Manhattan; Blinn Securities of Fort Lauderdale, Fla., and William Scott & Company of Union, N.J.

Executives at the firms either declined to respond to the states' allegations or could not be reached for

The New York Times

May 10, 1997

On the Shady Side Of the Bull Market

Large Returns Are Now Bringing In
Stock Promoters With Rap Sheets

By DAVID BARBOZA

In the annals of public disclosure, few news releases can match the chutzpah of one issued less than a month ago by Genesis Insurance and Financial Services Inc., a Chattanooga, Tenn., company that is in the process of being shut down and whose stock has recently taken an extraordinary beating.

Buried in an announcement on April 18 about the sale of a Genesis unit was an unusual defense of the chief executive, Mohamed Khairy Mohamed Zayed 2d.

"Friends, associates and business partners of the C.E.O.," the release stated, "have long been aware of a youthful indiscretion over a decade ago that resulted in Mr. Zayed having fully paid a debt to society through a period of incarceration, completed over seven years ago."

That "youthful indiscretion," the statement failed to explain, was a 1986 Federal conviction for counterfeiting and weapons possession for which Mr. Zayed was sentenced to 78 months in prison, but was released on parole in November 1990. The Genesis release also failed to note that Mr. Zayed, according to Federal records, had a 1981 drug conviction.

It is not every day that investors learn that a company is run by a convicted felon. But at Genesis, which operated as a holding company and has changed its name several times in recent years, it turns out that Mr. Zayed was not the exception but the rule.

Indeed, depending on how you look at it, Genesis was either a haven for criminals or a perfect case study in the benefits of rehabilitation. Several people who worked for the company or were associated with it also have criminal records, ranging from loan fraud to cocaine smuggling.

And that is not counting Michael Rehtorik, the director of investor relations, who does not have a criminal record but was barred for life from the securities industry in 1989 by the Securities and Exchange Commission for falsely promising 22 investors that he was using their money to buy Government bonds. Almost \$2 million was misappropriated, according to the securities rap sheet maintained by state and Federal regulators. Mr. Rehtorik did not return phone calls seeking comment.

There is no lack of companies these days in which disbarred brokers, low-rent lawyers and assorted white-collar fixers engage in stock

Unusual Résumés

Mr. Zayed, above, is one of several men associated with Genesis who have pock-marked backgrounds. They include:

MOHAMED KHAIRY MOHAMED ZAYED 2d, chief executive, Genesis Insurance and Financial Services Inc.

1986: Convicted on Federal charge of conspiracy to counterfeit currency and unrelated weapons violation. Sentenced to 78 months in prison. Paroled in 1990.

1981: Convicted of conspiracy to manufacture drugs. Sentenced to 20 months.

MICHAEL REHTORIK, director of investor relations, Genesis

1994: Enjoined by the S.E.C. for involvement in a stock trading scheme.

1989: Barred for life from brokerage business for securities fraud.

JERRY DORMINEY, former chairman, Genesis's Motorsports Travel Center unit

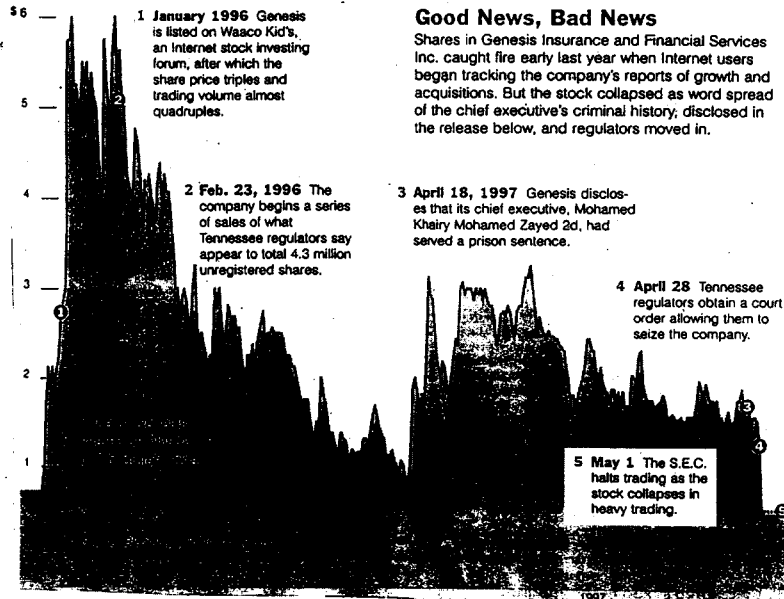
1978: Sentenced to 10 years on Federal fraud and racketeering charges.

DARIO JARAMILLO, provided Genesis with assets valued by company at \$2 million

1994: Sentenced to 10 years in Federal prison for a loan fraud scheme. Previously convicted on cocaine-smuggling charges.

Continued on Page 25

The New York Times



The company has become aware, for instance, that as a final resort, threats have been made to attempt to undermine shareholder value through unethical attacks on the Company's 34 year-old CEO, Mohamed Khairy Mohamed Zayed, II and his character. Friends, associates and business partners of the CEO have long been aware of a youthful indiscretion over a decade ago that resulted in Mr. Zayed having fully paid a debt to society through a period of incarceration, completed over 7 years ago. This has been made known



Gains Attract Stock Promoters With Rap Sheets

Continued From First Business Page

fraud. But the tangled tale of Genesis suggests that the money to be made in the soaring stock market has begun to attract a more dangerous kind of criminal to businesses that end up fleecing investors.

Beyond Genesis, several grand juries are investigating the activities of small brokerage firms that have been linked to crime figures. And just last month, two men were indicted in Brooklyn on charges they tried to hire a hit man to protect their profits in a securities fraud they helped run.

"People who used to engage in questionable activity are now following the money to the market," said William R. McLucas, enforcement director at the S.E.C.

Mr. Zayed, who is now 33 and was 23 when he most recently went to jail, defends his actions by saying that he was a "juvenile" when his criminal offenses occurred. And of his colleagues, he said it was merely a "coincidence" that several had criminal records.

In a telephone interview, Mr. Zayed — who said he was in Uruguay conducting business — said that Tennessee state regulators and jealous critics were spreading malicious lies about him and dredging up ancient history to undermine his company.

"None of my problems had to do with the operation of a business," he said. "Moral turpitude, maybe. But some people think what I have done since then has been honorable and successful."

Genesis is one of hundreds of penny stocks that attract a lot of attention from investors even though they fly below regulators' radar. The company, for example, did not file financial documents with the S.E.C. and was not traded on an exchange, but rather on Nasdaq's O-T-C bulletin board, which has no listing standards.

Nevertheless, investors enticed by aggressive stock promotions on the Internet have lost thousands of dollars in the collapse of Genesis. Last fall, when the stock was trading — rarely — for just 75 cents, it suddenly zoomed to \$3.50, as hundreds of thousands of shares changed hands. Trading volume continued to be heavy even as the stock headed south, falling recently to 51 cents.

"I took a five-figure bath in this thing," said Jeff Silverman, a California investor who bought shares of Genesis after reading about it on the Net. "They take these shell companies and then hype the assets."

Such talk caught the attention of state regulators and Federal law enforcement officials. Last week, Tennessee officials seized Genesis, charging that a subsidiary had operated without an insurance license. Two days later, the S.E.C. halted trading.

A Federal grand jury is also looking into Genesis, and on Thursday the Tennessee Attorney General

ing possible state and Federal securities violations, tax evasion, mounting debt and a host of other problems.

Today, disgruntled investors cannot quite believe how easily they were duped. In retrospect, Genesis's rise and fall seems almost farcical, replete with a stolen attaché case filled with jewels, a dummy corporation in Costa Rica and claims of \$140 million in assets that have largely vanished into thin air.

Even Paul Jennings, the lawyer Mr. Zayed has said represents Genesis, acknowledged on Thursday that he was "kind of a lost ball in tall weeds."

Although Genesis said it was expanding through mergers and acquisitions, state regulators and law enforcement officials now contend the firm was acquiring questionable as-

Regulators say a harder breed of player and the Internet make for new dangers.

sets, then using the Internet and news releases to exaggerate the company's size, which may have helped inflate its stock price. That kind of stock manipulation may have allowed insiders to sell shares at a profit in what has come to be known as the "pump and dump" strategy.

"Press releases issued by Genesis representing certain subsidiaries as viable entities, or earnings representations as to Genesis and/or these subsidiaries, appear to be false," according to the report released on Thursday by the Tennessee Attorney General's office.

The company, according to state regulators, had few operations and very little cash flow. Regulators suspect that salaries and other expenses were paid for by illegally issuing stock, often funneling the purchases through Canada under the name of a dummy corporation in Costa Rica.

The tale of Genesis begins with Mr. Zayed, who got control of Academy Insurance and Financial Services, a Florida-based insurer, in late 1995. He quickly put the company through a series of name changes before settling on Genesis, and began acquiring real estate and other holdings, usually in exchange for restricted stock.

Before long, Genesis claimed assets of \$140 million, even as several of the companies it acquired had quickly ceased operations.

Mr. Zayed had promised to act as a "turnaround artist" for the concerns but several former associates said he had just let the businesses languish.

THE WALL STREET JOURNAL MONDAY, MARCH 3, 1997

Regulators Say Market's Bullishness Has Led to Big Rise in Securities Fraud

By PAUL BECKETT

Dow Jones Newswires

WASHINGTON — Federal regulators say the stock market's recent bullishness has led to a sharp rise in securities sales fraud and stock price manipulation.

"If the catch phrase from 'Jerry Maguire' was 'Show me the money,' the catch phrase here is 'Follow the money,'" Bill McLucas, director of the enforcement division at the Securities and Exchange Commission, said at an industry conference Friday.

Mr. McLucas suggested that the higher incidence of securities law abuses could lead to a greater number of criminal prosecutions against rogue traders and brokerage houses.

"We're seeing a migration of people—who used to, I suppose, sell shoes—into the markets and a level of behavior that I don't think civil and administrative sanctions are adequate to address," he said. "We are going to see more aggressive

criminal prosecutions in some sections of the markets today where the damage that can be done is fairly substantial."

For the most part, industry regulators said, the abuses aren't new or particularly imaginative, just more commonplace.

"The conduct isn't new but it's pervasive," said Carmen Lawrence, director of the SEC's northeast regional office in New York. "There's a lot of money to be had and hard core criminals are gravitating there."

Mr. Lawrence didn't provide data on the increase in abusive practices, but said that based on reports from field officers and examiners "we are finding more violations and more egregious violations."

Recent news reports have alleged that organized crime is seeking a foothold in the small-cap sector of the equities market—allegations that SEC Chairman Arthur Levitt, in a Feb. 25 letter to Rep. John Dingell, (D., Mich.), called "disturbing."

Manipulations and fraud concerning small-cap issues has become one of the most pressing problems that regulators face and has led to some high-profile cases in recent months.

In February, the SEC filed suit against Sterling Foster & Co., a small-stock brokerage firm based in Melville, N.Y., alleging that the company defrauded investors out of at least \$75 million and used so-called boiler room high-pressure sales practices.

Without admitting or denying the allegations, Sterling Foster settled the complaint and agreed to the installation of a compliance monitor.

The increase in securities fraud and abuses is also expected to lead to more combined investigations between the SEC and other federal agencies, such as the Federal Bureau of Investigation and the Justice Department, regulators said.

One example: In October, a "sting" operation led by a squad of FBI agents posing as stockbrokers at a Manhattan small-stocks firm, resulted in 46 people being charged countrywide. The squad collected more than \$100,000 in kickbacks in exchange for buying stock in small companies, authorities say.

Antifraud**Court Bars Georgia Man,
Freezes Assets Over Fraud Charges**

The U.S. District Court for the Northern District of Georgia has preliminarily enjoined an Atlanta man and frozen his assets in connection with Securities and Exchange Commission charges he fraudulently solicited investments using the offering documents of a dissolved limited partnership, the SEC announced June 26 (SEC v. Eskind, DC NGA, Civil Action No. 1:97-CV-1790-CAM, 6/23/97).

According to the release, Judge Charles A. Moye Jr. also ordered defendant J. Scott Eskind to provide an accounting "of all monies received from the scheme and of the disposition and use of said funds." The SEC said Eskind consented to the relief without admitting or denying its allegations.

Tower Asset Management Officer. In its June 20 complaint, the SEC said it asserted that from November 1994 to May 1996, Eskind was secretary and treasurer of Tower Asset Management, and the general partner and investment adviser of Asset Management Fund L.P., which was formed for the limited purpose of investing in securities. "In or before April 1996," the commission said, "Eskind misappropriated or converted approximately \$246,000 of Asset Management's assets, and concealed his actions by falsifying the partnership's books. When the thefts were discovered, Eskind was terminated by Tower," it added.

Thereafter, Eskind solicited investments from the public using Asset Management's offering documents, the SEC alleged. In so doing, it said Eskind failed to inform investors that he had been terminated by Tower and that Asset Management had been dissolved.

Accordingly, the commission related, the court enjoined Eskind from violating the antifraud provisions of the federal securities laws, and froze all assets held or controlled by him. In addition, it said the court directed Eskind to provide an accounting of all monies he received from his alleged scheme within 20 days.

investment pool managed by Ben Mar. The investors were located in Kentucky, Ohio, Florida, and other states.

Illusion of Profits. In soliciting investors, the commission charged, Gatch and Schmidt claimed that the investments would earn profits of 4 to 5 percent per month. Gatch also allegedly made false representations concerning his trading strategy, which according to the SEC, consistently resulted in substantial losses. The agency said that Gatch concealed these losses, and maintained the illusion of trading profits, by using the

funds of existing investors and new investors to repay principal and pay purported profits. "By the time the scheme came to light, investors had lost approximately \$12.2 million, including approximately \$4 million that Gatch and Schmidt took for themselves," according to the commission.

Gatch, who handled all of Ben Mar's trading and accounting, has pled guilty to criminal wire fraud based upon his role in the scheme, the commission related. It charged here that Gatch made material misrepresentations and omitted to disclose material facts to Ben Mar investors; sold unregistered securities; and failed to comply with the registration and custody provisions of the 1940 Investment Advisers Act. Schmidt, in turn, allegedly solicited Ben Mar investors and repeated Gatch's false performance claims. Schmidt failed to investigate the performance claims and failed to take any steps to monitor Gatch's activities, the SEC said. It is seeking injunctive relief, disgorgement, and penalties against the defendants.

Crime**Bennett Officers Indicted
In Massive Securities Scam**

NEW YORK—A federal grand jury in the U.S. District Court for the Southern District of New York June 26 indicted Patrick R. Bennett, former chief financial officer of Bennett Funding Group (BFG), in an enormous securities scam that allegedly bilked some \$700 million from about 12,000 investors in what prosecutors called one of the biggest such schemes in U.S. history (U.S. v. Bennett, DC SNY, Cr. No. 97-626/97).

Bennett faces 43 counts of conspiracy, securities fraud, and money laundering, among other charges. Three other company officers also were indicted and charged with similar crimes, following a 16-month investigation by the FBI, the Securities and Exchange Commission, and the U.S. Attorney's Office.

BFG, which was based in Syracuse, N.Y., and filed for bankruptcy in March 1996, had been involved with the purchase and sale of office equipment leases. The indictment alleged that between 1990 and 1996, at Bennett's direction, the company bilked investors by selling the same lease contract more than once, selling wholly fictitious leases, overselling participations in lease contracts, and selling lease contracts that were also pledged to banks and other financial institutions in connection with loans and credit obtained by BFG. Bennett also was charged with fraudulently overstating the company's net income on financial statements and he faces 14 counts of bank fraud in connection with those actions. He also allegedly diverted funds to company affiliates whose operations were not consolidated with BFG to conceal the scale of the fraudulent sales.

U.S. Attorney Mary Jo White tried to convey the impact of Bennett's allegedly massive scheme. "Calling this white-collar crime may trivialize the enormous hardship and economic devastation suffered by the thousands of hardworking investors who were the victims of these crimes," she said. "Many are elderly and face the loss of their life savings and their hopes for a secure retirement. Others now cannot obtain necessary medical treatment or provide for their children's education."

Bennett's attorney, Charles A. Stillman, Stillman & Friedman, said his client has worked to recoup company assets to maximize the return for BFG's investors and claims to have assisted the company's trustee in recovering millions of dollars in holdings. "He deeply regrets that any investor has suffered any financial injury, and as a former officer and director of the Bennett companies accepts full responsibility for his actions," Stillman said. Nevertheless, Stillman said the trial will prove BFG's operations and Bennett's actions were no Ponzi scheme and that the companies "were not run for his personal enrichment." The indictment prevents any further comment on specific charges, Stillman noted.

Five people associated with the Bennett case already have pled guilty to charges related to the investigation. Securities fraud charges against Bennett from the SEC are still pending before U.S. District Judge John E. Sprizzo.

Contempt for Commission. According to the U.S. attorney's indictment, Bennett and his three co-defendants—his brother Michael, Charles T. Genovese, and Gary Peiffer—tried to dupe the SEC by inventing and back-dating documents during the agency's probe. They are all charged with conspiracy to obstruct justice and to commit perjury in connection with the SEC investigation.

The four men's behavior "reflects complete and utter disregard and contempt for the SEC and its duty to protect the investing public," White said. "These massive acts of brazen obstruction, which are charged, were not inadvertent nor confined to a few wrongdoers," she added.

None of the co-defendant's attorneys could be reached for comment.

The charges against Bennett amount to a maximum prison sentence of 760 years while his brother faces up to 15 years in prison, if convicted. Genovese also faces up to 15 years and Peiffer 10.

In a related matter, Anthony R. Pavoni, the owner and president of Scriptex Inc., and Thomas Pomposelli, the company's former comptroller, pled guilty June 24 to a five-count information of obstruction of justice, perjury, and conspiracy charges, that arose out of the SEC investigation of BFG. Both men admitted to fabricating and back-dating documents and giving false testimony to the SEC, White said.

By JEFFREY GOLDFARS

Antifraud

SEC Charges Five in Alleged Scheme To Create False Appearance of Sales

The Securities and Exchange Commission announced July 1 that it instituted two separate administrative cease and desist proceedings against five individuals over their alleged roles in a scheme to create the false appearance that a Nasdaq-listed company—Ferrofluidics Corp., of Nashua, N.H.—had sold 620,000 shares of stock.

In one action, respondents Helen Chalut and Saleem Noorani agreed to settle the charges without admitting or denying misconduct (*In re Chalut*, SEC, Admin. Proc. File No. 3-9344, 7/1/97). Chalut allegedly was re-

cruited to act as a nominal purchaser of the securities, and Noorani allegedly provided misleading documents to support the fraudulent scheme. They agreed to cease and desist from future securities law violations, and to disgorge \$21,000 and \$65,000, respectively.

Meanwhile in the second case, charges remain pending against respondents Paul Okuda, Stephen Thorpe, and David Chester (*In re Okuda*, Admin. Proc. File No. 3-9345, 7/1/95). The three men, along with Chalut, allegedly were recruited to act as nominal buyers of Ferrofluidics' stock until the shares could be registered and sold to bona fide investors, the SEC reported. It said it is seeking disgorgement and prejudgment interest against all three respondents, and civil penalties against Okuda and Chester.

False Appearance. In particular, the SEC said that during March and April 1992, two senior Ferrofluidics officials devised a scheme to create the false appearance that their company had sold 620,000 shares of stock. Okuda, Thorpe, Chester, and Chalut—who allegedly were recruited to act as nominal purchasers—each signed a subscription agreement, a promissory note, and a pledge agreement, the commission said. "However," it charged, "none of them paid for the Ferrofluidics stock, nor did they have the financial ability for the shares. Okuda, Thorpe, and Chalut each received payments from Ferrofluidics for their participation in the scheme," according to the commission.

Additionally, the agency alleged, at the entity's request, Okuda, Chester, and Chalut falsely confirmed to Ferrofluidics' outside auditors during the 1992 audit that they owned the company the amount payable under their respective notes. Also, at Ferrofluidics' request, Noorani allegedly sent the company a backdated letter that he had been told might be made available to the concern's auditors "outlining a commission schedule that never existed." Moreover, according to the SEC, Chester and Noorani's company received commissions for helping Ferrofluidics sell its shares, but neither Chester nor Noorani was registered as a broker-dealer with the SEC.

Broker-Dealers

CA 8 Sustains SEC Liability Findings Against Firm, President Over Offering

The U.S. Court of Appeals for the Eighth Circuit sustained Securities and Exchange Commission liability findings against a brokerage firm and its president over misconduct in an offering purportedly undertaken in part to develop a medical waste disposal facility (*Everest Securities Inc. v. SEC*, CA 8, No. 96-3293, 6/26/97).

However, Judge Roger Wollman vacated in part the sanction imposed upon Everest Securities Inc. and its president Jeanne Aiyce Kunkel. The disciplinary proceedings against Everest and Kunkel were undertaken in the first instance by the National Association of Securities Dealers Inc.

Stock Offering. The court explained that G.E.D. International Inc. sought to purchase Midwest Tire Service Inc., a business that would collect, process, and dispose of waste tires, and later sell the tire-derived product as

FEBRUARY 5, 1997

The New York Times

D-3

S.E.C. Asks Judge to Soften Stand on Fraud

By Bloomberg News

The Securities and Exchange Commission is urging a Federal judge to reconsider her earlier decision making it tougher for investor lawsuits against companies to go forward under a year-old law.

Judge Fern M. Smith of the Federal District Court in San Francisco ruled in September that under laws passed in 1995 to curb class-action lawsuits, shareholders must show deliberate corporate intent to commit fraud.

The commission filed a friend-of-the-court brief arguing that the judge misinterpreted Congress's intent in passing the Private Securities Litigation Reform Act of 1995 and deviated from other courts on the issue.

Congress, in passing the law, did not try to set a stricter standard than that established by the courts, but instead left to Federal judges "the discretion to create their own standards," said the commission's Jan. 31 brief, which was released yesterday.

Courts have typically required only that shareholders show that an

accused company acted with recklessness, a legal term defined by the courts as "an extreme departure from the standards of ordinary care," the commission said.

The brief said, "The recklessness standard requires a high level of culpability," adding that the commission used this standard in its own enforcement cases.

The S.E.C. brief was filed in an investor's fraud suit against Silicon Graphics Inc., which was dismissed by Judge Smith and refiled in October. Silicon Graphics, based in Mountain View, Calif., has filed another motion to dismiss.

The suit against Silicon Graphics contends that executives issued deceptive statements to inflate the price of company stock to sell it for a total profit of \$13.8 million. The company has denied any wrongdoing.

Silicon Graphics did not respond to a request for comment yesterday.

The law, enacted by Congress over President Clinton's veto, seeks to curb frivolous shareholder suits against companies when the compa-

ny's stock falls. A key provision requires that complaints state "with particularity" any facts that suggest corporations intended to commit fraud.

In September, Judge Smith ruled that investors "must allege specific facts that constitute circumstantial evidence of conscious behavior by defendants." It is not enough that they show that a company had a motive and opportunity to commit fraud, or acted recklessly, her decision said.

Judge Smith did not respond to a request for comment yesterday.

A lawyer who typically defends companies in class-action suits said the dispute might have to be resolved by the Supreme Court.

"The S.E.C. certainly raises a legitimate issue in terms of this opinion having staked out a position that no other court has adopted before," said John Sullivan, a lawyer with Fried, Frank, Harris, Shriver & Jacobson in New York. "But the prevailing standard is uncertain in light of the new act."

SEC Chairman: Federal Securities Law Reform Should Get Time to Work

By Lynn Stevens Hume

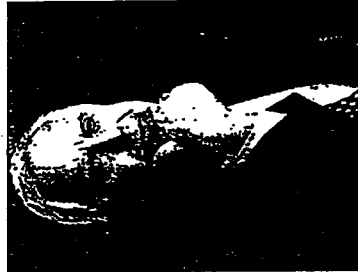
Securities and Exchange Commission chairman Arthur Levitt yesterday warned states like California against adopting their own securities litigation reforms before recently enacted federal legislation has a chance to work.

Speaking at the Securities Industry Association's annual meeting in Boca Raton, Fla., Levitt said "new federal law should be given time to work before further major actions are taken — such as California's Proposition 211."

Levitt had opposed the ballot measure, which — had it not been defeated by a 3-to-1 margin on Tuesday — would have effectively reversed some of the provisions of the new federal law and made it easier for securities fraud class action suits to be filed in California.

Levitt's remarks come as some members of Congress, including California Republicans Christopher Cox and Tom Campbell, consider drafting or pushing legislation that would preempt state initiatives making it easier to file frivolous securities class action suits.

Campbell asked House Commerce Committee chairman Thomas J. Bliley Jr., R-Va., in a recent letter to support draft legislation that would require all securities suits involving a security registered under Section 12 of the Securities Exchange Act of 1934 and seeking more than \$100,000 in damages to be filed in a federal court. But



Steve Barnett / AP Wirephoto

sources say Bliley might be considering drafting his own bill. Cox reportedly has been considering a number of proposals, including establishing a federal fraud standard.

It is not clear where the SEC would stand on such legislation.

On other issues, Levitt said: "Investors and issuers will be watching carefully to see if recent reforms put into place by the National Association of Securities Dealers are 'structural or superficial.'" The NASD has been trying to re-

SEC chairman Arthur Levitt says states should judge how effective the new federal laws are before trying to reform securities litigation themselves.

gain investor confidence after the SEC censured it earlier this year for being lax in enforcing securities laws and rules against member-firms, including the Municipal Securities Rulemaking Board's Rule G-37.

The SEC will continue to work with the Justice Department in wide-ranging investigations of abuses, such as the one that led to last year's arrest of a number of so-called rogue brokers.

The securities markets should be thinking about, and moving toward, one-day settlement of trades.

The SEC staff is planning to conduct a series of examinations of investment advisers, their institutional clients, and the broker-dealers with whom they have soft-dollar arrangements to determine if there are abuses. In such arrangements, funds obtain rebates or services from broker-dealer firms in return for steering them trades.

A new "milestone" will be reached in

the municipal bond market when dealers put procedures in place this summer that will allow them to begin reporting pricing and other information early next year on trades with institutional and retail customers. "Transparency has characterized our equity market and made them great. It will strengthen our multi markets as well."

The SEC is reevaluating its net capital rule. "We're exploring a more rational approach to determining how much capital firms must set aside, with an eye toward a more straightforward rule that better adjusts for a firm's exposures."

The commission, as expected, is considering a plan to establish a new class of limited-purpose broker-dealers to facilitate derivatives transactions. These firms would be subject to modified capital, margin and other regulatory requirements.

Broker-dealers should focus on having good internal controls and risk management systems in place and on improving sales practices. They should also "eliminate any (compensation) practices that can conflict with the interests of investors."

One of the SEC's "greatest challenges," said Levitt, is the advance in communications technology. "The Internet has already changed the face of brokerage and investment management, through online trading and other innovations," he said. "It may also redefine disclosure and what constitutes an exchange before we're through."

BOND BUYER

NOVEMBER 18, 1996

The Many Lives Made Miserable By a Low-Down High-Roller

WHITE-COLLAR CRIME often seems benign. It is not. Cases in point: the hundreds of victims of Steven Hoffenberg, the high-rolling debt collector and gambler who in 1993 briefly controlled the New York Post and who last week was sentenced to a range of fraud charges and for obstruction of justice.

Mr. Hoffenberg decided against the classic Ponzi scheme, whose pyramidal high returns would strike the conscience of too good to be true. Instead, his Towers Financial Corporation disarmingly offered investors a few percentage points more than market interest rates, while improving them with inflated financial statements. Brokers got large commissions to bring in money, and bring it in they did. But the financial statements were phony, certified by a crooked accountant, and the money raised financed Mr. Hoffenberg's lavish lifestyle.

At sentencing in Manhattan on Friday, he was ordered to serve 30 years in prison, pay a \$1 million fine and make restitution of the more than \$625 million he stole. In fact, the money is gone, and those he defrauded got back less than a penny for every dollar they lost. Their anger and anguish are reflected in letters to United States District Court Judge Robert W. Sweet, who cited them in imposing a longer sentence than recommended by Federal guidelines. Excerpts follow.

FLOYD MORRIS

From Anthony Matos of Holyford, Calif.:

I was employed by Armstrong Tea Company for 24 years. I started as a maintenance mechanic. When I retired I was a maintenance foreman. During my employment with Armstrong, I contributed up to 17 percent of my salary to a retirement fund. When I retired, I was informed that I would have to wait over my retirement to an LIRA within one year. I was told by an investment advisor that Towers Financial was a strong company. I invested \$12,500 in an LIRA, and \$25,000 in another account with Towers Financial.

I sacrificed a big portion of my wages as I would have something when I retired. My current financial condition is that I will have to continue working in order to survive. It is very depressing to learn that what one has worked for is gone. I worked the midnight shift, so I didn't have much time with my family. I thought I would have more time when I retired, but I guess not.

From RoseAnn Marches of Vista, Calif.:

I am 69 years old. My husband, John, is 75. We have worked hard all our lives, hoping to have a half-way comfortable retirement. Now with the loss of the money that was stolen from us by this person, Steven Hoffenberg, I have to watch every penny. My husband has had many strokes, which have left him legally blind. I cannot afford to send him to day care and therapy more than one day a week. He should have more. Specialized care is very expensive and not covered by insurance. I have had a heart attack due to stress and financial worries. I worry about how my husband will be taken care of if I am no longer able to care for him.

From Doreen L. Brannhoff of Tucson, Ariz.:

My husband and I were just married when we invested our \$12,500 with Towers, which was the first and only investment we have ever made. In the last two years we have been heartbroken to learn that neither fertilization is our only hope for having a child. The \$12,500 would have covered two IVF cycles, or in other words two full attempts at having a child. At this point, we have no child, and no hope of having the money it would take to try. We are now both 35 years old.

From Elaine L. Eaton of Parker, Ariz.:

On or about September of 1991, a broker for Thomas F. White and Company of San Francisco began pressuring me to invest in Towers Financial Corp. promissory notes. At first, I refused. (Eventually, I invested \$212,000.) I agreed that \$212,000 at 14 percent should bring me in around \$2,400 per month.

At the time I invested in the promissory notes, I was under a great deal of stress. My husband was seriously ill with Alzheimer's disease and major depression in a nursing center. His care was around \$2,000 a month.

My goal was to have a safe investment to help pay for his care and also take care of myself in the future. The bankruptcy court returned only \$1,100.00 of my \$212,000 investment.

From Tacie C. Smith of Woodstock, N.Y.:

We are both in our seventies. My husband retired as an engineer from L.R.A. and I retired as an elementary school teacher. What we have in mind for Steven Hoffenberg's sentence is not fit to print.

From Sharon D. Donschewer of Bellevue, Wash.:

The money invested represented 12 years of savings as a single mother with three children. Mr. Hoffenberg truly represents the evil we spend our lives protecting our children from.

From Lucille A. Wada of Cincinnati, Ohio:

The facts are that this person or corporation robbed us of our money. To us, it was a large sum. His greed deprived us of a dream we had for our future together. He is no better than a street thief with a gun, perhaps worse.

From David W. Purves of San Leandro, Calif.:

I am a retired schoolteacher. As for Mr. Steven Hoffenberg, I hope the judge puts him away for many, many years. I guess he's not better than I will.

From Margaret E. Spelman of New York City:

I made this serious investment because I hoped that income from the notes would supplement my not-very-large teacher's salary. At that time, we had two children in private high school, heading to private colleges and my husband had been "downsized."

From Linda Loveland of Middletown, Conn.:

I am a single mother with three dependent children who, at one time not so long ago, provided a comfortable lifestyle for my family. I am now receiving state aid as a result of the devastating losses to Towers Financial Corporation. Mr. Hoffenberg's business crime of outright delivery has wiped out my chance of my children ever receiving higher education, etc. Mr. Hoffenberg has single-handedly destroyed our lives.

From Doris M. Schuler of Rosville, Calif.:

This was almost all (my mother's) retirement money. She has now obtained a part-time job with Burger King restaurant to supplement her Social Security income. If this man can't pay back what he stole from my mother, I feel he should be given life imprisonment. This is the term of the sentence she will be serving for having trusted him.

From Verlene Brance of Grimsby, Tex.:

I am a 58-year-old woman who has been a teacher in the public schools of Texas for most of my adult life. I invested almost all of my life's savings, \$112,000. Mr. Hoffenberg has taken away what would have been a nice retirement income for me. So as a result, I have returned to teaching and will probably have to do so as long as I am able.

From Henry Field of Chicago:

Steven Hoffenberg caused me to lose \$41,000 from my retirement plan, which was over half his assets. It was supposed to be a safe investment.

Steven Hoffenberg hurt more people in a brief five years than a jail full of street criminals in their lifetimes. What they accomplish in a moment of fear with the swirl of a knife, Steve Hoffenberg accomplished a million times over in cold calculation with the swirl of his pen.

From Gail Peterson of Redwood Shores, Calif.:

I hope Steven Hoffenberg receives the maximum penalty. Our investment was for renovations to our house. With the loss of our investments the end result was the loss of our 13-year marriage.



The flamboyant Steven Hoffenberg in 1994.

'Steve Hoffenberg hurt more people in a brief five years than a jail full of street criminals in their lifetimes,' wrote one of his hundreds of victims.

From Dean B. Palmquist, vice president of Longmont United Hospital in Longmont, Colo.:

Longmont United Hospital invested \$300,000 of hospital funds with Towers Financial Corporation. Completion of the community's cancer care center was delayed due to funding shortfalls due to our loss of this investment.

From Frederick P. Rothman of King of Prussia, Pa.:

I am 55 years old and a lawyer and law professor for the past 28 years. I am embarrassed to admit that among the topics I teach in the Securities Act of 1933, particularly the anti-fraud provisions. The consequences of the loss affect me every day, and the personal guilt for not being able to do more for loved ones when they need it will stay with me for the rest of my life.

Forbes

MARKETS

Swindlers' paradise

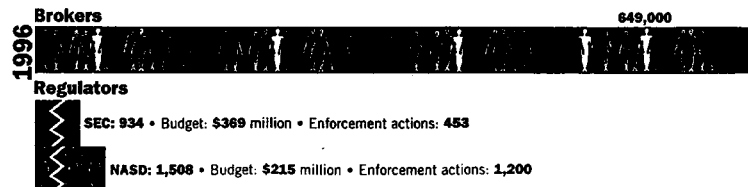
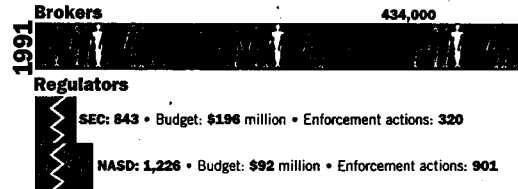
Apparently greed makes people careless. They shouldn't count on the cops to protect them.

THE CHARTS BELOW TELL THE STORY. In the past five years the army of stockbrokers has grown by 50%, to 650,000 strong. The U.S. now has more stockbrokers than steelworkers. The regulatory staffs at the Securities & Exchange Commission and the National Association of Securities Dealers have grown 18% during the period: 2,442 regulators last year, versus 2,069 in 1991. One regulator for every 266 brokers. Ditto for enforcement actions: The NASD and

SEC—combined—brought one enforcement action for every 400 brokers.

Cities are getting federal help to put more uniformed cops on the beat. How about a little extra staffing for the security cops? Even with increased staff, the NASD did 5% fewer routine examinations at brokerages last year than in 1991. Preying on the least-informed people, the security crooks are giving capitalism a bad name.

—GRETCHEN MORGENSON ■



Source: Securities & Exchange Commission; Securities Industry Association; National Association of Securities Dealers.

THE WALL STREET JOURNAL THURSDAY, FEBRUARY 20, 1987

Seniors, Prey of Con Artists and Brokers, Are Mad as Heck, Won't Take It Anymore

By EILEEN KINSHELLA
Staff Reporter of THE WALL STREET JOURNAL

Brokers and scam artists beware. The senior set is getting savvy.

And angrier.

Take Willis H. Duryea, a retired businessman in Casa Grande, Ariz., who says he's "pushing 83." Some 5½ years ago, he lost \$8,650 to American Microtel Inc., a fraudulent telemarketing company that claimed to be involved in a wireless cable venture.

After making his original investment, Mr. Duryea became suspicious when the company always seemed to be "in the process" of some complicated procedures. He began cataloging his correspondence and recording his telephone conversations with company officials.

In 1981, Mr. Duryea was the star witness in the Arizona Corporation Commission's case against American Microtel, driving more than 80 miles round-trip each day to testify. Attorneys credit his testimony with a court decision that effectively put Microtel out of business.

Months later, when Mr. Duryea began receiving telephone calls from an obscure Wall Street firm claiming that it was pursuing American Microtel's efforts to obtain wireless licenses, Mr. Duryea fired up his tape-recorder again. And again he was instrumental in shutting down another scam operation.

"These guys are crooks, and have to be stopped. Those tapes helped break their case to pieces," says Mr. Duryea proudly. But he's still furious about the money he lost, adding: "They can't give it back to me unless they find it."

Now his telephone-answering machine informs any salespeople calling him to simply "Forget It."

Increasingly Seniors Get Data

For years seniors have been a target not only of scam artists trying to chisel them out of their savings, but also of unscrupulous or not-so-bright brokers urging inappropriate investments. But many older investors are taking charge of their own financial lives. They are scouring financial publications, haunting brokerage offices and even surfing the Internet in their quest for higher returns and, in some cases, something to occupy their days.

"It's a whole different world when you're not working," says Paul Terowsky, 55, a retired car-wash owner in Great

Neck, N.Y. "I need to keep that drive somehow."

Mr. Terowsky is a frequent visitor to the Great Neck public library, where he has been known to race other retired investors to snap up the latest copy of Value Line Investment Survey when it arrives at about 1 p.m. each Friday. Demand for the publication is so great that the librarian restricts its use by any one patron to just 30 minutes. Mr. Terowsky is convinced that a stock upgrade in Value Line leads almost inevitably to a rise in the stock's price.

When he isn't at the library perusing Value Line, Mr. Terowsky can often be found at the local Charles Schwab office watching the tape spool by with a dozen or so other retiree investors. Each of the "lobby rats," as they call themselves, are known for their investment choices: Joe Katz, for instance, is a gold bug, convinced that his holdings of gold stock will save

the day when "inevitably there will be some disaster in the world." Ed Guindly, a retired bank officer, not surprisingly, favors financial stocks. He points to the most recent quote on Chase Manhattan's stock—\$81.75—and boasts that he bought it in 1990 for about \$10 a share.

"When I go to a party, I want to be able to say that I had a 25%-to-30% return last year," says Mr. Terowsky. "I just think I can beat anything out there."

Plenty to Invest

Mutual funds and brokerage houses love clients like this. They have plenty of money to invest—one study indicates that families headed by those 65 or older have \$1 trillion invested, not including home equity or employer pensions—and they trade often, generating commission revenue for brokers.

But as with the Great Neck Schwab office, brokers are finding that there can be too much of a good thing. When the noise level in the lobby got out of hand a few months ago, the sofas suddenly disappeared and Schwab employees began pointedly asking the lobby rats if they had accounts at Schwab, the lobby dwellers say.

Tom Taggart, a Schwab spokesman, says the firm's branches are designed to allow people to "interact," but "at the same time, we want to make sure that all customers have equal access."

Retirees also are forming investment coffee klatches at diners and pancake houses across the country. Billie Taylor, a 55-year-old retired high-school teacher in Kettering, Ohio, meets weekly over coffee and donuts at the local Meijer food shop for a discussion about computerized investing. And woe

Please Turn to Page C16, Column 1



Lars Larson

Seniors, Often the Prey, Are Mad as Heck

Continued From Page C1
be unto him who makes a bold statement without the facts to back it up.

Joe Wade, an accountant, learned that the hard way after he proclaimed at one lunch session that General Motors stock, bought in 1955 and held until 1995, would have been a bad investment when adjusted for inflation.

The resulting uproar, particularly among worried owners of the stock like Dr. Taylor, the retired teacher, consumed the next few weeks of meetings as each member researched stock splits, spinoffs, dividends and inflation rates. When the group finally smoothed out its spreadsheets, they realized that Mr. Wade hadn't factored in all of GM's stock splits, thus seriously undervaluing the stock's performance during that time period. Dr. Taylor says that their diligent research did uncover at least one extended time period during which the stock would not have been a lucrative investment. Despite his initial upset, Dr. Taylor says the research effort taught the group more about the investment process.

"It was certainly worth the price of a breakfast," he says.

A former real-estate broker who joined

the gathering at Meljer last summer didn't last long after proposing a risky strategy involving trading so-called naked options. By the time the gang had grilled him about taxes, commissions and risks, the ex-broker conceded that he hadn't actually closed out his positions or earned any money, even though he had been urging the other members to adopt the same strategy. He stopped attending meetings.

"Maybe he was embarrassed or maybe we hurt his feelings," says Dr. Taylor. "But if you're going to suggest something like that, you'd better be able to back it up."

But it's the scamsters who have the most to lose when they tangle with savvy seniors. The Federal Bureau of Investigation relied in part on seniors recruited by the American Association of Retired Persons to crack down on telemarketing scams in a nationwide sting operation known as "Senior Sentinel." Some of the volunteers were former law-enforcement officers. But others were ordinary citizens, some of whom had been victimized in the past and were targets of repeat efforts by other scam artists, who circulate so-called "reload," or "sucker" lists among themselves.

The evidence provided through the recorded conversations proved damaging for the telemarketers, but it also yielded valuable information about the variety of schemes used to defraud people. One telemarketer employing what is termed a "Rip and Tear" strategy (so-called because it inflicts great damage in a short time by relying on outrageous claims) was recorded verbally abusing a potential victim. Relying on the tapes, the FBI was able to identify and arrest the person. Like a number of other scam artists, he is currently in FBI custody and has been charged with multiple counts of fraud.

Senior Sentinel resulted in the issuance of 117 search warrants and approximately 400 arrests by 38 FBI offices, and trials are continuing. An FBI analysis following the sting operation established that about 75% of the people targeted by these scams were elderly.

"The telemarketing fraud con artists should pay careful attention to this investigation," says Robert Shreve, AARP chairman. "The older person you believe to be a helpless victim may be turning you in to the authorities."

WSJ 6-3-97 B13

*A.R. Baron Ex-Brokers
Plead Guilty to Charge
Of Criminal Activity*

By a WALL STREET JOURNAL Staff Reporter

NEW YORK—Two former A.R. Baron & Co. brokers pleaded guilty yesterday in state court here to participating in a criminal enterprise and said they would cooperate in the prosecution of executives of the defunct brokerage and investment bank.

The men were among 13 former A.R. Baron officials indicted last month on charges of running a criminal enterprise that defrauded investors of more than \$75 million. The New York firm operated from 1991 until last July, when a trustee appointed by the federal bankruptcy court in Manhattan took over the firm at the request of regulators.

The men, Garvey Fox of Stratford, Conn., and Matthew Hirsch of New York, both admitted in court to lying to investors, manipulating stock prices and participating in a criminal enterprise. "The company was nothing more than a group of people who had gathered together for the purpose of committing securities fraud," Mr. Fox told the court.

Messrs. Fox and Hirsch, who are free on bail, both face mandatory minimum sentences of one to three years in prison.

WSJ 3-24-97 B4B

NASD to Study Stock Claims on Internet; Device Will Look for Suspicious Phrases

By REBECCA BUCKMAN
Dow Jones Newswires

If you are planning on hyping your company's stock on the Internet anytime soon, try to avoid comparing it with high-tech success story Microsoft Corp.

It might also be wise to avoid phrases such as "guaranteed moneymaker" and "hot little tech stock."

The reason? Regulators at the National Association of Securities Dealers soon will be on the lookout for those red-flag terms, as well as others that might indicate a company is making unsubstantiated—and possibly dangerous—claims about its shares.

They are "all phrases we've already encountered, and [ones] that generally signal trouble," said NASD Regulation Inc. President Mary Schapiro, who launched a campaign last summer to warn investors about Internet stock fraud.

Now, Ms. Schapiro's agency is developing a sophisticated computer search engine that would troll the World Wide Web for specific, too-good-to-be-true phrases such as "the next Microsoft."

A prototype of the technology, which could be programmed to search for different words and phrases as stock fads come and go, might be ready as early as this summer, a spokesman for NASD Regulation said.

The surveillance tool could patrol popular securities bulletin boards such as Silicon Investor and America Online Inc.'s Motley Fool, where anonymous messages tout or pummel specific stocks—often without many facts to back up the claims.

The NASD Regulation spokesman, however, stressed that the search engine remains in the early stages of development. He said details about exactly how and when it would be used haven't been worked out.

But in a speech delivered last week in New York, Ms. Schapiro said regulators could use the technology to catch potential stock scams before they spiral out of control.

She said the technology could have blunted the damage done to investors by Comparator Systems Corp., a once-high-flying fingerprint-identification company that was delisted by the Nasdaq Stock

Market last May. The company later settled charges of asset inflation with the Securities and Exchange Commission without admitting or denying wrongdoing, although the SEC did sanction two company officials.

For two months before Comparator's collapse, Ms. Schapiro said, messages about the company piled up in Internet forums.

"I would like for us to be able to recognize those building masses of messages early enough and alert the public," she said. "We'd like to be able to stay ahead of the Comparator situations before they tank and cost people a lot of money."

John Stark, supervisor of Internet surveillance for the SEC, called the idea of an NASD search engine "terrific."

Although many investors are becoming more savvy about dubious stock claims posted on the Web, fraud still abounds, he said. Since securities chat forums have sprung up in the last couple of years, the SEC has brought nine enforcement actions against companies whose shares were fraudulently promoted on the Internet, according to Mr. Stark.

The agency also has investigated Web-based newsletters and other cases of stock manipulation in cyberspace, he said.

HALLMARK CARDS INC.

Flextech Stake of 8.4% Is Sold for \$9.95 a Share

An 8.4% stake in Flextech PLC, the U.K. cable programming company, was sold Friday by Hallmark Cards Inc. through Goldman, Sachs & Co. Hallmark, Kansas City, Mo., bought the stake in 1994 for around 430 pence (\$6.85) a share and sold the shares for 624.5 pence (\$9.95) each on Friday. Flextech Chief Executive Roger Luard said Hallmark's strategic partnership with Hallmark to produce movies and develop long-term film distribution rights is unaffected by the disposal. "It increases the size of [Flextech's] public float, which has been a problem," Mr. Luard said. About 80% of Flextech stock is owned by a unit of Tele-Communications Inc., Cox Communications, Pearson PLC and a handful of institutions.

[Back](#)**NASD Press Release**

National Association of Securities Dealers, Inc. • 1735 K Street, NW • Washington, DC 20006-1500 • 202-733-8000

For Release: Thursday, August 7, 1997

Contact: Michael W. Robinson - (202)
728-8304**NASD Board Approves New Taping Rule And Approves Order
Audit Trail System Implementation**

Washington, D.C.— The National Association of Securities Dealers, Inc. (NASD®), today announced that the Board of Governors approved a new rule that, if approved by the Securities and Exchange Commission (SEC), would require brokerage firms to tape record all of their brokers' phone calls with investors, if a certain percentage of their brokers were employed by an expelled brokerage firm within the last two years.

The taping rule defines an expelled firm as one that has been expelled from a securities industry self-regulatory organization, or has had its registration revoked by the SEC, for sales practice violations or telemarketing abuses. The threshold percentage of brokers from a disciplined firm that would thereby require recording, will vary from 40 percent for a small firm, to 20 percent for a large firm. Under the rule, every firm will be required to conduct a quarterly review to determine whether they must be taping. To ease compliance burdens, NASD RegulationSM will provide its members with lists of expelled firms and their former associated persons (organized by current employer).

"Putting potential problem brokers on notice that calls are being taped is a positive step for every investor. Firms that hire a concentration of brokers from a firm with an egregious disciplinary history have an obligation to the investing public to ensure that those brokers are properly supervised and conduct themselves appropriately," said Frank G. Zarb, NASD Chairman, Chief Executive Officer, and President.

This rule grew out of the results of the Joint Regulatory Sales Practice Sweep Report, a joint effort of the NASD, SEC, New York Stock Exchange, and the North American Securities Administrators Association.

The Board also ratified the approval by the NASD Regulation Board of Directors of the NASD's Order Audit Trail System (OATS), which is currently in development. The proposed rule governing OATS was filed with SEC on July 29th.

The OATS project will capture important order surveillance information for use by regulators. The proposed rule allows for the phase-in of the full system beginning with the inclusion only of orders that are captured or input directly into an electronic system by August 1998. All orders in equity securities received by other than electronic means would be covered by January 1, 1999. All other orders would be phased-in by no later than January 31, 2000.

"This phase-in schedule has been developed in order to allow broker-dealer firms a greater opportunity to efficiently implement the OATS system's technical requirements while also making necessary changes to fully implement the SEC order

handling rules and Year 2000 protocols. Because the majority of Nasdaq's order flow comes to us electronically, the initial phase will, in itself, provide us with an extremely useful surveillance tool," Zarb added.

The National Association of Securities Dealers is the largest securities-industry self-regulatory organization in the United States. Through its subsidiaries, NASD Regulation, Inc., and The Nasdaq Stock Market, Inc., the NASD develops rules and regulations, provides a dispute resolution forum, conducts regulatory reviews of members activities and designs, operates and regulates securities markets all for the benefit and protection of the investor.

[Back](#)



Max Cleland
SECRETARY OF STATE
(404) 696-3901

June 27, 1995

The Honorable Paul Coverdell
U.S. Senate
200 Russell Senate Office Building
Washington, DC 20510

Re: S. 240, the "Private Securities Litigation Reform Act"

Dear Senator Coverdell:

I understand that the Senate is now considering S. 240, the "Private Securities Litigation Reform Act." In my capacity as the Secretary of State and the Commissioner of Securities of the State of Georgia, I am writing today to express my serious concerns with S. 240 as it was reported out of the Senate Banking Committee. As you know, I am responsible for investor protection and for overseeing the capital formation process in Georgia.

In evaluating the variety of securities litigation reform measures that have been introduced in the 104th Congress, I applied one test: Does the bill achieve a balance between protecting the rights of defrauded investors and providing relief to honest companies and professionals who may find themselves the target of a frivolous lawsuit?

Regrettably, S. 240 as it was reported by the Senate Banking Committee does not achieve this balance. Instead, the bill would tilt the balance too far in favor of corporate interests and would have the effect of depriving many defrauded investors the ability to recover their losses.

It is my understanding that pro-investor amendments are being offered as S. 240 is being considered on the Senate floor. Among the amendments expected to be offered are the following:

- Extending the statute of limitations for civil securities fraud actions;
- Fully restoring liability for aiding and abetting securities fraud;

The Honorable Paul Coverdell
June 27, 1995
Page 2

- Narrowing the scope of a safe harbor for forward looking statements so that the Securities and Exchange Commission (SEC), which has the necessary expertise, is directed to engage in rulemaking to develop a reasonable and effective safe harbor without giving corporate executives free rein to make misleading statements; and
- Modifying the severe limitations on joint and several liability so that innocent defrauded investors have a chance to fully recover their losses.

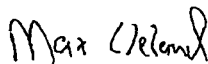
The Securities and Exchange Commission, the North American Securities Administrators Association (the organization representing the 50 state securities regulators) and others generally have expressed concerns over the bill's treatment of these issues. The amendments expected to be offered on the floor (as discussed above) respond to those concerns and are deserving of your support. Please vote in favor of these amendments when they are offered on the floor.

If these amendments are offered and rejected, I respectfully encourage you to vote against S. 240 on final passage.

Although there may be room for constructive improvement of the federal securities litigation process, S. 240 as reported by the Banking Committee goes beyond the stated goal of curbing frivolous lawsuits and instead would, in practical effect, eradicate all private actions under the federal securities laws.

In closing, I want to emphasize that our financial markets do not run on money; they run on public confidence. It is my view that the confidence investors have in the marketplace will be dramatically altered if they come to believe that not only are they at risk of being defrauded, but that they have no recourse to fight back against those who have defrauded them. I urge you to support balanced and targeted reform measures and to reject S. 240 if it does not incorporate the amendments discussed above.

Most Sincerely,



Max Cleland

MC:jbt



Secretary of State
214 State Capitol
Atlanta
30334

Max Cleland
SECRETARY OF STATE
(404) 636-2882

June 27, 1995

The Honorable Sam Nunn
U.S. Senate
303 Dirksen Senate Office Building
Washington, DC 20510

Re: S. 240, the "Private Securities Litigation Reform Act"

Dear Senator Nunn:

I understand that the Senate is now considering S. 240, the "Private Securities Litigation Reform Act." In my capacity as the Secretary of State and the Commissioner of Securities of the State of Georgia, I am writing today to express my serious concerns with S. 240 as it was reported out of the Senate Banking Committee. As you know, I am responsible for investor protection and for overseeing the capital formation process in Georgia.

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- Fully restoring liability for aiding and abetting securities fraud;

Opening Statement of Senator John Glenn
Ranking Member

Permanent Subcommittee on Investigations

September 22, 1997

Hearing on Fraud in the Micro-Cap Stock Market

Madam Chairman, I want to commend you for organizing this hearing on the problem of fraud in the micro-cap market, sometimes referred to as "penny stocks." The purpose of this hearing is to turn a much-needed spotlight on what the Securities and Exchange Commission, the self-regulatory organizations such as the National Association of Securities Dealers, and the states need to do to ensure that securities fraud is deterred, securities swindlers and scam artists are caught and punished, and American investors are protected.

In the late 1980's, abuses in the penny stock area resulted in the defrauding of American investors to the tune of \$2 billion dollars a year. In response, Congress enacted the Penny Stock Reform Act of 1990 to address the problem. In addition, the Securities and Exchange Commission promulgated additional rules to alleviate the problem. The National Association of Securities Dealers has begun to implement a series of long-overdue reforms addressing the problem of fraud and abuse in the penny stock fraud area.

Those are positive developments. However, the problem is that it is now 1997, and even after Congressional and SEC reforms aimed precisely at penny stock fraud and abuse, securities regulators estimate that penny stock abuses result in the swindling of Americans

now to the tune 6 billion dollars a year -- 3 times the harm done to American investors before the reforms I just mentioned were put in place.

This would be disturbing enough standing alone. It is even more troubling, however, at a time when fewer and fewer American families can rely on employees' pension plans to pay for college tuition, or to save for their retirement. More and more, American families are left to fend for themselves, and must rely on themselves, to guard their savings and preserve their financial futures, and those of their children. They are, therefore, even more vulnerable than ever to the growing problem of pressure tactics, misrepresentations, and market manipulation that has triggered this hearing.

We have a panel of citizens who have each been victimized by penny stock fraud, and whose testimony about their experiences illustrates the failure of the federal government, the self-regulatory organizations and the states to address the problem of securities fraud in general, and penny stock fraud in particular.

Indeed, when we speak of the need for the SEC, the self-regulatory organizations and the states to do more to enforce standards in the penny stock area, we do so not only because American families are being defrauded out of their hard-earned savings, but because our markets depend on the trust of American investors.

Plainly, we are not doing the job we need to do to protect purchasers of penny stocks,

or in securities in general. That means that we in Congress who are concerned about fraud in the sale of securities are required to ask a number of questions. Among them are the following:

Has the SEC been aggressive enough in seeking injunctions against wrongdoers and in enforcing those injunctions with contempt actions when the injunctions are ignored?

Do we need to extend the jurisdiction of the Department of Justice so that it, too, has the authority to bring civil actions in the securities area, and so that we do not rely entirely on the SEC? Does the SEC need to step up its activity in the area of criminal investigation and referrals?

In the case of the principal self-regulatory organization in the penny stock area, the NASD, there is a well-documented history of inadequate self-scrutiny. In August, 1996 the SEC issued a report regarding the NASD and the NASDAQ market it is charged with overseeing. The report followed a 2-year investigation.

The Commission found that the NASD violated the federal securities laws, SEC rules, and, indeed, the NASD's own rules, in numerous different respects. A brief excerpt from the Report summarizes the problem succinctly, and I quote:

"A primary focus of the investigation was whether the NASD had adequately carried out its obligation under the Exchange Act to oversee the NASDAQ market and the conduct of its members. The investigation identified a number of serious deficiencies

in the NASD's performance of its duties as a self-regulatory organization, especially as they relate to oversight of the NASDAQ market.

* * * * *

The investigation revealed that the NASDAQ market has not always operated in an open and freely competitive manner. NASDAQ market makers have engaged in a variety of abusive practices to suppress competition and mislead customers."

The Executive Director of the NASD, one of our panelists today, has himself testified, and I quote: "Let me be blunt. There are significant problems in the over-the-counter market and a strong regulatory response is needed."

So the questions that need to be posed to the NASD include the following: Should the American people, and the Congress, believe that they can rely on the NASD to regulate its own members? In most other areas, we are entitled to be deeply skeptical of institutions that tell us that they can be trusted to oversee themselves. Why, particularly given the demonstrated failure of the NASD to regulate its members so that they conform to the securities laws, should we believe that the NASD is up to the job? At this point, Madam Chairman, it is fair to place the burden on the NASD to come forward to demonstrate why the investing public and the Congress should feel confident that the NASD can, in fact, regulate its members.

Finally, what kind of role should the states play in the effort to regulate securities dealers? The states are on the front line in the efforts to protect the consumer and fight stock fraud at levels that the SEC and the SRO's may be unable, or unwilling, to pursue. The state

regulatory authorities have been an important partner in the fight against fraud, and it will do no one -- except the perpetrators -- any good to truncate that partner's authority or effectiveness.

Indeed, we need to ask whether there is greater assistance that the Congress can give the states in their own efforts to regulate securities dealers. The President of the North American Securities Administrators Association, Mr. Griffin, put it plainly when he said recently: "If the [securities] firms feel like they're not at risk of having an auditor knock on their door, they are not going to feel afraid." It seems clear that penny stock dealers and their employers -- and perhaps the clearing brokers with whom those dealers contract -- do not feel sufficiently at risk of meaningful oversight, and we need to explore ways not only of improving the federal oversight of these dealers, but assisting the states to better protect their citizens from the securities law violators who are creating the problem. So we are interested in hearing the witnesses' views on how we can do that as well.

It is the collective responsibility of Congress, the SEC, the SRO's and the states to protect not only the stability of the market, but the families who invest in it as well. It is our job to ensure that the tools and the resources to fulfill that responsibility are provided, and that that responsibility is met. This hearing is an important step in testing whether this job is being done.

Thank you, Madam Chairman.



TESTIMONY OF

**ARTHUR LEVITT, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION**

CONCERNING FRAUD IN THE "MICRO CAP" MARKET

**BEFORE THE PERMANENT SUBCOMMITTEE
ON INVESTIGATIONS**

COMMITTEE ON GOVERNMENTAL AFFAIRS

UNITED STATES SENATE

SEPTEMBER 22, 1997

**U.S. SECURITIES AND EXCHANGE COMMISSION
450 FIFTH STREET, N.W.
WASHINGTON, D.C. 20549**

TESTIMONY OF

ARTHUR LEVITT, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING FRAUD IN THE "MICRO CAP" MARKET
BEFORE THE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS,
COMMITTEE ON GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

Chairman Collins and Members of the Subcommittee:

I appreciate this opportunity to appear before the Permanent Subcommittee on Investigations on behalf of the Securities and Exchange Commission ("Commission"), to discuss fraud in the micro capital ("micro cap") and "penny stock" markets and the Commission's efforts to combat such fraud.

Summary

We are living in an era of tremendous expansion in our capital markets. Last year, the Dow broke 6,000, and then 7,000, and this year broke 8,000. Daily volume on the New York Stock Exchange and Nasdaq is also at an all-time high, and initial public offerings are running at a record pace -- as shown in 1996, \$50 billion was raised for new businesses. It is not surprising then that public participation in our securities markets has grown to record levels. Mutual fund assets (\$135 million in 1980) are now a record \$3.7 trillion, surpassing the \$2.6 trillion that Americans have on deposit at commercial banks. As recently as 1980, only one in 16 households invested in mutual funds; today that number is more than one in three, as we have evolved from a nation of savers into a nation of investors.

With this vast expansion in our markets and in public participation in those markets, we would expect to see an increase in the incidence of fraud. We have particularly seen an increase in abuses in the market for micro cap securities, which provides opportunity for small businesses to raise capital, but also provides opportunity for fraudsters to prey on innocent investors. Despite the record-setting pace of our markets, the Commission's resources have remained relatively constant. We must, therefore, rely increasingly on innovative and efficient ways of minimizing fraud and of maximizing the deterrence achievable with the Commission's limited resources.

The Commission's campaign against fraud in the micro cap market is an example of such innovation. The three parts of our strategy are prevention, enforcement and regulatory initiatives.

Prevention Obviously, the Commission recognizes that preventing securities fraud is far more effective than seeking to punish wrong-doers after the fact. We prevent fraud through our programs involving broker-dealer inspections, market and Internet surveillance, and investor education.

Enforcement The Commission's Division of Enforcement has been working in partnership with the criminal authorities to lock up recidivist brokers and deter wrongdoers. Indeed, in the past year alone, at least 80 individuals have been charged or prosecuted through the coordinated efforts of the Commission and the Department of Justice. The

Commission has also coordinated its activities with other securities regulators to maximize our resources and stop micro cap fraud at its earliest stages.

Regulatory Initiatives Over the last several months, the Commission's staff has worked with the New York Stock Exchange, Inc. ("NYSE") and the National Association of Securities Dealers, Inc. ("NASD") to develop rules that address the vulnerabilities in this sector of the market, such as a rule that increases the responsibility of clearing firms for notifying regulators of problems with introducing firms. The Commission is also studying how best to increase the amount of public information available regarding companies that are quoted on the NASD's over-the counter ("OTC") Bulletin Board and in the National Quotation Bureau's "Pink Sheets."

I. Introduction

The terms "micro cap" stock and "penny stock" have been used to describe a particular segment of the securities market. As both terms suggest, these stocks are generally low-priced securities issued by small companies. A penny stock is generally a security that is priced at less than \$5 per share and is not traded on Nasdaq or listed on a stock exchange.¹ "Micro cap" stock generally describes a somewhat broader universe of

¹ Under the federal securities laws, penny stock is defined generally as: an equity security that is not listed on Nasdaq or a national securities exchange and either (a) has a price per share that is less than \$5 or (b) whose issuer has net tangible assets that are less than \$2 million, if the issuer has been in continuous operation for at least three years; or that
(continued...)

stocks than "penny stocks" -- the stock of any company with comparatively low capitalization, regardless of its price or where it is traded.² Thus, the term "micro cap" often includes "penny stock" as defined by the Commission.

Fraud in the "micro cap" stock market follows a fairly predictable pattern. We find two different, but often related problems:

- The first problem is aggressive, and sometimes fraudulent, sales practices, such as unauthorized trading in a customer's account.
- The second problem involves manipulation of micro cap stocks by brokers, issuers and promoters to benefit themselves while harming innocent investors.

¹(...continued)

are less than \$5 million, if the issuer has been in continuous operation for less than three years; or whose average revenues are less than \$6 million for the last three years. See Section 3(a)(51) of the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(51), and Rule 3a51-1, 17 C.F.R. § 240.3a51-1, promulgated thereunder.

When the Commission adopted the \$5 threshold for penny stocks it cited three reasons: 1) the perceived difficulty of manipulating higher valued stocks; 2) the fact that \$5/share was the threshold for the ULOR/SCOR -- a uniform, streamlined state registration form for companies raising less than \$1 million under the Rule 504 exception under Regulation D; and 3) the perception that legitimate small businesses could still raise capital and the liquidity for their shares would not be impaired. Exchange Act Release No. 30608 ("Penny Stock Rule Release"), 57 Fed. Reg. 18,004 (Apr. 28, 1992).

² The term "micro cap" is not a term defined under the federal securities laws. Lipper Analytical Services, a mutual fund rating organization, generally categorizes micro cap companies as companies with market capitalizations of less than \$300 million. Lipper-Directors' Analytical Data, Investment Objective Key, 2d ed. 1997. In general, securities of micro cap companies are quoted on Nasdaq's OTC Bulletin Board, in the National Quotation Bureau's Pink Sheets and on the Nasdaq Small Cap Market.

Micro cap stock fraud presents a difficult challenge: to control the fraud without damaging the market for securities issued by legitimate small businesses. In this effort, the Commission is guided by three principles:

- First, we must try to prevent fraud before it happens through early intervention and investor education.
- Second, we must vigorously enforce the securities laws against con men and criminals who take advantage of investors.
- Finally, we must continue to encourage legitimate capital formation through flexible regulation, especially for small businesses.

II. Background

A. What is Micro Cap Stock Fraud?

Before expanding upon the Commission's response to micro cap fraud, it may be useful to briefly consider the nature of the problem. Stock manipulators need stock. They usually get it in one of two ways. One way is to find a "shell" company that already has issued publicly trading securities. This shell company typically has little or no operating history; few assets; few, if any, employees; and slim prospects for financial success. The shell is sometimes merged with a privately-held company. The other vehicle for these individuals to get stock is to take advantage of exemptions from the federal registration requirements.

The securities involved are usually traded in portions of the OTC market where public information is limited and a small number of brokers control the market. The securities are usually sold through hype or high pressure tactics, often involving "boiler room" operations where a small army of sales personnel cold call potential investors using scripts to induce them to purchase the "house stocks" -- those stocks in which the firm makes a market or has a large inventory. The information conveyed to investors often is at best exaggerated and at worst completely fabricated. Increasingly, stocks also are being touted on the Internet by unregistered promoters who work to raise interest in the stock.

Once they have lured investors, the unscrupulous brokers employ a variety of inappropriate practices, from "bait and switch" tactics, unauthorized trading, "no net sales" policies (where investors are discouraged or actually prevented from selling their stocks) to churning (excessive trading in their accounts in order to generate commissions for the broker). The firm often charges excessive, undisclosed markups³ and issues arbitrary stock quotations. Even if investors complain to the brokerage firm, it rarely disciplines its registered representatives or reports the investor complaints.

The promoters of these companies, and often company insiders, typically hold large amounts of stock and make substantial profits when the stock price rises following intense promotional efforts. Once the price rises, the promoters, insiders and brokers sell, realizing

³ Excessive mark-ups in boiler room operations typically occur when a broker-dealer acquires a supply of stock at low cost and resells it at a substantially higher price to retail customers.

their profits, and the promoters cease their promotional efforts. After the manipulation of the stock ceases, the stock price plummets and innocent investors not only incur large losses, but may also lose their initial investments entirely.⁴

B. The Commission's Previous Response to Micro Cap Fraud

The last major outbreak of micro cap stock fraud occurred during the bull market of the 1980s. The Commission formed a Penny Stock Task Force in 1988 to coordinate its response to the problem. In 1989, the Commission adopted Exchange Act Rule 15c2-6, which requires brokers to obtain relevant financial information about their customers, document their penny stock recommendations and obtain written agreements from the customer for the first three penny stock purchases.⁵ The intent of the rule is to require and document customer suitability when penny stocks are recommended. Armed with this new rule, the Commission devoted substantial resources to policing "penny stock" fraud, bringing 86 penny stock enforcement actions in 1990 alone that represented 28% of all enforcement actions brought that year.⁶

⁴ This type of manipulation frequently is referred to as a "pump and dump" scheme.

⁵ In 1993, the Commission redesignated Rule 15c2-6 as Rule 15g-9, joining it with the other Penny Stock Rules. Exchange Act Release No. 32576 (July 2, 1993), 58 Fed. Reg. 37,413 (July 12, 1993).

⁶ 1990 Annual Report of the U.S. Securities and Exchange Commission, at 6 and 156.

In 1990, the Commission approved the NASD's pilot project to bring more accurate and current information to the OTC market,⁷ where micro cap stocks generally trade. The vast majority of micro cap stocks are not listed on exchanges or traded on Nasdaq. Before 1990, the National Quotation Bureau's "Pink Sheets" were the primary source of information about the stocks for this large group of smaller companies. The Pink Sheets are daily lists of stocks, published by a private financial information vendor, advertising the brokerage firms that make markets in these stocks. They sometimes include indications of interest or non-firm bid and offer prices for small quantities of stock. The Pink Sheets are not widely distributed and often contain stale information. In order to provide more public information about these stocks, the NASD created the OTC Bulletin Board, a centralized, automated alternative to the Pink Sheets that can provide real-time price and volume information. The pilot project was made permanent in 1997.⁸ The OTC Bulletin Board has strengthened the NASD's ability to monitor those quotes that are displayed.

Congress also has previously worked to address micro cap fraud. In 1990, the Subcommittee on Telecommunications and Finance of the House Commerce Committee took up the issue of penny stock fraud,⁹ and ultimately Congress enacted the Penny Stock Reform

⁷ Exchange Act Release No. 27975 (May 1, 1990), 55 Fed. Reg. 19,123 (May 8, 1990) [Corrected Order, Exchange Act Release No. 27975-A (May 30, 1990), 55 Fed. Reg. 23,161 (June 6, 1990)].

⁸ Exchange Act Release No. 38456 (Mar. 31, 1997), 62 Fed. Reg. 16,635 (Apr. 7, 1997).

⁹ Penny Stock Market Fraud: Hearings on H.R. 4497 Before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce, 101st Cong. 27 (1990) (Statement of Richard C. Breeden, Chairman of the Commission).

Act of 1990 ("Penny Stock Act") as part of the Securities Enforcement Remedies Act ("Remedies Act").¹⁰ The Penny Stock Act expanded the Commission's authority over such previously unregulated persons as promoters who associate with broker-dealers to sell penny stocks, and it required the creation of a toll-free hotline investors could call to obtain the disciplinary history of brokers. The Act also placed significant restrictions on so-called "blank check" offerings and required broker-dealers to disclose more information to customers when selling penny stocks. Finally, the Act called for the creation of an automated quotation system for OTC stocks, which the NASD and Commission already had underway with the OTC Bulletin Board.

After the enactment of the Penny Stock Act, the Commission adopted new rules to implement the statute.¹¹ Among the requirements are rules requiring brokers to give customers specific information before the sale about the market for penny stocks and the broker's compensation. After the sale, the broker must provide clients with monthly statements reporting the market value of the client's penny stocks. The goal of these rules is to provide information to investors and provide prospective investors with an opportunity to consider whether to make a purchase without the pressure of boiler room tactics.

¹⁰ Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931.

¹¹ Penny Stock Rule Release, *supra*, at fn. 1.

In 1991, the Commission amended Exchange Act Rule 15c2-11. That rule requires a broker-dealer to review financial and other issuer information before publishing a quotation in the issuer's stock in a quotation media such as the OTC Bulletin Board or the Pink Sheets. The rule also requires brokers to have a reasonable basis for believing the information is accurate. Finally, the amended rule requires broker-dealers to obtain a copy of any trading suspension order in the issuer's stock for the previous twelve months.¹²

In 1993, the Commission conducted an extensive examination sweep with the NASD and state regulators to determine whether firms were complying with the Penny Stock Rules. The sweep found widespread adherence to the Penny Stock Rules, along with generally diminished activity in stocks covered by the Penny Stock Rules.¹³

C. How Micro Cap Fraud Has Changed

Although the Penny Stock Act and Rules and the creation of the OTC Bulletin Board have by and large curbed certain abuses in the market for securities priced under \$5, we are now finding that promoters and broker-dealers have adjusted their schemes so that the securities fall outside these measures. The simplest way around the Penny Stock Rules, for

¹² Exchange Act Release No. 29094 (Apr. 17, 1991), 56 Fed. Reg. 19,148 (Apr. 25, 1991).

¹³ Joint Regulatory Penny Stock Examination Sweep (June 1994). Only 14 of the 129 broker-dealer examinations disclosed violations serious enough to warrant consideration of enforcement or disciplinary action.

example, is to offer or sell securities that do not meet the technical definition of "penny stocks". The Commission today sees more fraud in mostly lower-priced Nasdaq-listed securities and in securities valued at \$5 or more.

In addition, the Internet is being used as a new vehicle to perpetrate securities fraud, especially in the micro cap market (including touting in "chat rooms", bulletin boards and on e-mail). The Commission has already brought enforcement actions involving fraudulent securities offerings, stock manipulations,¹⁴ and investment advisers fraud through Internet newsletters.¹⁵ The fraudulent securities offerings often promise unreal returns and include everything from interests in an eel farm,¹⁶ an ethanol plant,¹⁷ gold and diamond mining enterprises¹⁸ and a coconut chip enterprise,¹⁹ to more sophisticated offerings of sham

¹⁴ SEC v. Hutto, Litigation Release No. 15237 (Jan. 31, 1997), 63 SEC Docket 2383 (Mar. 4, 1997).

¹⁵ SEC v. Chelekis, Litigation Release No. 15264 (Feb. 25, 1997), 63 SEC Docket 2900 (Mar. 25, 1997).

¹⁶ SEC v. Odulo, Litigation Release Nos. 14591 (Aug. 7, 1995), 59 SEC Docket 3105 (Sept. 5, 1995), and 14616 (Aug. 24, 1995), 60 SEC Docket 122 (Sept. 19, 1995).

¹⁷ SEC v. Spencer, Litigation Release Nos. 14856 (Mar. 29, 1996), 61 SEC Docket 1960 (Apr. 30, 1996), and 15042 (Sept. 12, 1996), 62 SEC Docket 2409 (Oct. 8, 1996).

¹⁸ SEC v. Wye Resources, Inc., Litigation Release No. 15073 (Sept. 26, 1996), 62 SEC Docket 2762 (Oct. 22, 1996).

¹⁹ SEC v. Frye, Litigation Release Nos. 14720 (Nov. 15, 1995), 60 SEC Docket 2123 (Dec. 12, 1995), 15139 (Oct. 29, 1996), 63 SEC Docket 422 (Nov. 26, 1996).

promissory notes²⁰ and bonds purportedly issued by a nonexistent offshore company.²¹ The Internet can be used for scams because it provides anonymity, broad circulation and the appearance of legitimacy at low cost. Accordingly, the Commission has been developing an effective surveillance strategy for the Internet.²² However, the Commission is committed to the legitimate use of the Internet by honest market participants.

III. The Commission's Program to Prevent

Fraud in the Micro Cap Markets

The Commission's program to prevent fraud in the micro cap market involves:

- early detection and intervention; and
- investor education.

A. Early Detection and Intervention

The Commission's program of early detection and intervention includes: (1) regular examination of broker-dealers; (2) surveillance of the Internet and the markets; (3) imposition

²⁰ SEC v. Sellin, Litigation Release No. 15012 (Aug. 12, 1996), 62 SEC Docket 1749 (Sept. 10, 1996).

²¹ SEC v. Octagon Tech. Group, Inc., Litigation Release No. 14942 (June 11, 1996), 62 SEC Docket 377 (July 9, 1996).

²² See discussion at pp. 14-15.

of trading suspensions; and (4) an increasing resort to emergency litigation to stop active and on-going frauds.

The Commission's Office of Compliance Inspections and Examinations ("OCIE") examines broker-dealers and oversees the examinations which the Self Regulatory Organizations ("SROs") -- the national securities exchanges and the NASD -- conduct of their members. Over the past several years, OCIE has focused its review of broker-dealers on their sales and trading practices. About 20% of examinations lead to referrals to the Commission's Division of Enforcement. OCIE is currently working closely with the NASD to focus on micro cap fraud through intense examination of broker-dealers.

The examination staff also periodically conducts "sweeps" to determine if particular violations are widespread and then it issues recommendations and reports. For instance, in 1994 the Commission staff with the NYSE and NASD conducted a review of the hiring, retention and supervisory practices of nine of the largest brokerage firms. Two years later, the Commission, together with the NASD, NYSE and the North American Securities Administrators Association, Inc. ("NASAA") conducted a joint sweep to review the sales practices of selected registered representatives employed by small and medium-sized firms as well as the hiring, retention and supervisory practices of the brokerage firms that employ them.

The second sweep revealed that some firms employ registered representatives with a history of disciplinary actions and customer complaints, use only minimal hiring procedures, and have supervisors in branch offices who fail to review customer transactions adequately to detect sales abuses. We also found that almost one-half of the branches that engage in cold calling violated federal cold-calling rules.²³ As a result of the sweep, the Commission, NYSE, NASD and NASAA prepared a public report making specific recommendations designed to correct these problems.²⁴ For example, the report recommends more stringent hiring procedures for registered representatives; heightened supervision of registered representatives with a history of customer complaints, disciplinary actions or arbitrations; and training and supervision of cold-calling techniques.

These joint sweeps have resulted in greater coordination among the regulatory authorities. The Commission's compliance staff meets quarterly with the NASD and NYSE to discuss how to improve our combined examination procedures. In addition, the Commission's regional examination staff meet regularly with their state counterparts and local NASD offices to determine how to better craft regulatory solutions.

²³ In 1991, Congress passed the Telephone Consumer Protection Act, Pub. L. No. 102-243, 105 Stat. 2394 (1991), codified at 47 U.S.C. § 227. The Federal Communications Commission enacted rules which, among other things, restrict the hours unsolicited calls can be made and require telemarketing firms to have "do-not-call" lists. 47 C.F.R. § 64.1200.

²⁴ Joint Regulatory Sales Practice Sweep, A Review of the Sales Practice Activities of Selected Registered Representatives and the Hiring, Retention, and Supervisory Practices of the Brokerage Firms Employing Them (Mar. 1996).

To combat securities fraud on the Internet, the Commission's Division of Enforcement, with the assistance of other Commission staff, has assembled a group of professionals who devote more and more resources to Internet surveillance. These professionals use the latest browsing software to monitor the Internet, including such message areas as newsgroups and bulletin boards. The on-line Division of Enforcement Complaint Center also provides an easy means for investors to send complaints to the Commission staff. Currently, the Commission receives between 50 and 70 on-line investor complaints a day. Suspicious activities are investigated, with enforcement action initiated where appropriate. In addition, the Commission staff has helped states develop their own Internet surveillance programs and meets regularly with the states, both individually and as part of regional and national conferences, to coordinate our surveillance and investigations.

The Commission recently implemented a pilot program in our Florida regional office to intervene as soon as a potential sham micro cap offering is identified, which has already resulted in six trading suspensions.²⁵ The staff reviews regulatory filings for irregularities, or "red flags", that suggest the company may not be legitimate. After determining that the

²⁵ In the Matter of Amquest International, Ltd., Exchange Act Release No. 38695 (May 30, 1997), 64 SEC Docket 1862 (July 1, 1997); In the Matter of Green Oasis Environmental, Inc., Exchange Act Release No. 38588 (May 9, 1997), 64 SEC Docket 1395 (June 10, 1997); In the Matter of Genesis International Financial Services, Inc., Exchange Act Release No. 38565 (May 1, 1997), 64 SEC Docket 1259 (May 27, 1997); In the Matter of Historic Hotel Holdings, Inc., Exchange Act Release No. 38492 (Apr. 10, 1997), 64 SEC Docket 761 (May 6, 1997); In the Matter of OmniGene Diagnostics, Inc., Exchange Act Release No. 37966 (Nov. 19, 1996), 63 SEC Docket 709 (Dec. 17, 1996); In the Matter of Home Link Corp., Inc., Exchange Act Release No. 37292 (June 10, 1996), 62 SEC Docket 288 (July 9, 1996).

public interest and protection of investors require it, the Commission can suspend trading in the stock. Trading suspensions can be a very potent remedy because:

- Investors are put on notice of a potential fraud, hopefully encouraging more informed decision-making; and
- Promoters and brokers are hit where it hurts most: in the pocketbook. The financial reward of a micro cap scheme depends on selling all the stock at the height of the manipulation. A trading suspension often leaves the promoters holding worthless stock before they are able to dump it on unsuspecting investors.

Although a trading suspension only halts trading for a ten-day period, the suspension triggers application of Exchange Act Rule 15c2-11, which requires a market maker to have current and accurate financial information about the issuer before trading resumes. In other words, it is difficult for a broker-dealer to lawfully resume trading.

B. Investor Education

The Commission continually works to educate investors about how to avoid and report securities fraud through its Office of Investor Education and Assistance (OIEA). A well-educated investor is one of the most important defenses against securities fraud. Through Investor Alerts, an Internet Web Site²⁶ and a toll-free information line,²⁷ OIEA

²⁶ <http://www.sec.gov>

²⁷ (800) SEC-0330

provides investors with practical tips on how to spot securities fraud. Numerous pamphlets and brochures have been developed to warn investors about scams, stating in "plain English" what every investor should know about investing. All of our publications are available free of charge on the Commission's website as well as through our toll free number.

To educate investors and listen to their concerns, the Commission has coordinated -- and will continue to hold -- Investors' Town Meetings throughout the country. The town meetings are typically well-attended (often over 1,000 investors attended each meeting) and feature a series of seminars for investors on a wide variety of topics. We have also leveraged the modest resources required for these meetings by asking the securities industry to participate (we believe that investor education is among its most important responsibilities) and by recording some of the meetings so that they might reach audiences in the millions through television broadcasts.

The Commission receives over 44,000 letters and inquiries from investors annually. Some investors simply want information. Others have complaints. Where the OIEA can help, it attempts to resolve the disputes, although it cannot act as lawyer or judge. Through its efforts, investors recovered more than \$1.2 million last year. Sometimes the complaints are referred to the other divisions and offices of the Commission. Last year, nearly one-fifth of all investigations undertaken by the Division of Enforcement and "for cause" broker-dealer examinations were initiated, at least in part, in response to investor complaints. The Office

tracks trends in complaints in order to identify problem brokers and practices, so that the Commission's limited resources can be targeted at the areas of greatest need.

The most significant trend is the rapid increase in complaints about cold calling. In 1995, the Office received 265 complaints primarily alleging cold calling. In 1996, the number of cold calling complaints doubled, rising to 427. As of July 28th of this year, the Office had already received 231 such complaints.

*IV. The Commission's Enforcement Program to
Combat Fraud in the Micro Cap Market*

The Commission's enforcement program works in conjunction with state regulators, the SROs and criminal authorities to make life as difficult as possible for the con men and criminals who prey on American investors. The Commission has brought significant enforcement actions against micro cap stock brokers, such as A.R. Baron & Co., and micro cap stock issuers, such as Comparator Systems. The following enforcement actions recently brought by the Commission help illustrate some of the trends I have discussed above.

A. A.R. Baron & Co.

In 1996, the Commission brought an emergency administrative action against a broker-dealer, A.R. Baron & Co., Inc., and two of its principals for fraudulent sales

practices, including rampant unauthorized trading in customer accounts.²⁸ The Commission alleged that Baron and these principals manipulated the market for the stocks of two companies. Customers lost nearly \$17 million as a result of these practices before the enforcement staff was able to shut the firm down. The brokerage firm consented to the entry of an order revoking its registration, and the Manhattan District Attorney's office subsequently indicted several principals. The Commission has so far recovered approximately half a million dollars in connection with the Baron case, and actions are still pending.

B. Global Financial Traders, Ltd.

The Commission alleged that Global Financial Traders, Ltd., an investment newsletter publisher, and certain affiliated entities and individuals: (1) obtained a large undisclosed position in the stock of American Image Motor Company, an OTC Bulletin Board security; (2) carried out a concerted telemarketing campaign and made recommendations in one of its newsletters to promote the stock, making material misrepresentations concerning the market in the stock; (3) sold large amounts of the stock from their own accounts; and (4) maintained the market price through stock manipulation. Early this year, the Commission obtained a

²⁸ In the Matter of A.R. Baron & Co., Inc., Exchange Act Release No. 37240 (May 23, 1996), 61 SEC Docket 2869 (June 18, 1996), Exchange Act Release No. 37248 (May 29, 1996), 62 SEC Docket 11 (June 25, 1996).

temporary restraining order, an asset freeze and a preliminary injunction against the firms and its principals.²⁹

C. Comparator Systems Corp.

The ability to artificially inflate the price of a stock, in this instance using the Internet, was showcased in the dramatic rise and fall of the stock of Comparator Systems Corp. The Commission brought an action against Comparator and three of its officers and directors, alleging that the defendants sold tens of millions of shares of the company's stock while falsely representing that they owned certain fingerprint technology.³⁰ Moreover, the company's financial statements had been falsified, allowing Comparator to remain listed on the Nasdaq Small Cap Market and avoid classification as a penny stock. Due to touting on the Internet, the company's stock price rose from \$0.06 to \$1.88 over three days, setting Nasdaq trading volume records. Prior to filing its complaint against Comparator, the Commission issued a trading suspension.³¹ Comparator's former auditor has agreed to the entry of an order to cease and desist from further violations of the securities laws and to a

²⁹ *SEC v. Global Financial Traders, Ltd.*, Litigation Release Nos. 15291 (Mar. 14, 1997), 64 SEC Docket 402 (Apr. 15, 1997), and 15338 (Apr. 17, 1997), 64 SEC Docket 969 (May 13, 1997).

³⁰ *SEC v. Comparator Systems Corp.*, Litigation Release Nos. 14927 (May 31, 1996), 62 SEC Docket 236 (July 2, 1996), and 15056 (Sept. 19, 1996), 62 SEC Docket 2593 (Oct. 15, 1996).

³¹ Exchange Act Release No. 37209 (May 14, 1996), 61 SEC Docket 2759 (June 11, 1996).

bar from appearing or practicing before the Commission. Actions against other participants are pending.

D. Repeat Offenders

Once a fraudulent broker-dealer firm is put out of the securities business, it is important to prevent the staff that perpetrated that fraud from migrating to other securities firms. The presence of repeat offenders in the industry (commonly referred to as "rogue brokers") has concerned the Commission for several years. The Commission and other regulators can impose severe sanctions, including bars and suspensions, against those persons identified as serious securities law violators. The Commission has worked to ensure that a permanent bar from the industry is truly permanent³² and that barred brokers do not "slip" back into the system. In less egregious cases, we can limit the securities activities of offenders, or impose other sanctions such as fines or injunctions to deter further misconduct.

The Commission and the Justice Department have worked together to address the problem of rogue brokers. In November 1995 and again in May 1997, the Commission and the Justice Department announced the filing of charges against rogue brokers throughout the country. The brokers allegedly had engaged in a wide range of fraudulent conduct, including

³² Exchange Act Release No. 34720 (Sept. 26, 1994), 57 SEC Docket 1941.

forging investor checks, engaging in unauthorized transfers of client funds, selling securities of nonexistent issuers and creating false or fictitious account statements.³³

Under the federal securities laws, much of the responsibility for identifying and monitoring problem registered representatives lies with each individual firm and its supervisory staff. In April of this year, the SROs admonished the securities industry of its responsibility to be particularly aggressive in policing problem registered representatives.³⁴ The SROs' message -- echoing that of the Commission -- is that firms must maintain strong hiring procedures that either exclude or carefully evaluate applicants having records containing disciplinary actions, customer complaints, or adverse arbitration decisions. It also reminds firms that they must supervise such registered representatives closely, at both the branch manager and firm levels.

E. Criminal Prosecutions

In addition to our work with the state regulators and the SROs, the Commission coordinates its efforts to combat fraud with criminal authorities. Coordination with criminal authorities has produced some of the Commission's most dramatic efforts in combating fraud

³³ "Second Set of Charges in Broker Case," New York Times, May 23, 1997, p.2; Attorney General and SEC Chairman Announce Nationwide Prosecution of Unscrupulous Investment Brokers, Department of Justice Release (Nov. 30, 1995).

³⁴ The Joint Regulatory Sales Practice Sweep; Heightened Supervisory Procedures. Joint NASDR/NYSE Memorandum to Members and Member Organizations (Apr. 15, 1997).

in the micro cap market. The Commission will continue working to enhance these efforts. For example, in October 1996, the U.S. Attorney for the Southern District of New York, the Commission and the NASD announced the results of a year-long joint undercover operation in which FBI agents posed as brokers in a small Manhattan brokerage firm who were willing to accept payoffs to sell OTC Bulletin Board and Nasdaq stocks to their customers.³⁵ The payments were generally made by and through promoters, working with officers of the companies whose stocks were being touted. Payoffs were as high as 40% of the value of the stock. The FBI arrested 45 people, including promoters, brokers and company officials. Twenty-eight of those people have already been charged in Commission administrative proceedings for allegedly making undisclosed payments to brokers to sell stock.

In November 1996, the U.S. Attorney for the District of Nevada announced indictments against 30 individuals for their roles in an alleged scheme involving, variously, undisclosed payments to brokers for sales of the securities of three small issuers, money laundering, conspiracy and racketeering. To date, 20 guilty pleas have been entered, including eleven individuals named in the indictments. Three Commission staff attorneys were designated as Special Assistant U.S. Attorneys in this matter and have played leading roles in the criminal investigation and litigation. The NASD staff also has substantially assisted in the investigations. In a related matter, the Commission has instituted four administrative proceedings against 17 respondents.

³⁵ Criminal and Public Administrative and Cease-and-Desist Proceedings Announced Against 45 in Connection with Kickback Schemes, Exchange Act Release No. 37807 (Oct. 10, 1996), 62 SEC Docket 3027 (Nov. 5, 1996).

Successful coordination between the Commission and criminal authorities also resulted in the termination of a massive and on-going manipulation of the stock of Systems of Excellence, Inc., a manufacturer and distributor of video teleconferencing equipment with offices in Virginia and Florida. On November 7, 1996, after an expedited investigation, the Commission filed a civil injunctive action in federal district court against the former CEO of Systems of Excellence, the publisher of a daily stock newsletter that touted Systems of Excellence and was disseminated over the Internet, and eleven other individuals and entities. That same day, the Court ordered temporary restraining orders against all of the defendants, asset freezes, and other emergency relief, which effectively ended the scheme. The Commission also provided evidence it obtained to the Department of Justice, which opened a criminal investigation that now has resulted in guilty pleas by the former CEO and the newsletter publisher, who are both incarcerated, and a former auditor of Systems of Excellence.

V. *Regulatory Initiatives*

A. *Modifications to Rule 15c2-11 Governing*

Initiating and Resuming Quotations

As noted above, Rule 15c2-11 is intended to prevent the publication of stock quotations in the OTC Bulletin Board, the Pink Sheets and similar media that may be used in fraudulent schemes. Before publishing the initial quotation for a particular stock, or after a

trading halt, brokers must review such information as the issuer's most recent balance sheet, profit and loss, and retained earnings statements; the nature of the issuer's business; the nature of the products or services offered; the nature and extent of the issuer's facilities; and any relationship between the broker-dealer and company insiders. As a result of the recent rise in micro cap fraud, the Commission's staff is studying how to amend the rule; these amendments might take the form of requiring market makers to review additional financial information about the issuer or obtain updated information more regularly.

B. Modifications to the Penny Stock Rules

The Commission staff is also considering whether to recommend amendments to the Penny Stock Rules, such as broadening the definition of "penny stock" to include securities with a price greater than \$5 per share and prohibiting a broker-dealer from recommending any non-Nasdaq OTC equity security without reviewing current information about the issuer.

***C. Regulation of the Relationship
Between Introducing and Clearing Brokers***

The federal securities laws permit brokers that are often minimally capitalized -- with as little as \$5,000 -- to "clear" their trades through a more substantially capitalized firm (a "clearing broker"). These small brokers (an "introducing broker" or "correspondent") generally handle the "retail" relations with the customer -- opening accounts, taking orders,

and making recommendations – while the clearing broker clears and settles the trade by exchanging money and securities, handles the back office paperwork (primarily, providing trade confirmations and monthly statements), and delivers securities. The clearing broker may also execute the trade for the introducing broker.

Clearing firms perform a valuable function by financing customer trades and smaller market makers, centralizing recordkeeping and safekeeping customer funds. Moreover, they help maintain competition in the securities industry by lowering the cost for new, small brokerage firms to enter the market. Unfortunately, some of these small introducing firms end up cheating the investing public. I have personally expressed the Commission's concerns in this area to Richard Grasso, Chairman of the NYSE, and Frank Zarb, Chairman of the NASD, and have encouraged them to develop rules to address this issue. The NYSE Board has already approved a rule that would, among other things, require clearing firms to send copies of customer complaints about introducing firms to the introducing firm's regulator. The Commission will consider this proposal carefully. The Commission's own examination staff is also conducting a series of examinations to look at the procedures of clearing firms, particularly those that clear for broker-dealers that make markets in OTC Bulletin Board and Nasdaq Small Cap stocks.

D. Listing Standards

Because of concerns regarding micro cap fraud, the Commission has recently approved stronger Nasdaq listing standards.³⁶ Nasdaq and the national exchanges have established listing and maintenance standards, setting forth financial and other criteria that a company must satisfy to include its securities in Nasdaq or list its securities on an exchange. Listing on Nasdaq or the exchanges raises the visibility of a company and provides greater liquidity for its shares. Listing comes with a cost: companies are subjected to greater regulation, such as periodic financial reporting and rules on corporate governance. Higher listing standards should be studied to determine whether they would make manipulation and other fraudulent schemes even more difficult, as companies without substantial assets or expectations of revenues would be prevented from obtaining a listing for their securities. Raising the standards will result, however, in the de-listing of some companies from Nasdaq, forcing their shares to trade in markets that require less information. The Commission carefully weighs the balance between the cost of providing the information necessary to deter fraud and the need for a marketplace where the stock of legitimate small companies can trade.

³⁶ Exchange Act Release No. 38961 (Aug. 22, 1997), 62 Fed. Reg. 45,895 (Aug. 29, 1997).

E. Telemarketing

Within the last three years, the Commission approved new SRO telemarketing rules that impose "hour-of-the-day" restrictions, disclosure requirements and "do not call" lists.³⁷ These rules have since been incorporated into the examination modules of the Commission and the SROs. The Municipal Securities Rulemaking Board ("MSRB") has also adopted telemarketing rules for the municipal securities market.³⁸

Other SRO measures currently under consideration include:

- implementing new Internet technology to identify potential frauds;
- taping sales calls at broker-dealers that have hired sales personnel from firms that were expelled from the securities business; and
- increasing SRO examinations targeted at sales practice abuses.

F. The Role of State Regulation

The Commission supports the states' authority to license broker-dealers and their associated persons. State regulators are justly concerned about who is doing business in their

³⁷ See, e.g., NASD Rules 2211 and 3110; Exchange Act Release No. 38009 (Dec. 2, 1996), 61 Fed. Reg. 65,625 (Dec. 13, 1996). NYSE Rule 440A and NYSE Interpretation of Rule 472; Exchange Act Release No. 38638 (May 14, 1997), 62 Fed. Reg. 27,823 (May 21, 1997).

³⁸ MSRB Rule, SR-96-6, filed with the Commission on July 30, 1996, and amended on Nov. 1, 1996.

backyard. Furthermore, as the "local cop on the beat," a state regulator is well positioned to monitor and respond to the numerous, but relatively small, abuses that occur daily in their state. These are abuses that the SEC and SROs, with limited resources and staff in certain jurisdictions, may not be able to respond to as promptly. In the aggregate, state regulators recover substantial sums of money for small investors.

To address the need of broker-dealers and issuers for a predictable, uniform regulatory system, the states have already taken substantial steps to unify their regulatory schemes. The states, through NASAA, have worked effectively with the SROs, industry associations, and the Commission to develop more uniform requirements and procedures for the registration of broker-dealers and the licensing of associated persons.

For example, NASAA and the states helped develop standardized forms such as the U-4 for licensing associated persons. NASAA and the NASD created the Series 63 examination to provide associated persons with a single, uniform examination relating to state securities laws, reducing the burden that had resulted from multiple state law examination requirements. Further, NASAA and the NASD were instrumental in developing the Central Registration Depository ("CRD"), the computer system that processes licensing applications and holds disciplinary records. Certain technological limitations in the CRD system have been identified -- the system relies on 1981 technology which sometimes makes conducting searches and producing reports difficult -- and we are working with the NASD and NASAA to improve the system and to make it more widely and readily available. NASAA and the

NASD have also developed the Temporary Agent Transfer ("TAT") program, which allows registered representatives without disciplinary histories to transfer from one firm to another without an interruption in business. More recently, NASAA created the Task Force on the Future of Shared State and Federal Securities Regulation as well as the MultiState License Committee, which are both exploring additional ways in which to make state regulation more uniform.

In the National Securities Markets Improvement Act of 1996 ("NSMIA"),³⁹ Congress made the financial responsibility, recordkeeping and reporting requirements imposed on broker-dealers uniform at both the federal and state levels.⁴⁰ Congress also directed the Commission to study the impact of disparate state licensing requirements on associated persons of registered broker-dealers and to identify methods for the states to make licensing requirements more uniform. The Commission is consulting with state securities regulators, SROs, broker-dealers, and other industry participants to determine how best to work together without duplication. Because the Commission is in the process of completing this study and will submit a report to Congress by October 11, 1997, it would be premature to report the final conclusions of the study at this time. I can say, however, that the study does not call for the federal preemption of state licensing powers.

³⁹ Pub. L. No. 104-290, 110 Stat. 3416 (1996).

⁴⁰ Exchange Act Release No. 34-37850 (Oct. 22, 1996), 61 Fed. Reg. 555,930 (Oct. 28, 1996).

VI. Conclusion

The Commission is dedicated to fighting fraud in the micro cap market through early intervention and prevention of harm, coordinated and strong enforcement, and regulatory initiatives that balances the need to facilitate capital formation with the elimination of fraud. This fight requires a unified front of federal and state regulators, prosecutors, and investors to make the costs of perpetrating a fraud in the microcap markets much greater than the benefits. We are completely committed to achieving this result, and we are deeply grateful for the support of Congress.

Before closing our discussion of fraud in the micro cap market, it is important to remember that legitimate small businesses are the lifeblood of the United States economy. The Commission is proud of its efforts to reduce the regulatory burdens imposed on small businesses over the last several years:

- Companies can raise up to \$1 million dollars a year in seed capital, without complying with the registration requirements of the federal securities laws.
- Companies can raise up to \$5 million dollars a year through exempt public sales of securities using an offering document that, though reviewed by the Commission staff, includes unaudited financial statements, which cost substantially less than audited statements.

- Companies can "test the waters" for offerings up to \$5 million dollars, allowing the company to determine whether there is public interest in its securities before being required to prepare documents for the offering.
- Non-public companies can issue securities without registration to compensate their employees.

Together, these initiatives permit small businesses to raise adequate capital without the cost of full federal registration.⁴¹ We do not plan to turn back these efforts, however, we are concerned about any abuse of these measures and the harm that may cause not only investors, but also those businesses the rules were designed to help.⁴² The Commission will continue to work in earnest to help legitimate small businesses gain access to the public capital markets while aggressively rooting out fraud among those that are not legitimate.

Thank you for this opportunity to address the Subcommittee.

⁴¹ The federal securities laws are based on full and fair disclosure. Thus, companies that wish to raise capital in the national securities markets generally must register their securities with the Commission and file annual audited financial statements. The cost of preparing and distributing this information may affect the ability of some legitimate small companies to raise capital in the public securities markets.

⁴² For example, while not a small business initiative, the Commission recently modified Regulation S -- which permits United States companies to raise capital overseas without registering the stock with the Commission -- to better monitor the extent to which the stock was re-entering United States public markets. Exchange Act Release No. 37801 (Oct. 10, 1996), 61 Fed. Reg. 54,506 (Oct. 18, 1996). The Commission is currently considering additional modifications to restrict such re-entry of Regulation S stock. Securities Act Release No. 7392 (Feb. 20, 1997), 62 Fed. Reg. 9,258 (Feb. 28, 1997).

STATEMENT
OF
EMILE O. MURNAN
BEFORE THE
U.S. SENATE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
HEARING ON
EMERGING SECURITIES FRAUD:
FRAUD IN THE MICRO-CAPITAL MARKETS
September 22, 1997

* * *

Madam Chairman and Members of the Subcommittee:

My name is Emile Murnan and I am pleased to be here today to testify before you about my recent experiences as a victim of fraud by a securities brokerage company. I am 78 years old and retired several years ago from a career as a salesman. My home in Ballwin, Missouri is one of many suburbs of St. Louis. I do not receive a pension and therefore must be very cautious in the management of my limited funds. It is apparent to me that increased regulatory control is needed to prevent others from becoming unwitting victims of fraud by an industry entrusted by so many to conduct transactions which are critical to their financial security.

My story begins on January 16, 1997, when I received a call from Mr. Marlon Tropeano who identified himself as a stock broker with the firm of L.T. Lawrence and Company in New York City. I had never done any business with L.T. Lawrence and Company and I do not know how Mr. Tropeano identified me as a potential customer. Mr. Tropeano was very persistent and convincing in his recommendation for me to purchase shares of a company called Callaway Golf Company. I was familiar with the Callaway Golf Company and after listening to Mr. Tropeano, I felt that this stock would be a good investment for me. Coincidentally at this time I was searching for an investment to replace some recently matured bonds. I therefore instructed him to purchase 200 shares of Callaway Golf Company stock. I regarded this as a long term investment and on January 18th I mailed my check in the amount of \$6,040.

The trouble began 6 days after the date of the purchase when he sold Callaway Golf for a total of \$6,308.78 - not bad - and on the same day, January 22nd, he bought 1,000 shares of Medaphis Corporation for my account for a total price of \$13,840. He has now established a margin account of \$7,530.32.

It Gets Worse! Six days after that, on January 28th, Mr. Tropeano purchased 4,700 share of QPQ Corporation stock for \$12,940. The margin account is now \$20,470.22! This was all done without my knowledge. He did not ask me, he did not tell me – he just did it! The last thing in this world I would do is buy on margin.

On February 5th, without my permission, he sold the 1,000 shares of Medaphis for \$13,109.56 – a loss of \$730.44. It gets worse! On the same day he sold 1,600 shares of QPQ and on February 12th, he sold 1,900 shares, and finally on April 10th the account was closed and I received a check for \$292.47 for a loss of \$5,748 out of my original investment of \$6,040. (Total sales of QPQ \$7,662.22.)

On February 13th, I returned from a trip to Florida and opened my mail to final confirmations of all these unauthorized trades. I was astounded to learn that my stock in Callaway Golf had been traded for two other stocks without my permission, at a substantial loss.

On February 21st, I sent a letter to the Compliance Department of L.T. Lawrence and Company disputing the six unauthorized trades made by their employee. On March 11th, I was contacted, via telephone, by Mr. Andrew Basile who stated he was Senior Vice President and Head of the Compliance Department. He assured me that he would investigate my complaint, but nothing was ever done to resolve the issue of their unauthorized trades on my account.

Since I could get no satisfaction from L.T. Lawrence and Company, I sort of took matters in my own hands. I wrote the NASD in New York City; the Securities & Exchange Commission in Chicago, Illinois; North American Securities Administration Association in Washington, D.C.; as well as the Commissioner of Securities of the State of Missouri in Jefferson City. Plus, I retained the services of an attorney.

An Examiner for the Missouri Securities Division determined that L.T. Lawrence and Company had 15 customer complaints filed against Mr. Tropeano – 11 of these complaints prior to his solicitation to me.

Finally, on July 12th, a settlement was reached and the losses were reimbursed thru my attorney, minus his fee. This whole affair has been an extremely troubling experience for me and has cost me considerable expenses. It seems that in this age of technology such renegade fraudulent activity should no longer be possible by companies who are entrusted with key elements of our financial security.

This concludes my statement Madam Chairman and I would be pleased to answer any questions. I thank you for this opportunity.

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STATEMENT
OF
HELEN SPRECHER
BEFORE THE
U.S. SENATE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
HEARING ON
EMERGING SECURITIES FRAUD:
FRAUD IN THE MICRO-CAPITAL MARKETS
September 22, 1997

* * *

My name is Mrs. Helen Sprecher and I reside in Philadelphia, Pennsylvania. My husband, Harry Sprecher, is unable to attend this hearing due to his declining health. My husband and I are both 85 years old. Before our retirement in 1988, we owned a small neighborhood grocery store in Philadelphia. We worked very hard 7 days a week for 31 years and were able to save about \$100,000.00 for our retirement. But, as a result of the devious and deceptive practices of unscrupulous stock brokers and their firms, nearly every penny was lost. I am appearing before you today and making this statement in the hope that what happened to my husband and me can be prevented in the future. I am telling my story so that other elderly and other vulnerable citizens might be spared the suffering, the financial loss and the emotional trauma that we have had to endure.

Our problems with stock brokerage firms began in the fall of 1990 when we were contacted by a stock broker named John Baratta. At that time we were led to believe that Mr. Baratta was affiliated with the prestigious Wall Street brokerage firm of Morgan Stanley. Mr. Baratta persuaded us to open a brokerage account with him, and he started to purchase stock for us shortly after the account was opened. While Mr. Baratta was our stock broker, we periodically received account statements from Morgan Stanley showing the status

of our account. The account statements indicated that Morgan Stanley had been introduced to us through a company called Manchester Rhone Securities. However, I don't recall Mr. Baratta ever telling us that he worked for Manchester Rhone Securities, and, during this time, we always thought we were dealing with the firm of Morgan Stanley. It wasn't until I recently consulted with attorney Henry Pass that I found out that Mr. Baratta actually worked for Manchester Rhone Securities, a very small brokerage firm that has since gone out of business. Had we known Mr. Baratta was not affiliated with Morgan Stanley, we would probably not have done business with him.

Some time during the fall of 1991, Mr. Baratta informed me that he had switched brokerage firms and was now working for S. D. Cohn & Company on Wall Street in New York City. At that time, he also told me that Morgan Stanley was no longer doing business with small investors such as me and my husband. We then agreed to have the stock in our Morgan Stanley account transferred to a new account at S. D. Cohn by Mr. Baratta. When we switched brokerage firms, our account was worth approximately \$98,000. Mr. Baratta continued to be our stock broker until February or March of 1993. Around that time, we learned that Mr. Baratta was no longer affiliated with S. D. Cohn and that a stock broker named Donald Lou Spitzer had taken over our account. Although I had never met Mr. Spitzer, he seemed nice on the telephone and persuaded us to let him handle our account in the future.

Around September of 1994, Mr. Spitzer informed me by telephone that he had left the S. D. Cohn brokerage firm and had joined a new firm called Investors Associates. We trusted Mr. Spitzer so we allowed him to transfer our account to Investors Associates and we continued to deal with him until June of 1995. Around that time, a gentleman named Keith Bleich telephoned me and identified himself as a broker for Investors Associates. He said that he was calling to inform me that Donald Spitzer had been discharged from Investors Associates because of unethical practices. Mr. Bleich then told me that our account had been transferred to him and that he intended to give our account his personal attention. He also assured me that because of our age, he would make sure that we would never lose any money. Unfortunately, I believed him.

About a month later, Mr. Bleich called again and asked if I had any other securities that were not in our account with Investors Associates. At the time I had in my personal possession 440 shares of RJR Nabisco stock. Mr. Bleich said it would be to our advantage to have everything in one place. He told me he would send Federal Express to pick up my stock certificates for delivery to his office. He was so glib and persuasive that I agreed to send him my stock in RJR Nabisco. Because the RJR Nabisco stock paid a nice dividend which supplemented our Social Security benefits, I told Mr. Bleich that the stock was not to be sold and he promised not to do so. Over the next several days he called me three or four times a day trying to convince me to buy stock in a company

called Electronics Communications. He told me that the company was new and that the stock was about to skyrocket. I had never heard of the company so I would not commit myself. I told him that it was a very difficult time for me since I was recuperating from surgery for an aneurism of the aorta which had left me very weak and unable to make decisions, and I was very upset by the pressure he was putting on me.

Some time in August of 1995, a statement arrived from Investors Associates and to my utter shock and surprise, most of the stock in our portfolio had been sold without my permission, including the RJR Nabisco stock from which we had been relying on the dividends to supplement our Social Security benefits. The statement also indicated that we now owned 3,000 shares of Electronic Communications and 1,500 shares of a company called Air Methods, Inc. Both of these stocks were purchased by Mr. Bleich without my permission, and I later learned that Investors Associates was an active market maker in these securities.

Shortly thereafter, the value of both stocks started to plummet and our margin obligation went from about \$950.00 to almost \$5,000.00. Margin calls were coming in two or three times a week, so I frantically called Mr. Bleich. He insisted that the stocks were going to make a lot of money. Margin calls continued to come in two or three times a week . . . calls that I could not meet. Although I continued to call Mr. Bleich, it became obvious to me

that my calls to him were seen as a nuisance; whenever I would call, I would always be told that he was in a meeting or out of the office. Eventually, the 1,500 shares of Electronic Communications had to be sold off to partially satisfy the margin calls, and we also had to pay \$3,000.00 to satisfy the balance.

In July of 1996, I informed the NASD about my problems with Investors Associates and Mr. Bleich. When Mr. Bleich heard about this, he called to tell me that everything that had been in our portfolio when he took over the account had been put back and that we no longer owned any of the stock that he had purchased without my permission. I later learned this was not true because the statements I continued to receive from Investors Associates did not show the changes in our account that Mr. Bleich had assured me had taken place. In the meantime, margin calls against our account were still coming in, but when I phoned Mr. Bleich, he insisted the changes had in fact been made and everything would be fine. During one of my last telephone conversations with Mr. Bleich, he brought another gentleman on the line who claimed to be an attorney for Investors Associates and who verified that the changes in our account had been made. However, I continued getting margin calls and our account statements from Investors Associates indicated that they were still selling stocks that I was not supposed to own in the first place.

In February of this year, I consulted an attorney, Mr. Henry

Ian Pass, to see what legal recourse we had as a result of the unscrupulous handling of our stock brokerage account. After Mr. Pass reviewed our records, I learned about the losses my husband and I had incurred since the time we first opened our account through Morgan Stanley in 1990 until the time that we closed the account with Investors Associates in April of this year. Due to the declining health of my husband and myself, I had not been able to keep track of all of the activity in our account. During this period, I had been recuperating from heart surgery relating to an aortic aneurism. My husband had also undergone surgery as well as chemotherapy for cancer of the colon and esophagus, and a lot of my time was spent caring for him. I therefore was not aware of all of the churning and other improprieties that occurred during this time.

In December of 1990, when we entrusted our retirement savings with John Baratta through Manchester Rhone Securities and Morgan Stanley, our account was worth almost \$76,000. However, when we closed our account with Investors Associates in March of this year, our account was only worth about \$2,300.00. The stress of this situation has greatly affected my health, both physically and emotionally. I have been experiencing anxiety attacks, nausea, loss of appetite and inability to sleep. The distress and anguish are sometimes unbearable and have caused me to lose over 15 pounds.

Until I was referred to attorney Henry Pass, I did not know that there are laws on both the state and federal levels that are supposed to protect my husband and me from the unscrupulous and illegal practices that we experienced. Unfortunately for us and for so many, many others, these laws did not prevent the firms and stock brokers with which we dealt from engaging in the practices that caused us to lose so much money and to experience so much grief and misery. Mr. Pass has instituted lawsuits against the companies and individuals involved, and I am hopeful that my husband and I will be able to recover at least some of the money that we have lost over the years. I only hope that something can be done by the government to prevent retirees such as myself from becoming victims of the unsavory and unethical practices of investment firms and stock brokers that seek us out. Something must be done to protect all of us from the kind of people such as those who preyed on my husband and me, caused us to lose most of our retirement savings, and inflicted on us such terrible anguish and distress in our twilight years.

Thank you for inviting me to share my story with you.

Mr. Pass and I would be happy to answer any questions that you might have regarding my statement and ordeal.

STATEMENT
OF
LOUIS POGGI
BEFORE THE
U.S. SENATE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
HEARING ON
EMERGING SECURITIES FRAUD:
FRAUD IN THE MICRO-CAPITAL MARKETS
September 22, 1997

* * *

Madam Chairman and Members of the Subcommittee:

My name is Louis Poggi and it is a pleasure for me to be here today to tell you my personal story of being defrauded by a stock brokerage firm. I am employed as a truck driver by Federal Express. I live in Pembroke, New Hampshire and am the father of five children. My life is hectic, to say the least, and the story I am about to tell you was a devastating experience for me and my family. I sincerely hope that this hearing will lead to new regulations of the securities industry which will prevent others from such unnecessary suffering.

My experience with this scam started in June 1995, when I received a telephone call - out of the blue - from Pat Boyce. Mr. Boyce identified himself as a broker for Investors Associates, Inc. of Melville, New York. I am not sure how Mr. Boyce obtained my telephone number or identified me as a potential customer.

During this initial conversation Pat Boyce solicited me to purchase stock in Cheyenne Software, Inc. His sales pitch was overwhelming and he tried very hard to convince me that the price of this stock was going to rise very quickly which would result in a huge profit for me. I became tired of Boyce's relentless solicitation and told him sure go ahead and buy the stock. It didn't mean anything to me, he was just a guy on the phone from New York. I told him sure go ahead and buy the stock, but I thought it was a joke. I didn't realize what I was doing, because Boyce told me, at a later date, that I had actually bought stock in Cheyenne Software, Inc. as a result of this initial conversation. I learned later that the trade date of this purchase was June 30, 1995 for 1,000 shares of Cheyenne Software at a total cost of \$18,216.75.

Mr. Boyce called me a few weeks after our initial phone conversation. He informed me that the price of Cheyenne Software stock was rising and that I had already made a profit of \$3,000. I was astounded to have gained such a profit on an investment that I did not really think I had made. A sudden profit of \$3,000 was like

a major windfall to me. I told Mr. Boyce that I now wanted to sell my shares in Cheyenne Software in order to receive my \$3,000 profit. Mr. Boyce told me that I must send Investors Associates \$18,216.75 to cover the purchase price of the stock. I replied that I was not able to do that, but if I owned the stock why couldn't he just sell it and send me the \$3,000 profit? Please note that to this point I had not submitted any money to Investors Associates. Mr. Boyce stated that I must send him a check for the initial purchase and then I would own the stock so I could then in turn sell it. I did not understand the stock market business and this situation was confusing to me, but I was intent upon getting that \$3,000. That is a lot of money to me, and I was going to make that profit even if it meant coming up with \$18,216.75.

It just happens that my father lives about 20 minutes from the Investors Associates office in New York. I routinely visit my father, so I decided to make a trip there to check out the Investors Associates offices. I wanted to see if it was a real company or just some guy calling me from his kitchen. I went to the Investors Associates office and it appeared to be a legitimate company in a normal office building. This visit gave me confidence in Investors Associates, so I told them that I would purchase the Cheyenne Software stock with my credit card. They told me that I could not use a credit card to purchase stock. At this point I felt that all I had to do to get the \$3,000 profit was to obtain \$18,216.75 which would be quickly returned to me because I intended to sell the stock as soon as the purchase was confirmed. In fact, I was lead to believe that I could quickly sell the stock to make back the \$18,216.75 plus the additional \$3,000 gain. That same day, on or about June 30, 1995, I obtained cash advances from my credit cards and purchased the 1,000 shares of Cheyenne Software. I told Investors Associates that I wanted to sell my 1,000 shares of Cheyenne Software as soon as possible in order to receive my \$3,000 profit and get my initial investment back to pay off the credit card debt. And they said fine.

It was my understanding that the stock would be sold and my money from the sale would be placed in an account with Investors Associates. I waited approximately ten days and still did not receive the money or any confirmation of the trade. I called Pat Boyce who told me he had made money for me once and that now he knew of another stock, Universal Self Care, that I should buy. I told Pat Boyce that I wanted to close out my account because I needed the money to pay back the cash advances on my credit cards.

Pat Boyce gave me a strong sales pitch about Universal Self Care stock. I told him that I did not want to purchase Universal Self Care stock and he became very upset with me. Boyce said that he had made money for me on the Cheyenne Software stock and he could not understand why I would want to close my account. Boyce told me the Universal Self Care stock was guaranteed to rise in price because Investors

Associates is on the Board of Directors and they would be able to control the stock. I told Boyce that the profit in Cheyenne Software was just a fluke and that I really don't know anything about Universal Self Care. I informed Boyce that I would *not* buy this stock over the phone, that I needed time to research it. Boyce did not seem to hear me because he said, Mr. Poggi, do you want me to put that order in now? The conversation ended with the agreement that we would watch Universal Self Care stock until the end of the day, but no purchase would be made without my authorization. It seemed to me that Pat Boyce was reading from some type of a script during this conversation, because he would not take no for an answer.

I immediately called Waterhouse Securities, who I have done business with previously, to determine the price of Universal Self Care stock. The stock was quoted as selling at \$.25 less a share than the quote from Pat Boyce. I was outraged, so I called Pat Boyce and told him that he is charging me \$.25 more per share than Waterhouse Securities which is outrageous. I informed him that I didn't want anything to do with Universal Self Care stock. Boyce told me it was too late because he had *already* bought 5,000 shares of Universal Self Care with the money in my account from the Cheyenne Software trade. He said that the \$.25 extra per share was his commission. I told Boyce that I did *not* authorize this purchase and just wanted my money back.

I was, to say the least, extremely upset. I now owned a stock that I knew nothing about, which was purchased with money from credit card cash advances. I called Boyce again that day and told him to immediately sell the stock in Universal Self-Care. He told me that he was not in a position to sell the stock.

I called Boyce again a few days later at which time he told me that I have no worries because the price of Universal Self-Care is going to be pushed up and then he will sell it. I continued to insist that Boyce sell my shares in Universal Self-care, even though he had almost convinced me that the stock was going to be profitable. Boyce then transferred my call to Vince Grecco, who told me that he was the owner of Investors Associates. Grecco said that he would sell the stock in Universal Self-Care, but he snidely told me to enjoy retiring on Social Security. He said that his company could have made me a fortune. I told him just to sell the stock and send me my money.

A few days later I received a notice that I had bought 5,000 shares of Universal Self-Care at a net cost of \$17,360.50. I thought that this was just a mistake and that I would be receiving my funds in the near future from Investor Associates. About ten more days passed and I called Pat Boyce who told me that the Universal Self-Care stock was not sold from my account. I told Boyce that Grecco had ensured me that the stock would be sold. Boyce stated that my account had been closed and the stock certificates

were being forwarded to me. He said that I should receive the stock certificates in six to ten weeks at which point I could then have the shares sold by a brokerage of my choice.

I broke down at this point in the conversation and became very emotional. I was hysterical and Boyce hung up on me. I composed myself and called Investors Associates a short time later. This time my call was transferred to Vince Grecco. He told me that I had instructed him to close my account and that it is standard procedure with his company to send investors the stock certificates of their shares when they close an account. I told Grecco that I wanted the shares in Universal Self-Care to be sold, I did not want the stock certificates. Grecco told me that it was too late to sell because the account had been closed and the stock certificates were in the system.

Shortly after this conversation with Grecco I went on vacation with my family, but I called Grecco everyday trying to resolve this matter. Grecco told me that there was nothing he could do and that he was sorry I did not understand the jargon of the industry. Grecco repeatedly told me that he just followed my orders to close the account.

The clearing house for Investors Associates on my account was Prudential Securities. I finally decided to call the local office of Prudential Securities to try to determine the status of my stock certificates. I do not remember the name of the person I spoke with at Prudential, but he assured me that the stock certificates would be forwarded to me as soon as possible. The stock certificates for Universal Self-Care were subsequently received on or about August 22, 1995 in the mail by my sister on Long Island. I instructed her to take the certificates to the local Waterhouse Securities office and have them sold. The 5,000 shares in Universal Self-Care were sold on or about August 25, 1995, for \$14,437.50.

Subsequently, I filed a complaint with the National Association of Securities Dealers (NASD) in New York. A couple of months passed before the NASD conveyed to me that I should pass on my complaint to New Hampshire authorities. I then filed a complaint with the State of New Hampshire Bureau of Securities Regulation. This complaint was finally settled on April 23, 1997, with Pat Boyce being ordered to make restitution to me in the amount of \$2,925 and Investors Associates assessed a penalty of \$25,000.

This concludes my story which obviously has been a terrible experience that will affect me in many ways for the rest of my life. I thank you for allowing me to share this information with you and I would be pleased to answer any questions.

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TESTIMONY OF

JOSEPH P. BORG

Director, Alabama Securities Commission

**on behalf of the North American Securities Administrators
Association, Inc.**

before the

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

U.S. Senate

September 22, 1997

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Madam Chairman and members of the Subcommittee:

I am Joseph Borg, Director of the Alabama Securities Commission, and I welcome the opportunity to participate in your oversight hearing on the growing problem of fraud in the sale of small company stocks. Today I am representing the North American Securities Administrators Association ("NASAA") which has led numerous enforcement efforts in this area.¹ I commend you for your timeliness in holding a hearing on this important subject. With over one in three U.S. households now investing in our capital markets (up from one in seventeen in 1980), securities fraud has a profound impact on a great number of working families.

I have been involved in the securities markets for 15 years, as a partner in a law firm, as a state securities regulator, and as an investor; and I come before you today to discuss the very serious and growing problem of fraud in the micro-cap market. Daily, it threatens investors across the United States with the loss of millions of dollars. Moreover, in my opinion, this threat casts a shadow on every financial institution in our markets today. One of the unreported costs of this problem is the millions of dollars intended to seed new businesses that end up in the pockets of swindlers, rather than creating new jobs.

I am speaking about the efforts of some small unscrupulous firms who use sophisticated scripts and an army of cold-calling solicitors and brokers to sell micro-cap stocks to investors by any means, including false and fraudulent representations and dishonest and unethical sales practices.

On May 29, 1997, at a news conference with the New York and New Jersey Attorneys General, NASAA announced that 20 state securities agencies had filed 37 actions against 14 of these firms. The announcement was phase one of what is the biggest nationwide crackdown ever by the states aimed at brokers fraudulently selling stock over the phone. A number of press articles describing the actions are attached to this testimony.

¹ The oldest international organization devoted to investor protection, the North American Securities Administrators Association, Inc., ("NASAA") was organized in 1919. It is a voluntary association with a membership consisting of the 65 state, provincial, and territorial securities administrators in the 50 states, the District of Columbia, Canada, Mexico and Puerto Rico. In the United States, NASAA is the voice of the 50 state securities agencies responsible for grass-roots investor protection and efficient capital formation.

That announcement resulted from a January, 1997, NASAA directive to create a strike force represented by 12 states. In February, audit teams comprised of examiners from these states struck five pre-selected firms in the New York metropolitan area. Concurrently, other states conducted similar investigations, and ultimately 20 states participated in the actions with NASAA serving as the coordinating council for this nationwide crackdown.

The primary target, the brokerage firm of Investors Associates, Inc. was subject to fifteen state actions. To date, Alabama, California, Indiana, Massachusetts, New Hampshire, Oklahoma, South Carolina and Texas have revoked the license of Investors Associates, and Ohio recently denied its application for a license. I will speak specifically how Investors Associates fits into the problem later in my testimony.

State securities examiners confirmed that employees of the targeted firms pressure their victims into buying stock in unknown companies by reading from scripts. The brokers and cold callers know little or nothing about the companies they are paid to hype. As you will see, brokers bounce from firm to firm, taking their favorite scripts with them wherever they go. Here's an excerpt from one taken from a trash can at a brokerage house in Long Island, New York, that begins with a stage instruction to speak "slowly and nonchalantly":

"Two or three times a year, we at Investors Associates get our preferred clients involved with a niche area of the market where we can potentially turn a six seven figure profit within the course of a few trading hours. . . More specifically, initial public offerings."

After providing more detail about a particular stock, the script goes on to say: *"In other words, a return of 100% in 20 minutes perhaps sounds a bit unrealistic. . . but that's exactly how our IPOs trade. . . We did three deals last year . . . yielding collectively 34 points within the first ten days of trading. . . [That's a] fact!"*

Once enough shares are sold and the price is driven high enough, insiders sell the stock, creating an unstoppable price slide, making fortunes for themselves and wiping out the savings of innocent investors. In the vernacular of the industry, this procedure is known as a “pump and dump.” Although the unknown companies being peddled are all small, it is not their size that is dangerous, but the dishonest way that their stock is represented and sold.

In the course of NASAA’s sweep, state examiners discovered four systemic abuses by the targeted firms. These include:

- **Trading Abuses.** Our examiners found an army of unlicensed solicitors who are accused of falsifying records, conducting unauthorized trades and failing to complete trades. These are the tools of stock manipulation and securities fraud.
- **Failure to Report Investor Complaints.** State examiners found hundreds of unreported investor complaints. Most of the offices audited failed to have centralized procedures for handling and reporting customer complaints, as required by law.
- **Evasion of Broker-Dealer Registration Requirements Through Use of Third-Party Franchise Agreements.** Rather than acting as a legitimate branch of a broker-dealer, these “franchises” operate independently, with no central compliance or supervisory procedures or oversight as is the industry practice. While they operate independently, they do not have independent capital and bonding upon which the investing public relies. When a broker-dealer or its satellite offices aren’t properly registered, that is a sure sign something is wrong.
- **Abusive Cold-Calling Practices.** Most of the firms and branches relied on high-pressure, scripted telephone cold calling techniques that include falsifying experience and performance, as well as other outright lies. This is the key to the scheme. Without the high pressure cold-calling, the rest of the illegal scheme could never succeed.

A small segment of the broker-dealer industry concentrated in the microcap markets has caused losses to investors in the hundreds of millions of dollars. The problem is systemic and nationwide. Even in Alabama such names as First Jersey Securities Co., Inc.; A.R. Baron & Co., Inc.; D. H. Blair and Stratton Oakmont Inc. are well-known to state regulators as problem firms.

Unquestionably, the use by unscrupulous broker-dealers and their agents of a prestigious New York/Wall Street type name and address still tends to create an air of legitimacy and the promise of a golden opportunity; not only for the unwary or inexperienced investor, but in many cases also for the well-educated, more sophisticated investors. This is especially true when the lesser known brokerage firm markets a recognizable clearing firm name as a way to impress investors and gain their confidence.

I am confident these hearings will uncover numerous examples of high pressure, boiler room sales tactics, misrepresentations, unsuitable sales, failure to execute trades, trading in assets without authorization and in some cases even threats.

I would like to focus today not on mere anecdotes, but on a specific case study detailing the history and extent of these abuses and present for your consideration indications of generational networking amongst firms. This history and progression of networking continues unchecked. Even after a notorious firm like First Jersey or Stratton Oakmont is shut down (usually long after huge losses have accumulated), others emerge to take their place.

In 1995-96, with the organizational support of the North American Securities Administrators Association ("NASAA") Alabama undertook the lead of a multi-state investigation of the broker-dealer firm, Stratton Oakmont which had its headquarters in New York state. Investigators and examiners from Alabama, Kansas, Pennsylvania, Illinois, Colorado, New Mexico, Arizona, Mississippi and Georgia, with assistance from other states joined together on this massive investigation that consumed nearly two years, and half-a-million dollars in time and expenses to complete. The results of this examination were both shocking and informative.

Let's take a look at one of these deals represented as a "golden opportunity" to the investing public. While we go over the details, please keep in mind that the investing climate during the 90s in the U.S. equity markets was delivering historic returns and success for IPOs. But, in the deals outlined today, investors never had a chance because the deals were constructed to enrich these unscrupulous operators at the expense of small investors and small businesses.

I'd like to direct your attention to the chart "Steve Madden Limited IPO Time Line." During the examination of Stratton-Oakmont, Inc., the examiners undertook to review five initial public offerings commonly known as IPOs, as well as review the activities of associated agents and the review of customer complaints.

The five IPOs were: Computer Market Place, Inc.; Dual Star Technologies Group, Inc.; Out Takes, Inc.; Solomon Page Group Limited; and Steven Madden Limited. Our focus today is on Steven Madden Limited, a shoe company which was incorporated in the state of New York. All these IPOs had been previously reviewed and approved by the North American Securities Dealers ("NASD") and the Securities and Exchange Commission ("SEC"). After being reviewed and approved, these IPO units, shares, and warrants were sold in numerous states. The IPO analysis revealed a common pattern.

One of the Stratton principals, Mr. Jordan Belfort, was barred from association with any broker-dealer in February, 1994, by the NASD. Yet he continued to be active at Stratton and continued to participate with the other principal, Mr. Daniel Porush, in IPO offerings such as Solomon Page Group Limited and Dual Star Technologies. He also participated in an apparent scheme to sell their restrictive shares purchased through private placement offerings prior to the IPO.

After purchasing the private placement shares, the Stratton insiders, Messrs. Belfort and Porush benefited from stock splits prior to the IPOs, giving them a major ownership position in the companies. In some cases, NASDAQ refused to list the stock citing the high percentage of ownership. To bypass this objection, Belfort and Porush would sell their shares to newly formed shell companies controlled by other insiders and received

promissory notes for huge amounts that often rivaled the remaining net proceeds from the IPOs. In my opinion, a more determined examination of the disclosure documents must be exercised by the SEC, state regulators, and the NASD. The disclosure must be meaningful to investors.

The shares owned by the shell companies were then sold to selective Stratton customers, friends and relatives at favorable prices. By way of example, the three Stratton principals, (Jordan Belfort, Daniel Porush, and Kenneth Greene) received promissory notes in Solomon Page Group Limited, Dual Star Technologies Group and Steve Madden IPO deals totaling in excess of eleven-and-a-half million dollars. This does not include additional commissions, bonuses or units and shares assigned to their accounts from Stratton's trading accounts. Please remember these insiders are enriching themselves from the investing public, your constituents.

The analysis further indicates that there was a pattern involving the use of bridge loans (also known as bridge financing) private placements and convertible debentures. The bridge loans and private placements often included individuals with questionable backgrounds or significant disciplinary history. Also, close friends and/or relatives of the principals of Stratton became involved in the bridge financing. In most cases, the IPO prospectuses failed to disclose to investors the relationship between these Stratton insiders (Messrs. Belfort, Porush and Greene), or their backgrounds.

Participation by close friends and relatives in the IPOs raises the question of excessive fees and commissions. This pattern becomes more abusive in that Stratton selected certain top agents to receive and/or purchase restricted shares (also referred to as cheap stock) to participate in the IPOs and to reap huge profits at the expense of the investing public thereby creating an irresistible economic incentive to rip off the small investor.

It appears that these selected Stratton agents further involved selected insiders, customers or relatives by selling, in some cases up to half of their allocated shares which are immediately sold on the first days of trading. In some cases, the shares were sold before they were actually purchased.

The IPO prospectuses also failed to disclose that the selling shareholders included Stratton agents. Stratton's undisclosed control starts by selling a majority of the units to its own customers. Stratton sold fifty-eight percent of Out Takes, Inc.; sixty-four percent of Computer Market Place, Inc.; seventy-eight percent of Solomon Page Group Limited; seventy-nine percent of Dual Star Technologies Group, Inc.; and eighty-eight percent of Steve Madden to its own customers. Stratton continued its inside control by using prearranged purchases of sales of units and shares at set prices.

From the review of the trade summaries, it appears that there was a pattern where customers were sold units at or near the unit offering price, then additional shares were purchased at a much higher price. In essence, we have common stock trading higher than units. There were numerous purchases of common stock at a high price, then a smaller purchase of common stock at a much lower price for the same customer. The review further revealed matched trades. The five Stratton IPO offerings raised amounts ranging from \$8.7 million to \$19.2 million. The size of these offerings made no difference as to Stratton's ability to conduct the sale of the IPOs with reckless indifference to the consequences for public investors.

Though the chart before you is complex, I would like to point out a few items. On June 12, 1992, Steven Madden issued to Madden Acquisition Group Network, ("MAGNET"), which consists of Messrs. Jordan Belfort, Daniel Porush and Kenneth Greene, a convertible eight percent debenture in the sum of \$100,000.00 that was originally due and payable on July 15, 1993, but was then extended.

As you can see on August 25, 1992, the number of authorized shares then goes from 200 shares to 10 million. On December 1, 1992, Stratton begins promoting the private placement of twenty-two units at \$25,000 a unit for a total of \$550,000 to Steve Madden. One unit equals 45,332 shares of stock. Therefore, the 22 units of the private placement equate to fifty-five cents per share.

What is not disclosed on the chart is that private placements included sixteen purchasers, of which twelve were employed by Stratton Oakmont.

After a series of further transactions, including a transfer of shares to further parties by the private placement holders many of whom are relatives or insiders, there is a two-for-one stock split and the private placement holders and those who purchased from the private placement holders doubled their shares. On December 2, 1993, MAGNET converts the \$100,000 convertible debenture into 2,040,000 shares of common stock and distributes it to its sole shareholders Messrs. Jordan Belfort, Daniel Porush and Kenneth Greene.

What becomes interesting is that the Stratton insiders, Belfort, Porush and Greene, enter into a stock purchase agreement with Bocap Corporation, of which Steve Madden is the sole stock holder. Bocap purchases 1,284,816 shares of common stock and delivers promissory notes in the amount of \$3.2 million, \$1.4 million, and a half a million respectively to Jordan Belfort, Daniel Porush and Kenneth Greene bearing interest at four percent. This totals \$5,139,264.

Consider that this \$5 million in notes originated with a \$100,000 debenture for which our examination found no evidence of payment. I find this absolutely astonishing. What also must be noted is that these promissory notes by Bocap Corporation, wholly owned by Steve Madden, had due dates that were extended. To the best of our knowledge, these promissory notes still remain due and payable.

The initial placement then went public on December 10, 1993, with the prospectuses dated the same date. And what does all this translate into?

If I can direct your attention to the pie chart you will note that of the approximately \$12.5 million raised, 52.31 percent went to Steve Madden Limited and the rest went to the selling security holders, which we have previously identified as agents and insiders, as well as to the bridge lenders, the Stratton-Oakmont principals, Stratton Oakmont itself and Mr. Steve Madden. Therefore, approximately half of the public investors' money went to these insiders rather than to the company the public thought it was investing in.

However, this pie chart does not tell the whole story. I mentioned earlier there are still over \$5 million in promissory notes outstanding and although technically the promissory notes are owned by Bocap, a wholly-owned company of Mr. Steve Madden, President of Steve Madden Limited, please now turn your attention to the overlay. Let us now add the five million dollars worth of promissory notes that still need to be paid. If the promissory notes had been paid on time as originally anticipated by Stratton in this IPO, we would have to change the pie chart to show that the 52.3 percent which went to Steve Madden Limited would be reduced by \$5,139,264, leaving approximately \$1,500,000 out of a total of \$12,500,000. What does this mean for the small investor? It means that approximately \$11 million of the \$12.5 million intended for the company went to these insiders.

It is interesting to note that the original due date of these promissory notes generally coincided with the beginning of the investigation and examination of Stratton Oakmont by the states and other regulatory authorities.

The analysis of the IPOs including the Steve Madden transaction detailed before you concluded that there were numerous failures to accurately disclose material information. I believe the question to be asked is if the public investors knew \$11 million of the \$12.5 million was going to these insiders --would they have invested? Certainly not. And in fact, from the investors point of view this is probably the best of the lot. Technically, the \$5 million in promissory notes have yet to be paid, therefore, the company still exists.

Just how large are these penny stock losses? In a Wall Street Journal article dated September 4, 1997, the Journal states, "penny stock fraud has come roaring back bolstered by some of the very remedies designed to prevent abuses. Regulators now estimate annual losses to investors at more than \$6 billion. Triple the 1980s peak." I agree with Barry Goldsmith, Executive Vice President of the NASD Regulation, Inc., when he stated, "there are significant problems in the over-the-counter market and a strong regulatory response is needed."

Please allow me to direct your attention to the chart entitled "Agent to Principal Genesis." This chart is probably more aptly named the bad broker-dealers "Hall of Shame." Agents who started at First Jersey or Investors Center became the principals of Stratton-Oakmont. The agents who gained experience in the training pits of Stratton and others of its ilk moved on to other broker-dealers, or have gone on to form their own broker-dealer and the saga continues along with the lying, stealing and cheating. Many of these firms and individuals are today subject to ongoing complaints and/or investigations and may have already been subject to numerous regulatory actions.

I might add that as we review this IPO and its impact on investors, it is important to note that as these abusive IPOs progressed, their structure and techniques have been handed down and refined as new bucket shops and boiler room mills take the place of older ones.

In addition to the charts before you, attached to my testimony is a more comprehensive set of charts that detail the entangled web amongst these problem individuals and firms in the micro-cap industry.

The conclusions are obvious and inescapable. The abuse in this arena continues to grow. As regulators pursue and shut down one firm, another or even several emerge to take its place. The lying, cheating and stealing continues unabated. Thankfully, Stratton Oakmont is gone and Mr. Jordan Belfort has been placed on a permanent bar from the industry along with Mr. Daniel Porush. Stratton, probably the worst of the worst no longer exists. Does this solve the problem? It is my position that the elimination or closure of one firm and the barring of several principals, who have already made their money does not in any way alleviate or correct the problem. It has been said that those who do not learn from history are condemned to repeat it.

Regulators, including the state securities agencies, the SEC, the NASD and the New York Stock Exchange have, in the past, concentrated their enforcement efforts on the firms. Although these may be the most obvious violators, they are not the only cause of the abusive practices. As demonstrated by the charts, this network of culprits is a fertile training ground for continued wrongdoing. There is a continual, systemic

training of rogue brokers, promoters and agents. When the training is complete, they graduate to higher positions or form their own broker-dealer firm.

Unless regulators are given the necessary enforcement tools and resources to strike at the individual agents with both civil and criminal sanctions, the infestation in our markets will continue. We must discourage rogue broker entrepreneurs by bringing criminal cases, prosecute the trainer, and let it be known that the cost of doing business just went up dramatically. Rogue firms or brokers will agree to pay a civil fine of 100 thousand or even one million dollars as the cost of doing business as long as he/she can continue to bilk investors of tens of millions of dollars; aggregate losses attributed to fraud in low dollar stocks are estimated to be several billion dollars annually. This is an unacceptable drain on our nation's economy.

The time is now to focus energy, resources and talents of the state regulatory and prosecutorial offices in conjunction with the SEC and Self-Regulatory Organizations ("SROs") to attack the causes, not the symptoms. While SROs cannot replace the role of government regulators, I have witnessed a more diligent NASDR in the last eighteen months which places a higher priority on the individual investor. NASAA is committed to working closely with them.

In conclusion, the May, 1997, twenty-state crackdown and the two-year Stratton investigation have provided the overwhelming evidence that leads me to recommend several issues for the Senate to consider. They fall into three broad categories: front-end protections, ongoing protections and after the fact responses.

FRONT END PROTECTIONS

SEC/NASD Recognition of State Enforcement Actions.

Under the Securities Exchange Act of 1934, Section 3(a)(39) establishes "statutory disqualifications" that the SEC and NASD may consider with respect to revoking, suspending or denying registration to broker-dealers and their agents. The Act does not specifically reference state securities actions as a statutory disqualification.

However, the SEC may have the statutory authority to disqualify persons based on state orders by interpreting the language in Section 3(a)(39), [(i) an order to the Commission, **other appropriate regulatory agency**], to mean state security agency. If so, thousands of state enforcement actions could form the basis upon which the SEC or the NASD could and should invoke the statutory disqualification authority.

Federal regulators may wish to consider such an interpretation.

Currently, the SEC and the NASD bring their own complaints concurrently or subsequent to state actions, which can create duplication of efforts and unnecessarily drain the finite pool of enforcement resources.

Continuation of State Licensing Procedures

State securities agencies are able to protect millions of investors through the front-end state licensing process which screens out problem brokers and firms. State agencies should build upon their current successes and bring even more resources to bear against this problem. In my opinion, increasing enforcement budgets without strong state licensing is like throwing good money after bad. It is more efficient and effective, to prevent unscrupulous persons from entering the industry rather than attempting to remove them once harm is done.

NASAA recently submitted a voluminous study to the SEC which finds state regulation and the licensure of securities agents to be extremely efficient and effective. States only review those brokers who have disciplinary records, enabling states to concentrate all of their efforts on less than 11 percent of all brokers in the U.S. History has shown that the agent review is an essential vehicle to identify and screen out those individuals who present a serious risk to the public. Any diminution of state licensing authority would create harm to investor protection.

A copy of this letter is attached to this testimony and the entire appendix is available through the NASAA office here in Washington.

ONGOING PROTECTIONS**The Role of Clearing Firms**

As eluded to earlier in my testimony, clearing firms can be a vital component in the business of a fraudulent boiler room operation. The relationship between introducing brokers and clearing firms needs to be examined. How do introducing brokerage firms utilize their affiliation with a recognized name clearing firm to gain an air of respectability in the eyes of the investor? State regulators have uncovered evidence of unscrupulous firms leveraging the name of the multi-national clearing firms to gain the trust of small investors only to perpetuate the scam.

Attached is a transcript from a cold calling broker who invoked the name of a clearing firm in a context calculated to convey to the investor false security and the illusion that the little known introducing broker possessed the same prestige and financial capital standards as the name recognizable clearing broker. In fact, the relationship is purely ministerial.

Is more disclosure necessary to inform the investor of the exact nature of the affiliation between the broker and the clearing firm? At least in the micro-cap area, we believe it is if investors received a full accounting of the enormous markups paid to the introducing broker in lieu of commissions, it would have a chilling effect on the type of fraud and abuse regulators are diligently working to eliminate. Some of these micro-cap firms market themselves as providing commission-free transactions only to extract their enormous profits from mark-ups that never appear on the clients' confirmation slip. This is a practice that merits regulatory attention.

NASAA applauds the New York Stock Exchange's recognition of this complex area, and welcomes the opportunity to work with the SEC and the SROs to explore the issue and identify ways to address the abuses.

Books and Records

The SEC's proposed rule for Books and Records Requirements for Brokers and Dealers Under the Securities Exchange Act of 1934 was originally released on October 22, 1996.

The proposed amendments clarify, modify and expand record-keeping requirements with respect to purchase and sale documents, customer records, associated person records, customer complaints and other matters. State securities agencies must rely on the scope of the federal rule to regulate local markets because they lack the legal authority to enforce standards other than those of the SEC. The SEC stated in its October, 1996, release, "The proposed amendments are intended to obligate broker-dealers to make and retain certain additional records that would be valuable to state regulators during examination and enforcement proceedings."

NASAA members have worked on this issue for nearly five years. We believe the time is ripe for SEC adoption of a meaningful and agreeable Federal Books and Records rule that closely tracks the October, 1996, release.

AFTER THE FACT

SIPC

The Securities Investor Protection Corporation was formed pursuant to the Securities Investor Protection Act of 1970. SIPC provides for a fund for the payment of customer losses due to a brokerage firm's failure in an amount not to exceed \$500,000 per customer on claims for securities, including up to \$100,000 on claims for cash, but not to exceed \$500,000 total.

This Act has not been amended since 1970. Is this protection still sufficient coverage for investors? Should consideration be given to raising the payment level? Should actions other than a firm's financial failure be cause to trigger the coverage?

These are issues that the Senate may wish to examine to ensure that investors understand the limited nature of current SIPC coverage and to determine if a review of the Act is necessary.

Madam Chairman and members of the subcommittee, in conclusion, I applaud your sponsorship of these hearings in an effort to shed light on the abuses in the nation's micro-cap market. The problems in this area are serious and systemic, but can be successfully addressed if securities regulators and policymakers work together on solutions. While it takes decades to build the foundation of investor confidence we enjoy today it can crumble in weeks or months. This hearing is a positive step towards ensuring that confidence in our markets is well founded. I pledge the support of the entire NASAA membership to work with you and provide any additional information or assistance you may need.

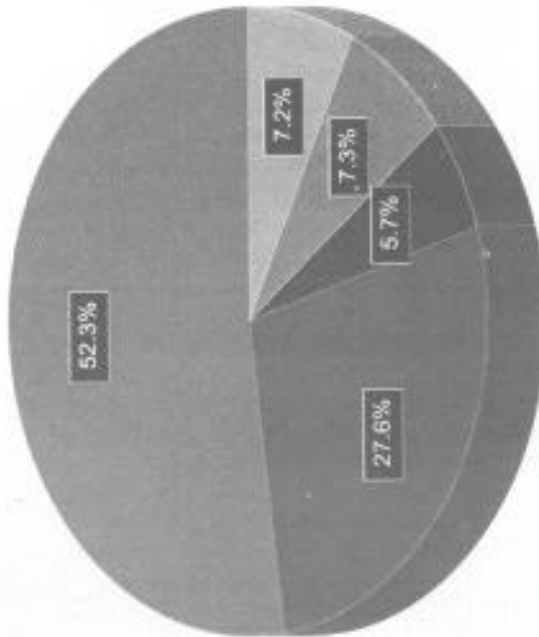
1993 Stratton Oakmont, Inc. IPO
 STEVE MADDEN, LTD.
 which raised \$12,539,755

PROCEEDS TO COMPANY

- 52.3% - Steve Madden, Ltd.
 \$6,599,433
 Proceeds from sale of 1,715,000 units
 @ \$3.85 per unit (\$6,500,000) less
 \$99,000 underwriting expenses and
 \$13,567 repayment of bridge loans
- 870,000 - Proceeds from sale of 150,000
 Underwriter Units @ \$5.80 per unit

PROCEEDS TO INSIDERS (immediately following IPO)

- 27.6% - Selling Security Holders
 \$3,458,152
 910,000 shares of common stock of the
 14 selling security holders @ \$3.80 per
 share
- 5.7% - Mr. Steve Madden
 \$711,605
 187,264 shares of common stock @ \$3.80
 per share
- 7.3% - Bridge Lenders
 \$100,000 Repaid Bridge Loans
 \$13,567 Interest on Bridge Loans
 \$600,000 Bridge Units
- 7.2% - Stratton Oakmont Underwriting Expenses
 \$897,000



1993 Stratton Oakmont, Inc. IPO
 STEVE MADDEN, LTD.
 Company/Insider Proceeds Distribution

■ PROCEEDS TO COMPANY

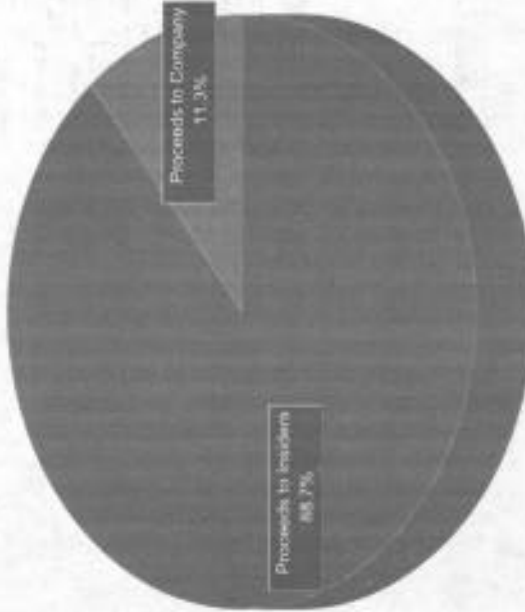
\$ 6,559,433
 \$ 5,139,264

 \$ 1,420,169

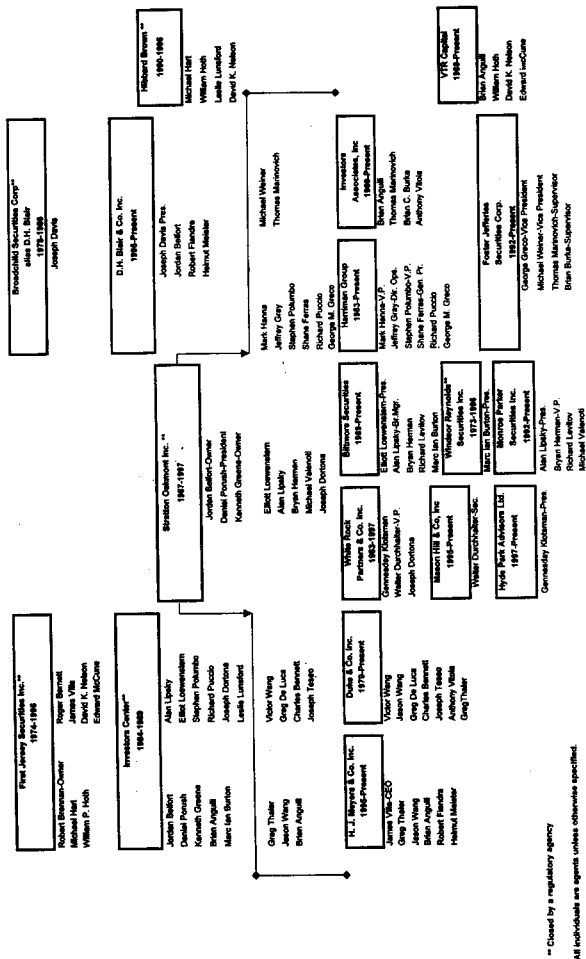
■ PROCEEDS TO INSIDERS

\$ 3,237,737 Jordan Belfort
 \$ 1,387,601 Daniel Porush
 \$ 513,926 Kenneth Greene

 \$ 5,139,264 (payment of
 promissory note)



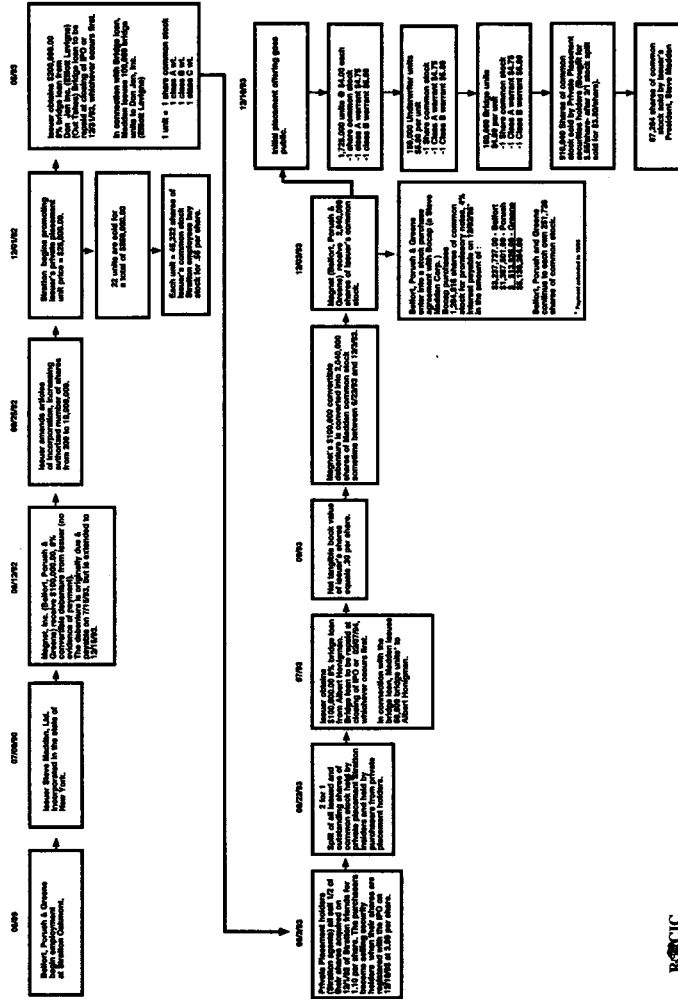
Agent to Principal Progression



== Closed for a regulatory agency

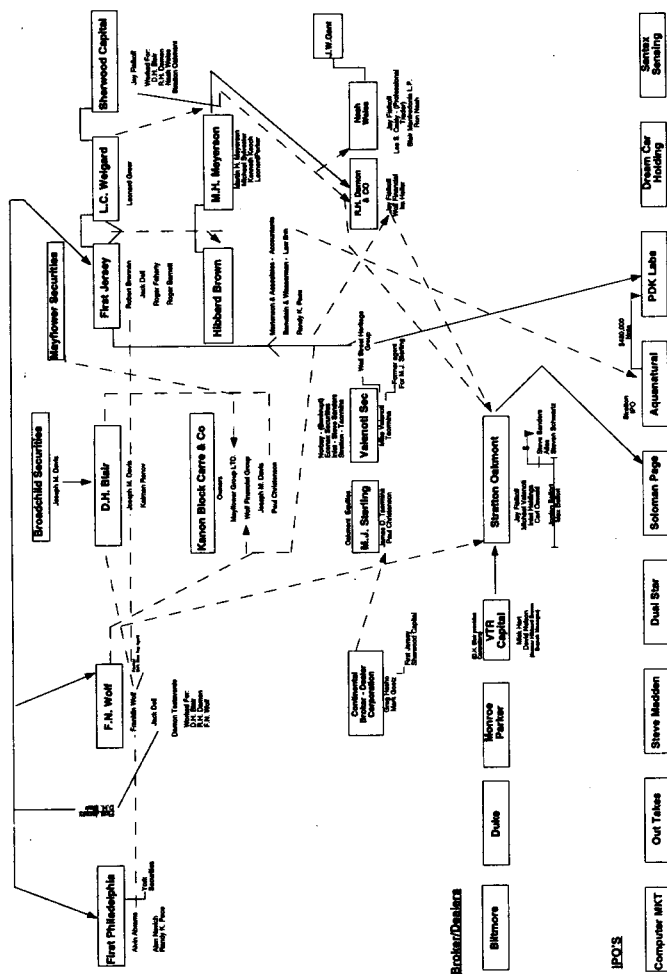
Individuals are named unless otherwise specified.

Steve Madden, LTD IPO Time Line



BOIC

[illegible]



States Lead a Crackdown On Telemarketing Brokers

14 Firms, Most in New York Area, Involved

By LESLIE EATON

Americans who live west of the Hudson may have good reason to hate New York, based on evidence presented yesterday by securities regulators from 20 states who cracked down on stockbrokers pushing penny stocks by phone.

Led by Attorney General Dennis C. Vacco of New York, the regulators filed lawsuits and other enforcement actions against several individuals and 14 firms, almost all based in the New York metropolitan area.

"They operate in the shadow of Wall Street, which lends them an air of legitimacy," said Mark J. Griffin, director of Utah's securities division and head of the North American Securities Administrators Association, which coordinated the sweep. He estimated that there were probably 50 such telemarketing boiler rooms doing business around the country.

Four defrauded investors — none from New York — told of losing their savings to fast-talking, high-pressure stock salesmen who bought and sold shares without their permission and sometimes against their wishes. "They can convince you right away," said Billy Hellums of Roswell, N.M., who added, "Beware!"

Legal actions filed by the state regulators included dozens of scripts used by cold-callers, complete with such stage directions as "pause," "lower voice," "sincerely," and even "chuckle, chuckle." The scripts include lines for breaking down victims' defenses, including flattery ("You are rated as an A+ investor through Dun & Brad Street (sic)"), promises ("My prediction is in 20 minutes you will get a 100 percent return") and even insults ("I'm not asking the color of your underwear, I'm sure it's white").

Regulators say the problem has gotten worse recently. Mr. Vacco said complaints and inquiries to his office jumped by 40 percent since last year, to 3,100. One reason, he said, is that with the soaring stock market, "more investors are coming in, and the pitches are being well received, unfortunately."

The states' special enforcement effort came as Congress, under pressure from many large brokerage firms and mutual fund companies to reduce state regulation, has been attacking state actions. Recently, states lost jurisdiction over large investment advisers like mutual funds.

Now, the Securities and Exchange Commission is working on a report, ordered by Congress, on state licensing of individual brokers and firms, which is also governed on the Federal level by the S.E.C. and the National Association of Securities Dealers. Securities firms argue that state efforts duplicate Federal work and waste time and money.

In a response that the state regulators' association plans to file today, the state officials will argue that their procedures weed out rogue brokers who would otherwise prey on

citizens. New York, for example, has twice barred a felon who was convicted of first-degree robbery and attempted murder. Ohio recently barred a salesman, approved by the N.A.S.D., who faced Federal charges of securities fraud.

The N.A.S.D. can pull brokers' licenses for only very limited reasons, and cannot take into account state actions, regulators say. Moreover, the states respond to all customer complaints, no matter how small.

"We're the local cops on the beat — when someone has a complaint, they may write the S.E.C. a letter, but they land up on our doorstep when we open our offices in the morning," Mr. Griffin of Utah said.

In addition to abusive sales practices, the states' regulatory sweep of small firms turned up what some regulators call an alarming new trend: franchise boiler rooms. Registered brokerage firms are said to be selling their names and licenses to "branches" that operate independ-

A bull market in complaints about pressure tactics over the phone.

ently, without supervision. The licensed firm may not have customer records or know about complaints.

One firm that engages in this practice, Investors Associates, was the target of 15 states' enforcement efforts. The firm is based in Hackensack, N.J., and has branches on Long Island and in Florida. New Jersey issued a cease-and-desist order against the firm and its principals; New York sued it in State Supreme Court, asking a judge to bar the firm and its employees from manipulating initial stock offerings, using unlicensed telemarketers and ignoring customer complaints.

Investors Associates said in a statement that it would cooperate with the state regulators to clear its name, adding that it "never condoned any improper sales practice and will take all necessary steps to rectify such inappropriate behavior, should it exist."

The other brokerage firms named by the regulators included First United Equities of Garden City, N.Y.; Kensington Wells Inc. of Syosset, N.Y.; L. T. Lawrence of Manhattan; Tolosa Pacific Securities, which has offices on Long Island, and in Florida and California; Meyers Pollock Robbins of Manhattan; Biltmore Securities of Fort Lauderdale, Fla.; and William Scott & Company of Union, N.J.

Executives at the firms either declined to respond to the states' allegations or could not be reached for comment late yesterday.

B7C THE WALL STREET JOURNAL MONDAY, JUNE 2, 1997

Securities Regulators Cracking Down On Sales Fraud at Brokerage Firms

NEW YORK (AP) — Securities regulators in 20 states are cracking down on fraudulent stock telemarketing practices, as visions of big returns in the booming stock market are making more people prey for scams.

Fourteen brokerage firms are accused of making unauthorized stock trades and other fraudulent sales practices.

"In this high-flying bull market, it's easy for swindlers to make claims of outrageous returns sound plausible," said Mark Griffin, president of the North American Securities Administrators Association.

NASAA is a private organization representing state securities regulators that spearheaded an investigation into fraudulent stock telemarketing. On Thursday, New York Attorney General Dennis Vacco announced civil suits against the 14 brokerages as part of the multistate crackdown.

The firms were charged with high-pressure calling techniques and outright lies. They also were accused of allowing unlicensed solicitors to falsify records and conduct unauthorized trades, as well as failing to report investor complaints and evading broker-dealer registration requirements.

"They're very impressive when they talk to you on the phone. Like a brother. They get you to feeling very comfortable with them," said Billy Hellums, of Roswell, N.M., who lost about \$1,500 and was on the verge of investing much more.

Mr. Hellums and three other victims of allegedly abusive telemarketing practices joined Mr. Vacco, NASAA's Mr. Griffin and New Jersey Attorney General Peter Verniero at a news conference.

"Unfortunately, far too many investors are falling for the lure of this latest trend in boiler room scams. And the telemarketers, playing upon people's desire for ever-greater financial returns, have been running away with millions of dollars of hard-earned money," Mr. Griffin said.

Brokers at Investors Associates Inc., based in Hackensack, N.J., allegedly absconded with about \$60,000 belonging to Helen Sprecher, 65 years old, of Philadelphia. The money represented 90% of the money saved by Mrs. Sprecher and her husband from a neighborhood grocery store they owned for 40 years.

Mrs. Sprecher said her troubles began when her regular broker took ill and she was contacted by another agent. "He sounded like a nice, friendly grandfatherly man," she said.

In a statement, Investors Associates said it would cooperate with regulators.

"A number of firms have recently been targeted by certain states in connection with allegations of improper sales practices. Investors Associates has never condoned any improper sales practice and Investors Associates will take all necessary steps to rectify such inappropriate behavior should it exist," the statement said.

Like Mrs. Sprecher, many victims were

complaints involved low-priced shares of high-risk stock.

Other New York City brokerage firms named by Griffin were First United Equities, LT Lawrence & Co. and Meyers Pollack Robbins. First United president Douglas Traynor had no comment. The other two firms did not immediately return phone calls for comment.

Mr. Hellums, a New Mexico building contractor, said he invested his money with a broker from the Uniondale, N.Y.-based Sterling Foster brokerage firm. The company did not return a phone call seeking comment.

Mr. Vacco said he had filed civil actions against First United and Investors Associates. A total of 16 states have taken action against Investors Associates, including New Jersey, which has moved to revoke the firm's registration to do business in the state.

Another alleged Investors Associates victim was Louis Poggi, 45, of Pembroke, N.H., who said he lost \$10,000, all of his savings. "I was careful as a human being can be and they did something illegal," the Federal Express driver said.

The 20 states participating in the crackdown are: Alabama, Connecticut, Delaware, Illinois, Indiana, Maryland, Massachusetts, Missouri, New Hampshire, New Jersey, New Mexico, New York, Ohio, Oklahoma, Pennsylvania, Texas, Utah, Vermont, Washington and Wisconsin.

California, Georgia and Florida are expected to announce similar actions against broker-dealer firms in the next month.

States Launch Crackdown on Phone Tactics of Some Brokers

By Sharon Walsh
Washington Post Staff Writer

NEW YORK, May 29—Baltimore lawyer Carl E. Byrne III recalls that he first heard of a stockbroker who called him out of the blue one night in late 1995: Invest with us and you can expect returns of 30 percent or more, said the broker, who was part of a firm called Investors Associates.

Byrne, a 45-year-old technical analyst with Xerox Corp., started investing. First, it was just a few hundred dollars that he had in a brokerage account. But his initial investments with the Haddonfield, N.J., brokerage firm seemed to do amazingly well, so Byrne opened a second account and started borrowing money to invest, ultimately entrusting about \$40,000 to the firm.

crackdown ever by the states against brokers who sell stocks over the telephone. Investors Associates is the only firm that Washington area residents had complained about, officials said.

The crackdown is the first fruit of an investigation that began in 1996, when the North American Securities Administrators Association Inc., a grouping of state securities officials, began a special project to target firms that used fraud in selling low-cost stocks over the telephone.

A task force of 12 states was created and divided into groups, with each group targeting a particular firm. In February, the teams began announced examinations of the firms. Their investigations found four abuses that were common to the firms targeted yesterday, the association said.

■ High-pressure, scripted "cold-calling" techniques in which stocks were sold with false information.

■ An army of unlicensed callers who falsified records and conducted unauthorized trades.

■ A failure to report investor complaints.

■ Evasion of broker-dealer registration requirements.

Investors Associates was named in actions in 16 states, making it the hardest hit among the companies named. Most of them were small brokerages.

Maryland was not one of the states involved in the original task force, but the Securities Division of the Maryland Attorney General's office filed an action seeking to bar Investors Associates permanently from selling securities in the state following complaints from residents about the company.

The customer complaints involved allegations of making unauthorized transactions, using high-pressure sales tactics, selling stocks that were unsuitable for the individual, making unnecessary trades, misrepresenting returns and other fraudulent conduct, according to Maryland's filing.

The actions varied widely in the 20 states where they were filed. They mostly involved revoking licenses or stopping the companies from doing business in the states. State securities officials, who worked with the Federal government's Securities and Exchange Commission and the National Association of Securities Dealers to avoid duplication, do not have the authority to get money back for residents. In most cases, investors will have to hire lawyers and go to court to get any money back.

Byrne, for one, said he will not forget the experience. "My personal finances are in such damage," said Byrne, who has one daughter in college and another who will begin college next year. "I guess I was just a babe in the woods.... It's been a very sobering and eye-opening experience."

BUSINESS

20 states move to stop suspect stock sellers

By Richard Melville
Reuters News Service

NEW YORK — Prosecutors and securities regulators in 20 states yesterday unveiled a series of enforcement actions intended as a crackdown on high-pressure penny-stock sales abuses by small brokerages.

Fourteen firms were named in 37 enforcement actions, officials said.

It was the biggest nationwide crackdown by state authorities against brokers selling stocks over the telephone, according to the North American Securities Administrators Association, an umbrella regulator group.

The actions, which followed an investigation that began last fall, centered on telephone sales practices that officials said were used to dupe individual investors into buying stocks.

"Reading from scripts, employees of these firms pressure their victims to buy stock in unknown companies," association President Mark Griffin said.

"Once the price is driven high enough, insiders sell the stock, making fortunes for themselves and wiping out the savings of innocent investors."

The nationwide actions were announced at the office of New York Attorney General Dennis Vacco. New Jersey Attorney General Peter Verniero also participated.

One firm cited in New York and New Jersey was Investors Associates Inc., based in Hackensack, N.J. The firm, which declined to comment, was named in actions in a total of 16 states, making it by far the hardest-hit among those named.

The enforcement actions varied widely from state to state, but in some cases temporary orders to cease business were handed down.

Oklahoma General Counsel and Director of Enforcement Gretchen Harris said her state had temporarily suspended and would seek to revoke the registration of Investors Associates, essentially halting business by the firm

there.

Helen Sprecher, an 85-year-old retired grocer from Philadelphia who appeared at the New York news conference, said she was "bilked of about \$95,000 when an Investors Associates broker sold her stake in RJR Nabisco despite orders not to and invested the proceeds in a little-known telecommunications company."

The new stock plummeted, and after her repeated demands to get her money, Investors Associates offered her a settlement of \$12,000, she said. She rejected the offer, and the case is in litigation.

Louis Poggi, a Federal Express delivery driver from Pembroke, N.H., said his life savings were wiped out in a series of unauthorized trades made by a broker at Investors Associates in Melrose, N.Y.

"What ensued was a nightmare," said Mr. Poggi, 45, who was trying to invest money for his retirement and for

college tuition for his five children. In the end, he lost about \$10,000, he said. "I was as cautious as a human being could be, and I still lost out," Mr. Poggi said.

Other firms named in more than one state were Meyers Pollack Robbins and L.T. Lawrence & Co., each cited in four states, and First Equities Corp., cited in two.

The 20 states participating in the sweep were Maryland, Alabama, Connecticut, Delaware, Illinois, Indiana, Massachusetts, Missouri, New Hampshire, New Jersey, New Mexico, New York, Ohio, Oklahoma, Pennsylvania, Texas, Utah, Vermont, Washington and Wisconsin. Additional actions are expected to result from the investigation, officials said.

"This is the overture, not the finale," Mr. Verniero said.

In the interim, he said, consumers must be aware that "an investment that seems too good to be true probably is."

<http://www.usatoday.com>


Money

FRIDAY, MAY 30, 1997

State regulators charge 14 brokerages with fraud

By Lorrie Grant
USA TODAY

Securities regulators from 20 states announced actions against small brokerages Thursday, saying they sold stocks over the telephone using dishonest sales pitches.

In the states' biggest crack-down ever, enforcement actions were filed against 14 firms as a result of the North American Securities Administrators Association's (NASAA) year-long campaign to stop fraudulent practices.

A strike force of state examiners found rampant abuses, such as high-pressure sales tactics and unauthorized trades.

NASAA says firms duped unwary investors by selling them

low-quality securities and lying about the risk. Once the stocks ran up in price, NASAA says, brokers sold the shares they owned at a huge profit, driving the price back down and wiping out investors' savings.

Hackensack, N.J.-based Investors Associates was cited by 15 state regulators. In one case, Helen Sprecher, 85, a retired grocer from Philadelphia, says she lost \$99,000. Sprecher alleges an Investors Associates broker sold her RJR Nabisco stock despite orders not to, then bought stock for her in a telecommunications firm that later plummeted.

David Sayid, a lawyer for Investors Associates, says it will cooperate with investigators and clear its name.

ON THE FRINGE

INVESTMENT GUIDE

Never open a brokerage account with a firm that calls with a hot stock. If you think we are being dogmatic about cold-calling, read about these horror stories. They could happen to you.

On Sleazy Street

By Gretchen Morgenson

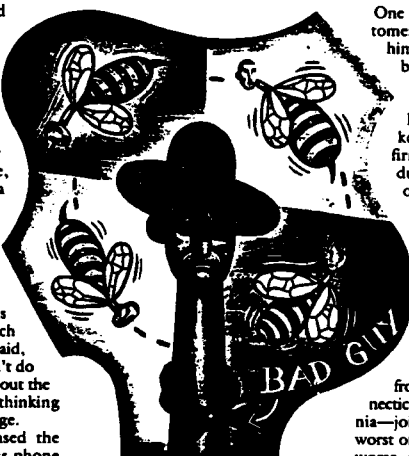
WHEN LOUIS POGGI picked up the telephone that day in June 1995, Patrick Boyce was on the line again. Boyce, from Investors Associates, had a stock tip: Universal Self-Care, trading over-the-counter at 3K. Poggi, a New Hampshire father of five, makes \$45,000 a year as a tractor-trailer driver for Federal Express and had bought stock only on a few occasions.

"I said no," Poggi recalls. "I tell you the guy was like a robot. He goes right back into the sales pitch again for the third time. I said, look, emphatically, no, I can't do it. I don't know anything about the stock." Poggi hung up, thinking Boyce had gotten the message.

Pitchman Boyce purchased the stock anyway. In a previous phone call, he had gotten Poggi's Social Security number and address—all he needed to enter the trade. Poggi had an account with Investors but had sent no money to Boyce.

When Poggi found out that he now owned 1,000 shares of Universal Self-Care, against his wishes, he told Boyce to sell it. Both Boyce and his branch manager refused and proceeded to browbeat him for payment.

"I lost it," says Poggi. "I just broke down crying. I mean, I'm up here in New Hampshire, these guys are down in New York killing me. You do this kind of stuff to someone who is your worst enemy." Poggi complained to the New Hampshire securities regulators, who sued Investors to revoke its license. After the license was revoked in April, Investors filed a motion for reconsideration.



If there were an award for bucket shop brokerage of the year, Hackensack, N.J.-based Investors Associates would win it. Three states have revoked the firm's license and another 13 are proceeding against it. Allegations: unethical practices, false and misleading statements, fraud. The firm regularly stonewalls regulators, refusing to honor subpoenas, continuing to do business without registering or in defiance of orders to desist.

Investors Associates, state regulators estimate, has relieved customers of at least \$10 million in the past two years. Its tactics are pure boiler room. A sales script recovered from a trash bin at an Investors office reads, "My prediction is in 20 minutes you'll get a 100% return in the stock."

One Investors broker had 30 customer complaints lodged against him. Was he reprimanded? No, because none of the complaints ever made it to the National Association of Securities Dealers, which supposedly keeps an eye on brokerage firms. Instead, they collected dust in a file at an Investors office. When state regulators asked the firm's compliance officer about this oversight, he said, "I have no idea why the guy is still here."

It's a never-ending battle against the cold-callers. They outnumber and outmaneuver the cops. In its ten-month-long Street Sweep, regulators from 20 states—including Connecticut, Illinois, Utah and California—joined to try to shutter the worst of them (*see table, p. 264*). It's worse out there than you think, according to Mark Griffin, president of the North American Securities Administrators Association, which coordinated the crackdown.

Says Indiana Securities Commissioner Bradley Skolnik, "For these firms, financial penalties are a cost of doing business." With mark-ups pretty much whatever they please, crooks can afford to pay penalties. In a case against Biltmore Securities, Skolnik barred the firm from selling any stocks other than those listed on one of the three major exchanges. This eliminated almost all the firm's business.

Bull markets make investors more vulnerable. They read about killings, they want in on the action. Andrew Kandel, chief of New York's Investor Protection & Securities Bureau, says that his office recovered more in

ON THE FRINGE

INVESTMENT GUIDE

finer, costs and penalties last year than in 1990 through 1995 combined. Complaints and inquiries from investors were 40% higher last year than the year before. In a 12-month period ending September 1996—the most recent figures available—state regulators like Kandel brought 7,000 enforcement actions against brokerages. The NASD brought 700, the Securities & Exchange Commission, 100. For every case brought, chances are many other victims swallowed their losses silently.

Don't be a willing victim. Information is your best friend. Don't rely on NASD material. You can get a disciplinary file from either a state regulatory agency or the NASD, but the latter's file is likely to be very skimpy. It includes only arbitration cases that have been settled and enforcement actions that have been taken. State regulators also supply information on cases pending against brokers, as well as customer complaints. And because the NASD does not recognize state sanctions against firms or individual brokers when evaluating them, a broker or firm could be sanctioned by 15 states,



and could still have NASD's stamp of approval.

Evasion of broker/dealer registration requirements is a new and growing problem. Regulators say two of the worst offenders are Meyers Pollock Robbins, with 30 branches, and Investors Associates, with 16. Another is Toluca Pacific, with 11 branches. They are basically franchisors who let out their names to independent, thinly capitalized operators. One Meyers Pollock franchisee bought his operation with an \$85,000 loan on which he paid \$30,000 in annual

interest. A branch manager told investigators: "Getting registered as a broker/dealer is too expensive and difficult, so we set up independent franchises."

Brokerage firms are supposed to tell the NASD about customer complaints. Sometimes they don't. Investors Associates had no complaints on file with the NASD for a particular branch office, but examiners found over 300 complaints at the branch during their sweep.

Even the file of 300 was incomplete, an employee explained, because "somebody broke into the branch and stole the customer complaint file." Some 90% of the complaints alleged unauthorized trading.

The 12 firms targeted in the late May sweep all use unregistered cold-callers to locate victims and bring in registered brokers (like Patrick Boyce) only to close a sale. A branch of Meyers Pollock had 90 phone banks all selling one illiquid stock from a list that included Creative Medical Development, Princeton Dental Management Corp. and SmartServe Online, Inc. A branch's phone records showed 1 million phone calls made in a month.

The scripts these frenzied phone callers use would be hilarious if they did not do so much damage. Scripted answer at First United Equities Corp. to a prospective investor who says he's not in the mood to invest: "That's what my wife said last night. You know what? This morning she thanked me."

Or this: A prospect asks for a report on the company being pitched. The cold-caller, without losing a beat, responds: "When Columbus discovered America, he didn't send a report until he actually saw the land. At that point it was history."

Now you see why we say, never, ever, ever buy a stock pitched over the phone from someone you do not know.

Wall Street's Hall of Shame

Here are the worst brokerages in America, singled out by state securities regulators in their recent enforcement actions. If a broker calls you from one of these firms, hang up.

Investors Associates Hickman, N.J. Branches: 16	
Meyers Pollock Robbins Inc. New York, N.Y. Branches: 30	First United Equities Corp. Garden City, N.Y. Branches: 1
Duke & Co. Inc. New York, N.Y. Branches: 1	17 Lawrence & Co. New York, N.Y. Branches: 1
Biltmore Securities Inc. Fort Lauderdale, Fla. Branches: 3	Toluca Pacific Securities Corp. Toluca Lake, Calif. Branches: 11

Nation

Regulators crack down on fraud

By CATHERINE CROCKER
The Associated Press

NEW YORK — The booming stock market is leading to more telemarketing scams, according to securities regulators in 20 states that are suing 14 brokerage firms for defrauding people with promises of huge returns.

"In this high-flying bull market, it's easy for swindlers to make claims of outrageous returns sound plausible," said Mark Griffin, president of the North American Securities Administrators Association.

The NASAA is a private organization representing state securities regulators who spearheaded an investigation into fraudulent stock telemarketing. On Thursday, Attorney General Dennis Vacco announced civil suits against the 14 brokerages as part of the multi-state crackdown.

The firms were charged with high-pressure calling techniques and outright lies. They also

were accused of allowing unlicensed solicitors to falsify records and conduct unauthorized trades, failing to report investor complaints and evasion of broker-dealer registration requirements.

"They're very impressive when they talk to you on the phone. Like a brother. They get you to feeling very comfortable with them," said Billy Hellums, of Roswell, N.M., who lost about \$1,500 and was on the verge of investing much more.

Brokers at Investors Associates Inc., based in Hackensack, N.J., allegedly absconded with about \$60,000, belonging to Helen Sprecher, 83, of Philadelphia. The money represented 90 percent of the money she and her husband saved from a neighborhood grocery store they owned for 40 years.

Sprecher said her troubles began when her regular broker took ill and she was contacted by another agent. "He sounded like a nice, friendly grandfatherly man," she said.

David Sayid, a lawyer for Investors Associates, said the company had no comment.

First United Equities, LT Lawrence & Co. and Meyers Pollack Robbins, all of New York City, were also named by Griffin.

First United president Douglas Traynor had no comment. The other two firms did not return messages seeking reaction.

Hellums, a New Mexico building contractor, said he invested his money with a broker from the Unicomdale, N.Y.-based Sterling Foster brokerage firm. The company did not return a phone call seeking comment.

The 20 states participating in the crackdown are: Alabama, Connecticut, Delaware, Illinois, Indiana, Maryland, Massachusetts, Missouri, New Hampshire, New Jersey, New Mexico, New York, Ohio, Oklahoma, Pennsylvania, Texas, Utah, Vermont, Washington and Wisconsin.

California, Georgia and Florida were expected to announce similar actions next month.

Ohio gets tough with brokerages

■ *One brokerage was forced to let customers cancel trades while another was denied a dealers' license.*

By Jeffrey Sheehan
Despatch Business Reporter

A California-based online discount stock broker must give thousands of Ohioans the right to cancel trades made since Jan. 1, Ohio securities regulators said yesterday.

In a separate action, Ohio and 19 other states took action against 14 securities firms with histories of high-pressure sales tactics, unauthorized trading and falsifying records.

The online broker, E-Trade Securities Inc. of Palo Alto, Calif., ran into problems with state regulators when it failed to renew its broker-dealer license that expired Dec. 31. The company has been licensed to sell securities in the state since 1992, and called its failure to renew the license an oversight.

Between Jan. 1 and March 31, the unlicensed E-Trade conducted 18,590 stock transactions and opened 1,100 new accounts in Ohio, a violation of state securities laws.

To settle the matter, the Ohio Department of Commerce's Division of Securities agreed to re-

new its license if Ohioans who bought stock through E-Trade were given the option to cancel the trades. Investors who sold stock aren't included in the settlement.

E-Trade also was required to notify customers of the agreement, and give them 30 days to respond.

"We don't consider them to be a problem broker-dealer," said Ohio Securities Commissioner Thomas Geyer, explaining the license renewal.

E-Trade also failed to renew its Nebraska broker-dealer license this year. That state fined the company \$94,000.

"I'd like to think our result was better," Geyer said. "We did something for Ohio investors and didn't just collect a fine."

In the other matter, the Division of Securities denied an application by Investors Associates Inc. of Hackensack, N.J., for a securities dealers' license.

Geyer said Investors Associates was licensed to do business in Ohio for several years. A 1997 license request was denied when a review of the application turned up 12 separate disciplinary actions against the company in other states.

"These are bad people that use high-pressure sales practices," Geyer said. "We said, 'You can't do business in Ohio because of all the problems in the other states.'"

Geyer said Investors Associates deals primarily in low-priced, little-known stocks, "and those are among the most risky securities."

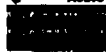
Ohio's action was part of nationwide crackdown on brokers who peddle stocks over the telephone. Securities regulators from 20 states yesterday accused 14 securities firms of violations that include falsifying records, unauthorized trading, failure to complete trades, operating without a license and using high-pressure sales tactics.

The disciplinary actions go back to last fall, when regulators who belong to the North American Securities Administrators Association decided to investigate fraudulent telephone stock sales practices.

The Hartford Courant

BUSINESSFriday
May 30

COURANT 100

OUTLOOK '97
AUDIO**States press case against broker fraud**

ASSOCIATED PRESS

This story ran in the Courant May 30, 1997

NEW YORK - Securities regulators in 20 states - including Connecticut - have begun a crackdown against 14 brokerage firms accused of making unauthorized stock trades and other fraudulent sales practices.

"They're very impressive when they talk to you on the phone. Like a brother. They get you to feeling very comfortable with them," said Billy Hellums, of Roswell, N.M., who lost about \$1,500 and was on the verge of investing much more.

Hellums and three other victims of allegedly abusive telemarketing practices by brokers came to Manhattan Thursday to attend a press conference at New York Attorney General Dennis Vacco's office announcing the crackdown.

Vacco filed civil actions against the firms, accusing them of high-pressure calling techniques and outright lies; sales practice abuses in which unlicensed solicitors falsified records and conducted unauthorized trades; failing to report investor complaints; and evasion of broker-dealer registration requirements.

Vacco was joined by New Jersey Attorney General Peter Verniero and Mark Griffin, president of the North American Securities Administrators Association.

The association, a private organization representing state securities regulators, helped to lead the investigation into the fraudulent stock telemarketing that resulted in Thursday's announcement.

North American Securities Administrators Association Web site

"In this high-flying bull market," Griffin said, "it's easy for swindlers to make claims of outrageous returns sound plausible."

"Unfortunately, far too many investors are falling for the lure of this latest trend in boiler room scams. And the telemarketers, playing upon people's desire for ever greater financial returns, have been running away with millions of dollars of hard-earned money."

Eric Wilder, an assistant director in the securities division of the Connecticut banking department, said one 24-year-old broker involved in

the scams made \$57,000 in one month alone on commissions. And that was the lowest amount the broker made in a month in a one-year period, Wilder said.

Wilder estimates that the broker made between 200 and 300 calls a day to rake in that much money.

Brokers at Investors Associates Inc., based in Hackensack, N.J., allegedly absconded with about \$60,000 belonging to Helen Sprecher, 85, of Philadelphia. The money represented 90 percent of the money saved by Sprecher and her husband from a neighborhood grocery store they owned for 40 years.

Sprecher said her troubles began when her regular broker took ill and she was contacted by another agent. "He sounded like a nice, friendly grandfatherly man," she said.

Investors Associates' outside counsel, David Sayid, said the company had no immediate comment.

Like Sprecher, many victims were senior citizens, Griffin said, and many complaints involved low-priced shares of high-risk stock.

Other New York City brokerage firms named by Griffin were First United Equities, L.T. Lawrence & Co. and Meyers Pollack Robbins. First United President Douglas Traynor had no comment. The other two firms did not immediately return messages seeking reaction.

Hellums, a New Mexico building contractor, said he invested his money with a broker from the Uniondale, N.Y.-based Sterling Foster brokerage firm. The company did not return a telephone call seeking comment.

Vacco said he had filed civil actions against First United and Investors Associates. A total of 16 states have taken action against Investors Associates, including New Jersey, which has moved to revoke the firm's registration to do business in the state.

Another alleged Investors Associates victim was Louis Poggi, 45, of Pembroke, N.H., who said he lost \$10,000, all of his savings. "I was careful as a human being can be, and they did something illegal," the Federal Express driver said.

Securities and Exchange Commission investor alert Web page

The 20 states participating in the crackdown are: Alabama, Connecticut, Delaware, Illinois, Indiana, Maryland, Massachusetts, Missouri, New Hampshire, New Jersey, New Mexico, New York, Ohio, Oklahoma, Pennsylvania, Texas, Utah, Vermont, Washington and Wisconsin.

California, Georgia and Florida are expected to announce similar actions against broker-dealer firms in the next month.

Connecticut investors who suspect that they are being targeted by a scam or just have questions should call the securities division of the banking department at (800) 831-7225 or (860) 240-8230. A copy of "Investor Alert," a pamphlet outlining the scams and tips to avoid them, is available by calling or writing the agency at 260 Constitution Plaza,

**STATE OF UTAH
DIVISION OF SECURITIES
MEMORANDUM OF INTERVIEW**

CASE & CASE #: Daniel Hernandez

DATE: Thursday, July 10, 1997

WITNESSES: Roxanne VanBeekum, Pam Redington, Ellen Bloedel, S. Anthony Taggart, Mike Mayfield

PLACE: Utah Division of Securities, Office

INTERVIEWED BY: Matt Jenkins

TRANSCRIBED BY: Roxanne Van Beekum

= = = = =

1 Hernandez: Dell computers trading at

2

3 Jenkins: Okay, go I'm sorry about this. Go ahead. Who were you again?

4

5 Hernandez: This is Dan Hernandez at Meyers, Pollock and Robbins. What I'm doing

6 today, Matt. I'm getting a call out to you over there in Kinney Circle. I

7 take it that's still your best address?

8

9 Jenkins: Yes.

10

11 Hernandez: Okay, in about a month I'm gonna give you a call back with a

12 recommendation in the market that you can use at your own discretion. But

13 Matt, right now, who you been dealing with in the market that is taking care

14 of you?

15

16 Jenkins: Uh. Piper Jaffray.

17

1 Hernandez: Piper Jaffray?
2
3 Jenkins: Yeah.
4
5 Hernandez: Great company. What was the last stock they bought you that made you
6 money?
7
8 Jenkins: Uh. Mutual funds mostly.
9
10 Hernandez: Mostly. Um, what I do here is I usually get my clients involved with stocks
11 that are 10 to 20 dollars for one major reason. We can see capital gains
12 much easier than a hundred or two hundred dollar stock. Wouldn't you
13 agree?
14
15 Jenkins: Yeah.
16
17 Hernandez: Okay what I'm saying to you is this Matt. Off the top of your head, what is
18 one of the last stocks you got involved in that did do well for you? I mean,
19 off the top of your head of course.
20
21 Jenkins: Iomega.
22
23 Hernandez: Iomega. Do you recall the price you got involved with it at?
24
25 Jenkins: No, but you know it was a long time ago. We made money.
26
27 Hernandez: Okay, you sold it already?
28
29 Jenkins: Yeah.
30
31 Hernandez: Okay, now most of my clients here, their average portfolio is between a
32 couple of hundred thousand to a few million in the common stock market.
33 A ball park figure, what do you see exposures now a days for the market?
34
35 Jenkins: Ah... well counting my pension plan and everything, I don't think I'm even
36 six digits.
37
38 Hernandez: Ball park.
39

1 Jenkins: Ah. Hundred thousand.
2
3 Hernandez: Okay, now my name again is Daniel Hernandez. A call will be getting on
4 your desk in the next couple days. When I call you back in a month, the
5 one thing I'm going to ask from you, give me two minutes of your time and
6 the same courtesy you've given me today. Is that fair enough Matt?
7
8 Jenkins: Yeah. Can I ask you a couple of questions?
9
10 Hernandez: Go ahead, speak.
11
12 Jenkins: How long have you been in the business?
13
14 Hernandez: I've been in the business for eight years now.
15
16 Jenkins: Eight years?
17
18 Hernandez: Yes. I'm the principal here at Meyers, Pollock on the seventh avenue
19 office. We have currently been in business since 1963. We co-wrote all of
20 our funds through Bears Stern. I'm sure your familiar with them?
21
22 Jenkins: Yeah.
23
24 Hernandez: Okay, in a month when I call you back I'm not going to waste your time. I
25 promise you it's going to be a stock that gonna be nothing less than
26 phenomenal. Now, Matt when you typically do start off or invest into your
27 ventures, what do typically put behind each individual stock
28 recommendation?
29
30 Jenkins: Ten to fifteen thousand.
31
32 Hernandez: Okay, I'm gonna call you back. I'm not going to waste your time, just give
33 me the same courtesy you gave me today. Is that fair enough?
34
35 Jenkins: Yes. So, hey, let me ask you a few more questions. You said you were a
36 principal or something like that you know.
37
38 Hernandez: Yes.
39

1 Jenkins: Ah, does that mean you are a vice-president or something?
2
3 Hernandez: No. A vice-president, anybody can be a vice-president. I'm part owner of
4 this firm. I have a 30 man staff that works below me. Anybody that tells
5 you their vice-principal or an account executive, it's just a fancy title to call
6 them a series 7 license broker. You follow me?
7
8 Jenkins: Yeah. So you have 30 guys. . . so you're the owner?
9
10 Hernandez: But me, I am one third of the ownership of this firm.
11
12 Jenkins: Oh really.
13
14 Hernandez: Yes.
15
16 Jenkins: Well, that's great.
17
18 Hernandez: What I'm telling you is this right now Matt. Are you familiar with a
19 company called Inso? I-N-S-O, it's a software company?
20
21 Jenkins: No, I have. . . I'm not.
22
23 Hernandez: You're not. This company came down from a high of 64 dollars a share
24 due to a loss of a contract with Microsoft for their spell check. Are you
25 familiar with that?
26
27 Jenkins: Ah, no not really.
28
29 Hernandez: Do you have a computer at your house?
30
31 Jenkins: Yeah, I do.
32
33 Hernandez: Okay, well you know when you type in, if you're doing any kind of
34 letterheads
35
36 Jenkins: (Interrupting) Oh, yeah, uh... uh... I
37
38 Hernandez: and you run a spell check that makes sure all your words are spelled right
39 and it's a, it's um, grammar wise?

1 Jenkins: Yeah. I know what a spell checker was. I just wasn't familiar with the
2 Microsoft stuff.
3
4 Hernandez: Okay, well Microsoft licensed their products for a 12 million dollar contract
5 for three years. This contract is now overdue. Now the reason why this
6 stock went to 54 dollars a share is that Microsoft is doing so much business
7 with them, that Wall Street was rumoring that there could be a buy out of
8 Inso by Microsoft. That was obviously just a rumor and after this news
9 came out with them losing that spell check, the stock came down
10 dramatically. Fact remains that it went down to 10 and three quarters. I've
11 been buying it for all my clients between ten and three quarters and eleven
12 and a quarter. I'm telling you right now, you hold this stuff for 45 days . .
13 day time frame and you are going to see a fifteen dollar stock because that
14 what its book value should be at. But what I'm telling you is that Microsoft
15 has come back to the table. They have three brand new software products
16 for the world wide web. One has to deal with the maintenance, one deals
17 with design and the third one is for the overall conception of all web site
18 portfolio, I mean, web pages out there right now. Now this contract is
19 going to exceed their previous 12 million dollar contract to be roughly 24
20 million over the next 2 years. Now, when this hits, it's not going to hit on
21 this quarter's earnings. They already reported them. Wall Street was
22 expecting 36 cents. They reported 10 cents. Stock came down almost 9
23 points in that one individual day of trading. Now, in the third quarter of this
24 year you are going to see this Microsoft contract come through and this is
25 where we are going to see the stock, I'd say conservatively 15, 16 in the
26 next three to four weeks of trading. I think in two to three months we are
27 going to see the stock back at 25 to 30 dollars a share. Now let me ask you
28 this. How many times have you gotten involved with bottom floor um. . .
29 situations before?
30
31 Jenkins: Well, I've never had a stock that made that much money.
32
33 Hernandez: You never have?
34
35 Jenkins: Well no! That's a double.
36
37 Hernandez: What I'm telling you is this, it's not going to happen in a week or two
38 weeks like an initial public offering. But I'll tell you right now, you show,
39 let me show you what I can do for you. . I'll get you involved with the

1 stock right now at ten and seven eighths. It's going to be nothing less than
2 a 15 dollar stock. In about three weeks, I'll show you in two to three
3 months about a 25 to 30 dollar company.
4
5 Jenkins: What are the risks involved in this stock?
6
7 Hernandez: Well, the risk involved was this. It's ten percent of your overall downside.
8 I make sure all my clients have a downside covered before they even get
9 involved with a stock. And that is ten percent of what you own it at. If this
10 stock would ever go below ten percent of what you originally own it at, I
11 will automatically sell you out and the maximum loss is ten percent. But
12 I'm telling you this much right now, when this stock is 13, 14 dollars a
13 share you're comfortable with me, more important, you know that I know
14 how to buy stocks, I think I might want you to step up and own a larger
15 position so that when the stock does go to 25, we're not just going to see
16 maybe a 5, 10 thousand dollar gain. 20 to 35 thousand dollars in profit. Let
17 me make a recommendation to you, if what you get involved in a very
18 conservative manner here of a thousand shares at these levels, vacation
19 investment of a touch under 11 thousand dollars, now I'll get you a standard
20 confirmation from Bears Sterns on your desk tomorrow, along with
21 information about my firm, Meyers, Pollock and Robbins and myself,
22 Daniel Hernandez.
23
24 Jenkins: How do you spell that?
25
26 Hernandez: Meyers, Pollock and Robbins?
27
28 Jenkins: No, Hernan . . Daniel Hernandez?
29
30 Hernandez: H-E-R-N-A-N-D-E-Z.
31
32 Jenkins: And it's Daniel, Dan?
33
34 Hernandez: Daniel, I prefer.
35
36 Jenkins: So D-A-N-I
37
38 Hernandez: E-L.

1 Jenkins: Okay, so uh now. . your talking now um. .
2
3 Hernandez: Can't start you out at under 11 thousand dollars.
4
5 Jenkins: Yeah but, you know, I mean, I'm not so sure if I'm really, you know, ready
6 to make a decision because I don't know who you are or anything like that,
7 you know. Can you tell me a little bit about yourself?
8
9 Hernandez: Okay, I'll tell you a little bit about myself. I used to work for a company
10 called Harriman Group Incorporated. H-G-I Incorporated. You familiar
11 with the company?
12
13 Jenkins: Yeah.
14
15 Hernandez: Okay. This company when I was working there, um, I came in on the
16 ground floor and I helped build that business. I brought in about 32 licensed
17 brokers and about 25 cold callers which I'm sure you probably get every
18 single day. Am I right, cold calls?
19
20 Jenkins: Yeah.
21
22 Hernandez: Well..
23
24 Jenkins: Well, no I don't get 25 cold calls a day, I mean . .
25
26 Hernandez: but what I'm saying is you're getting this type of a presentation brought to
27 you every day.
28
29 Jenkins: Well, no not really.
30
31 Hernandez: Okay, what I'm saying to you is this Matt. Um the reason why I left that
32 company is that . . . are you familiar with the company called Stratton
33 Oakmont?
34
35 Jenkins: Uh, no.
36
37 Hernandez: Okay, this company went out of business for breaking out fraudulent initial
38 public offerings. When they brought over principal from this old firm, I
39 then had an opportunity to come here and open up this branch office on 3-6-

1 3 Seventh Avenue. Which is where my office is located right now.
2
3 Jenkins: So how, what city?
4
5 Hernandez: In Manhattan, New York.
6
7 Jenkins: Manhattan, New York. So how long have you had that office?
8
9 Hernandez: This office. I've only been here for two months now. I recently came over
10 H.G.I. Incorporated. I stayed with them till close down. I helped them with
11 the bank, the bankruptcy proceedings. Once I found out that that was all
12 done with and I could get my license over here, I ran and jumped at the
13 situation.
14
15 Jenkins: So how long have you been a broker?
16
17 Hernandez: I 've been a broker for seven years.
18
19 Jenkins: Seven years?
20
21 Hernandez: Yes.
22
23 Jenkins: What, What, wait a minute, I couldn't, I didn't hear you.
24
25 Hernandez: I've been a broker for seven years, I've been in this business for eight years.
26
27 Jenkins: Oh, okay. So did you go to college?
28
29 Hernandez: Yes, I did. I went to Suni Farmingdale. What I'm telling you is this, my
30 knowledge right now of what I can do for you,
31
32 Jenkins: Wait a minute, what did you major in? I want to see how bright you are.
33 Alright, I mean, did you major in Finance or business or some ...
34
35 Hernandez: I majored in finance and computers.
36
37 Jenkins: Did you graduate?
38
39 Hernandez: Did I graduate? Of course I did.

1 Jenkins: Okay, so you have a bachelors degree.
2
3 Hernandez: Yes, I do.
4
5 Jenkins: Okay, so could you send me some information on this stock.
6
7 Hernandez: On this stock?
8
9 Jenkins: Yeah. I'd like, I mean, I don't know who you are. Is there anything else
10 you could tell me that would make me feel good about ...
11
12 Hernandez: Let me ask you, what do you do right now. What do you do for a living?
13
14 Jenkins: Oh, I do some bookkeeping, I, I uh you know, just bookkeeping.
15
16 Hernandez: Do you own the company of your bookkeeping?
17
18 Jenkins: Well, yeah, uh-huh.
19
20 Hernandez: Okay, now what I'm saying to you is this. I typically never open up
21 accounts with clients that have never men at my stature. I have men that
22 always do at least, at least a hundred thousand in gross for themselves every
23 single year because these type of individuals they can understand the
24 recommendations I bring to them, more importantly, when they get
25 involved in my stocks, especially when they are buying stock, I don't like to
26 make you know five, ten thousand dollars for people, cause that doesn't
27 change anybody's lifestyle. When you get comfortable with me, what I
28 recommend is I typically buy stocks between blocks. Are you familiar with
29 a block of stock?
30
31 Jenkins: No, not really.
32
33 Hernandez: These are ten thousand increments. They are of. Now when you get a
34 comfort level with me when I'm showing you consistent performance, my
35 clients have comfort ability dealing with me in this size. What I'm telling
36 you is this right now, I want to send you information on Inso. I could fax it
37 over to you right now, but what I'm telling you, the information you are
38 going to see on it is nothing to jump for. That's why people are not buying
39 that much. But over the last three to four trading sessions this stock is ove .

1 ... has exceeded its average daily volume. Has actually hit nine million
 2 shares traded last Thursday, was two million shares this past Monday. It
 3 traded over a million shares typically on any given day with this news
 4 coming out.
 5
 6 Jenkins: So how old are you?
 7
 8 Hernandez: 27 years old.
 9
 10 Jenkins: 27?
 11
 12 Hernandez: Yes.
 13
 14 Jenkins: Huh.
 15
 16 Hernandez: How old are you?
 17
 18 Jenkins: Um, 38. I really would like you to send me some information first. Let me
 19 get the information about your company, uh, let's just go with what we
 20 were going to do earlier when you said you were going to send me some
 21 stuff and call me back in a few months. That way I can read about you,
 22 read about your firm, get warm fuzzy feelings about how good you guys are
 23 and let's go with that so then you call me back like you were going to after I
 24 read the stuff you were going to send me.
 25
 26 Hernandez: Okay, I understand. But this is stuff we're going to send you is gonna be a
 27 business card of myself. You're going to see a brochure on my firm, that
 28 information that I send you is just going to, just ... take a broom in your
 29 file cabinet right now. What I'm telling you is this; you're a young guy, am
 30 I right?
 31
 32 Jenkins: Yeah.
 33
 34 Hernandez: You've seen success in the market. Now right now this is when your most,
 35 you're gonna see this market in the next six to eight months probably
 36 consistently do well. And if I call you back in a month or two months,
 37 you're gonna waste about, you're only gonna only have about five or six
 38 months to see this bull market run. I think in the 9 to 12 month period you
 39 are going to see this market slow down, I think you might even see the

1 bears come out and we're going to see this market slow down if not come to
 2 a down trend. What I say to you is this, I get involved with mostly
 3 NASDAQ and small cap issues for one major reason, I can control block
 4 trading and I can negotiate the stocks that I get my clients involved with.
 5 Now, when you buy a block of stock, you have institutional negotiating
 6 power. Do you know what that means?
 7
 8 Jenkins: I, I guess it means you're a big player?
 9
 10 Hernandez: No, I don't count myself. What I'm telling you is this, when you are buying
 11 blocks of stock you can get sometimes filled in between the bid and the
 12 offer. That's what an institutional trade can do for you as a private investor.
 13 What I'm saying to you is this, this stock is 10 and seven eighths. I'm not
 14 going to waste your time, the information I send you is gonna be mediocre.
 15 I'll send you enough to choke a horse. But you give me a small shot, show
 16 a little bit of confidence, one percent of it. The next two or three weeks I'll
 17 earn the other 99 percent.
 18
 19 Jenkins: Well, what I want you to do though, is I want you to send me the stuff like
 20 you were originally going to do.
 21
 22 Hernandez: I know what you want me to do. And I'm gonna do that for you.
 23
 24 Jenkins: Great I appreciate you sending it to me.
 25
 26 Hernandez: But what I'm telling you is this, what I want you to do is this; I'm the
 27 broker here, I only work on two situations, pricing and timing. It's the only
 28 tools that I come to the office with. Without these tools I'm nothing. So
 29 what I'm saying to you is this, you give me a shot here, I know you could
 30 step in on something, it's a joke, it's not even 11 dollar stock. How bout
 31 this, I'll make a recommendation that I know could be, you know,
 32 something that would be very simple for you and something very easy for
 33 me to do to gain a comfort level of yourself. You take a 500 share position
 34 of this stock, very mediocre, cash outlay, less than fifty six hundred dollars,
 35 You give me three weeks, you research myself and my company, once you
 36 feel comfortable with the decision you made today, I'd like to see you own
 37 at least a 3 to 5 thousand share position in this stock. Does that sound fair
 38 enough to you?
 39

1 Jenkins: I still want you to send me the information first.
2
3 Hernandez: Okay, it's in the mail already. I'll have my assistant mail that out the
4 second we get off this phone Matt. Let me ask you this, what information
5 do you want to see on me that's going to make you comfortable to buy
6 stock from me?
7
8 Jenkins: Well, you already told me about your education, you've been, you know,
9 how long you were a broker. And I'm very impressed that you own a third
10 of the company.
11
12 Hernandez: Well, that doesn't impress me. Why would that impress. . . if you were so
13 impressed you would say, you know what Dan, let's take five thousand now
14 and let's go to work.
15
16 Jenkins: You always like working with the owner, you know what I mean?
17
18 Hernandez: Understandably, because I'm not one of these board room brokers that gets
19 second hand news. I'm the one that's giving them that news. And what
20 I'm telling you right now, is when I'm showing you that I'm buying stocks,
21 I buy stocks for strictly institutional traders. I deal with men on the street
22 that don't take orders for less than 50 to a hundred thousand dollars. Do
23 you understand what I'm saying?
24
25 Jenkins: So why are you dealing with me?
26
27 Hernandez: Why am I dealing with you Matt, you told me you deal with Piper Jaffray,
28 am I right?
29
30 Jenkins: Yeah, but I don't have 50 to a hundred thousand at a pop.
31
32 Hernandez: You told me you put 10 to 15 into an idea, right?
33
34 Jenkins: Yeah, but that's not . . .
35
36 Hernandez: If I was showin' you three to four times that I was making you 7 to 8
37 thousand off these 10, 15 thousand dollar transactions, I think at one point
38 in time you're gonna give me a shot to show you that a 50 thousand dollar
39 order is going to be in your best interest, am I right?

1 Jenkins: If you do well, yeah.
2
3 Hernandez: That's my whole point here. But if we don't have a track record to speak of
4 and we keep running around the block chasing each other around, what the
5 hell's going to change between now and then?
6
7 Jenkins: Not much. But I still want you to send me the information first.
8
9 Hernandez: We're gonna get the information out to you. First? I don't know about
10 right now. I have you on the phone Matt. I know you know how to make
11 decisions. You're a bookkeeper, correct?
12
13 Jenkins: Well, yeah, but I just do, you know, bookkeeping.
14
15 Hernandez: Okay, let me say this to you, if you took a six thousand dollar investment
16 and I showed you a 4 thousand dollar profits in about a 45 day time frame,
17 would you send me 15 to 20 on my next idea, if you loved it?
18
19 Jenkins: Yeah.
20
21 Hernandez: Okay, now if I call you back in a month, Inso's gonna be 17, 18 dollars a
22 share and you're not gonna own it. It's kinda like if you and I go to the
23 horse track today, I give you a bet on a horse, if it hits, you're most likely
24 gonna ask me for my next horse, am I right?
25
26 Jenkins: Well, what's the biggest risk with Inso?
27
28 Hernandez: What's the biggest risk - it's got a 10 percent.
29
30 Jenkins: Okay, on the downside you were talking about.
31
32 Hernandez: That's it.
33
34 Jenkins: Okay.
35
36 Hernandez: Six hundred dollars of your. . .
37
38 Jenkins: Again, again, I want you to send the information first 'cause I don't know
39 you. I still want you to send it to me if you will please send it to me first.

1 And then I really would like to hear back from you.
2
3 Hernandez: I understand that.
4
5 Jenkins: I, I, you know, it sounds like you've got great ideas all the time, I know I'm
6 gonna miss this one, but will you please call me back with the next great
7 one?
8
9 Hernandez: Now, can I tell you, I've been in business for eight years, um, I can
10 appreciate your sarcasm, but let me say this to you, you haven't done
11 business with me. You don't, you don't know anything of what I can do for
12 you. All you think you can do is assume. Only way you're going to know
13 what I know is if you get involved with me today. What I'm telling you is
14 this, I want you to take a small piece, Matt. I want to see you own this
15 stock because when it goes to 17, 18 in a one month time frame, when I do
16 call you back, if you don't own it, it doesn't mean shit to you. Am I right or
17 am I wrong? Excuse my french.
18
19 Jenkins: Yeah, you're right.
20
21 Hernandez: Okay, so my point being, is I want you to own something here so when it
22 does go to 17, I have credibility, and you and I, we have a track record to
23 speak of. Now Matt, we've been on the phone for 15 minutes squabbling
24 back and forth. I'm gonna get you all this information. Bears Sterns has
25 been in business since 1923. All of our funds are cleared through them.
26 My company, Meyers, Pollock and Robbins, with 54 branch offices around
27 the United States, we've been doing business since 1963.
28
29 Jenkins: How many branches do you have?
30
31 Hernandez: 54.
32
33 Jenkins: 54 branches.
34
35 Hernandez: Yes.
36
37 Jenkins: Huh. Okay, I still want you to send me the information first.
38
39 Hernandez: Matt, I'm gonna get you that information. While I'm telling you I get you

1 executed and you see the traders that I deal with, I'm not gonna be the guy
2 that gets you in on market orders, I'll be getting you stocks that are
3 probably getting in fold between, in between. Am I going to do that every
4 time for you? I doubt it. But I know when you work with me on my timing
5 and pricing, I'm gonna work as hard as I can to do that for you. Now Matt,
6 this information that I send to you, I can appreciate that, we don't have a
7 track record, more importantly, you're not to comfortable yet. But
8 honestly, if I was your broker, somewhere over the last few years, I showed
9 you consistent winners, not 15, 10, 15 percent like a mutual fund but 40, 50
10 to 60 percent on your money, I know you'd be a buyer today. Right?
11
12 Jenkins: Yeah, but again, I still want you to send the stuff first.
13
14 Hernandez: Can I tell you what happened? I remember, it was two years ago, about a
15 company that IBM was looking at, are you familiar with Lotus?
16
17 Jenkins: The spreadsheet people?
18
19 Hernandez: Pardon me, yes.
20
21 Jenkins: Okay, yeah.
22
23 Hernandez: Okay, Lotus was, on a Friday was trading at 31 and three quarters. I was
24 prospecting for clients because I heard something from one of my
25 downtown traders, Mike Richter, and I, he told me that Lotus, there looked
26 to be a tender offer coming through from some big blue chip. We didn't
27 know what it was, but he's been doing very good by me and I called up all
28 my prospective clients and told them to get involved. The clients that knew
29 I was a real guy, they got involved. The men like you who wanted
30 information to see what it was about first, when Monday came around and
31 they saw the first tick on the Dow Jones tape that Lotus was taken over by
32 IBM at 64 dollars a share, I would never do business with them because
33 they didn't take me on my timing and pricing, but the guy that took a small
34 piece and they showed me that they had confidence in what I could do for
35 them, they right now are my biggest clients today. Now I'm telling you this
36 right now, I'm expecting Inso to pop in the next two to three days. I want
37 you to take something here, honestly Matt, what was the smallest account
38 that you have ever opened on a first trade?
39

1 Jenkins: Well, I'm not going to do anything because I still want you ah, to send me
 2 the information first.
 3
 4 Hernandez: You're gonna have three to five days to review all the information about
 5 myself, my clearing agent, what we've done for our regular clients, and
 6 your going to get that in a federal express package before 12 o'clock
 7 tomorrow. Now, you're gonna have three days to read this, you could do
 8 research in the computer in one day if you really had to, right or wrong?
 9
 10 Jenkins: I don't know.
 11
 12 Hernandez: You don't know?
 13
 14 Jenkins: I mean I'm not that savvy, I'm not that bright.
 15
 16 Hernandez: Savvy, bright, you have a computer, you go on line, you start asking
 17 questions. I'm on it every single night.
 18
 19 Jenkins: Well,
 20
 21 Hernandez: I'm talking to my Australian clients.
 22
 23 Jenkins: Why don't you send me the information and then why don't you call me
 24 back uh, tomorrow, or afternoon after I have it.
 25
 26 Hernandez: Tomorrow afternoon after you have it?
 27
 28 Jenkins: Yeah.
 29
 30 Hernandez: Okay, can I tell you this right now, I'm not here to chase you around in your
 31 bookkeeping, I know you have better things to do than talk to stock brokers
 32 all day long. See what I do is this, when I get people like you on the phone,
 33 I know you don't have a comfort level. You're in Utah, right?
 34
 35 Jenkins: Right.
 36
 37 Hernandez: I'm in Manhattan, New York.
 38
 39 Jenkins: Uh-huh.

1 Hernandez: There's about a two hour difference between you and I and more
2 importantly much more miles, am I right?
3
4 Jenkins: Right.
5
6 Hernandez: Now what I'm saying to you is this, the guy you deal with at Piper Jaffray,
7 is he local or is he here in New York?
8
9 Jenkins: Local.
10
11 Hernandez: He's local. Now, he probably does his own research, but where do you
12 think he gets his information from.
13
14 Jenkins: I don't know.
15
16 Hernandez: You don't know do you. I can almost guarantee you, all the information he
17 gets comes from some source here in Manhattan. This is the financial, this
18 is where the market is. I probably hear more ideas in the morning going
19 down to have coffee than he hears in an entire week. By the time we go
20 home here on Wall Street, absolutely not, but I think I'm showing you 30 to
21 40 to 50 percent on your money, you're going to know I'm the right guy
22 that you're dealing with. What I going to make it to you is this Matt, I want
23 to see you own the stock. I don't really give a shit how much you own.
24 You take 300 shares now, on my timing and pricing, change outlaid about
25 thirty-three hundred dollars. It's gonna be there in about four days, when
26 you see the information on your desk tomorrow at 12 o'clock, then I want
27 you to pick up the other 700 shares. Matt, how do you typically title your
28 accounts? Do you set this one up as individual, joint with your wife, or do
29 you do them corporately?
30
31 Jenkins: What I do is I wait till I get the information from you then I want you to call
32 me back and then let's discuss it.
33
34 Hernandez: Let me ask you one question, are you familiar with one of the New York
35 firms called E.F. Hutton?
36
37 Jenkins: Eh, uh, that sounds familiar.
38
39 Hernandez: Okay, E. F. Hutton, do you know what they are very well known for?

1 Jenkins: Uh, yeah, no, uh no.
2
3 Hernandez: Okay, they had some of the top analysts on Wall Street and whenever they
4 spoke to prospective clients, they got them 20 pages of research on
5 themselves, on the company they were looking at, and a business plan for
6 the next six to twelve months. Do you know what that company is doing
7 today?
8
9 Jenkins: I don't know.
10
11 Hernandez: They are looking at guys like me making money for my clients because
12 they are out of business. Their overhead was too strong. What I'm telling
13 you is this, I'm going to send you information, I'm not going to send you
14 enough information on Inso to choke a horse, but what I'm telling you is
15 this, I'll get you that information. I'll make sure it's thorough if you have
16 an account with me. I don't waste my time. I've already spent 25 minutes
17 with you. That time is money out of my pocket. Let's make it worthwhile.
18 I'm not here to make a commission off you first time around. I will charge
19 you a hundred dollars in and out of this stock. Write that down. When you
20 see I'm exactly right and this stock's trading higher, I'll only charge you
21 fifty dollars to buy more. Is that fair enough?
22
23 Jenkins: Again, unless you're willing to send me the information and I get a chance
24 to review it because you are so far away, I'm not going to do anything.
25
26 Hernandez: Matt, you know what, I like guys like you because men like you really
27 never dealt with a New York broker, so you really have no idea what
28 opportunity you are leaving behind right now. But you come into business
29 for one reason and one reason only; and that was to make money, am I
30 right?
31
32 Jenkins: Right.
33
34 Hernandez: Kay, that's why I'm at work right now and that's why I'm speaking to my
35 clients. Now me charging you a hundred dollar commission, how much
36 money do you think I make off of that?
37
38 Jenkins: I don't know, you own part of the firm.
39

1 Hernandez: What I'm telling you is this, I pay my secretary the hundred dollars just to
 2 get this account open, send the FedEx out to you, I don't need you to make
 3 money. Two to three years down the line when you do have real money
 4 with you, yeah, that's when I'll make my commissions off you. I have
 5 clients that have been with me for five or six years now. My commissions
 6 are made off of them. I don't need little guys like you to make money off
 7 of. I build guys like you up to be hundred, two hundred thousand, quarter
 8 million dollar accounts in six to seven months. I know in two to three years
 9 when you have a seven figure portfolio over here, all the problem you are
 10 going to have with me, Dan Hernandez, today, is that you didn't know me
 11 three years ago and you didn't step in and buy five thousand shares. Now
 12 Matt, stop jerking your chain and my chain and let's get this account open
 13 and get the ball rolling.
 14
 15 Jenkins: Let's send the information to me and let me review it and let's make a
 16 phone call.
 17
 18 Hernandez: Do you have a fax machine?
 19
 20 Jenkins: No, I don't.
 21
 22 Hernandez: You don't have a fax machine? .
 23
 24 Jenkins: No. It's in my computer at home and I'm not there. I really run a small
 25 business. I just do a little bookkeeping.
 26
 27 Hernandez: How much do you make a year? Ball park . .
 28
 29 Jenkins: Oh, 40 thousand.
 30
 31 Hernandez: You make 40 thousand dollars a year?
 32
 33 Jenkins: If it wasn't for my mother and father dying and leaving me money, I
 34 wouldn't have anything to invest.
 35
 36 Hernandez: Oh, um, my condolences to that. How much did they leave you?
 37
 38 Jenkins: All the money that I have invested.
 39

1 Hernandez: What's that, about a hundred?
2
3 Jenkins: Yes.
4
5 Hernandez: Okay. And did you inherit the account with Piper Jaffray with that?
6
7 Jenkins: Yes.
8
9 Hernandez: Okay, what are they doing for you? Are they pretty much holding you in
10 trustee and just watching you for long term or have they gotten you some
11 speculative stocks before?
12
13 Jenkins: They are mutual funds.
14
15 Hernandez: Okay, can I tell you one thing right now? I want you to do one thing for
16 you, I want you to set up a competitive account. I want you to start up a
17 very conservative account here on a very conservative basis so I can show
18 you aggressive returns. I know when I'm doing this for you, even if your
19 still not comfortable with the first couple of trades, when I'm showing you
20 that I'm exactly right every time, you're going to working sides with me.
21 And I think in four to five months that Piper Jaffray account will be non-
22 existent and you're going to have a broker here in New York that's
23 maintaining your account and all your friends' accounts. But we can't do
24 that, unless we have nothing to work with here. Let me say this to you
25 Matt, if you had a, if you had a 3 thousand dollars, that showed you 2
26 thousand dollars in profit in the next 45 days, I have a feeling you're going
27 to send me 10 to 15 on my next one. And the information I send to you,
28 believe me it's, when you see it all in black and white in the Federal
29 Express package and you're looking at it all spread out on your desk and
30 you see every single piece of information I told you was fact; then you're
31 going to be comfortable.
32
33 Jenkins: So you're going to send me the information?
34
35 Hernandez: I want to send the information, but what I want to do is this. I want to get
36 you a confirmation of you owning Inso. Anything under 11 dollars a share
37 is a steal.
38
39 Jenkins: You're gonna send me the information, then you're gonna call me back

1 right?
2
3 Hernandez: I want you to get involved with this stock today so when I can tell you that
4 my timing and pricing is everything and not just bull-shit. . .
5
6 Jenkins: I, Okay, I uh, I'll give you a hint, if I have to buy it tomorrow at 12 bucks a
7 share, I won't blame you.
8
9 Hernandez: Well, Matt, I don't care if you blame me. My job is very, very simple. I
10 am to buy you stocks when the timing is right, not on your timing and
11 pricing because if you want to buy stocks on your timing and pricing you're
12 going to make 10, 12 percent like every other investor out there. Every
13 investor in America looks for guys like me that can buy stocks two to three
14 weeks before Wall Street has the attention on it and before the stock is up
15 13, 14 percent. Now you add 13,14 percent on top of the 30, 40 percent that
16 we're already making on it, that's how real Wall Street brokers work. I'm
17 not gonna buy stocks when you're ready. I buy stocks when I'm ready.
18
19 Jenkins: But, Dan, I really, . . .
20
21 Hernandez: Give me a commission.
22
23 Jenkins: Dan, I think you need to send me the information. I want to review it, I
24 want
25
26 Hernandez: In the mail.
27
28 Jenkins: And I want to hear back from you but I'm not going to do anything until
29 then. He hung up.
30
31 Jenkins: (Off Line) Okay, the gentleman just hung up on me. Right now I'm in the
32 presence of um, at my office Securities Division of Utah, uh, it is 11:19,
33 July the 10th, 1997. Present for the phone call is myself, Roxanne, Pam,
34 Ellen for part of it, Tony Taggart for a good chunk, and Mike Mayfield for
35 a part of it also.



NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.

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June 2, 1997

Ms. Belinda Blaine
Senior Special Counsel
Division of Market Regulation
US Securities and Exchange Commission
450 5th Street, NW
Washington, DC 20549

Re: Submission to SEC for Mandated Study under the National Securities
Markets Improvement Act on the Uniformity of State Licensing
Requirements of Associated Persons of Registered Brokers and Dealers.
("Uniformity Study")

Dear Ms. Blaine:

The North American Securities Administrators Association, Inc. ("NASAA")¹ appreciates the opportunity to make a submission to the US Securities and Exchange Commission ("SEC" or "Commission") for consideration by the Commission in meeting its reporting obligation under the National Securities Markets Improvement Act ("NSMIA") regarding state licensing requirements of associated persons of registered brokers and dealers.²

All states are fair, efficient and uniform in licensing agents. While maintaining uniformity, state licensing procedures are also designed to meet regional needs of given jurisdictions. History has shown that the states' role in agent registration review has provided a viable vehicle to identify and screen out those individuals who present a serious risk to the public but would otherwise become automatically licensed. The states' "EARLY DETECTION" program is based on a fundamental principle that it is more efficient, both from a cost and enforcement perspective, to prevent unscrupulous persons from entering the industry rather than attempting to remove them once harm is done.

¹ In the US, NASAA is the national voice of the 50 state securities agencies responsible for investor protection and the efficient functioning of the capital markets at the grassroots level.

² State statutes generally refer to associated persons as either agents or registered representatives.

President: Mark J. Griffin (Iowa) • President-elect: Bruce Velt Crawford (Texas) • Secretary: Adrienne Wamsell (British Columbia) • Treasurer: Deborah R. Barner (Washington)
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Outstanding: Robert M. Lam (Pennsylvania)

NASAA believes that systematic fraud within firms is facilitated by associated persons; that actions against firms are only part of the investor protection equation. The other part is to deny licenses to those individuals contributing to the wrongdoing within their respective firms. Without such oversight, individuals with significant disciplinary history and those with recent regulatory problems, would be continually re-licensed and able to do additional harm to the investing public.

In evaluating state licensing requirements two key components may be considered: state processing requirements and state substantive requirements. Both of these components will be discussed below.

I. AGENT LICENSING - STATUTORY AND REGULATORY AUTHORITY

State securities statutes mirror either the Uniform Securities Act of 1956 (the "1956 Act") or the Revised Uniform Securities Act of 1985 (the "1985 Act"), with the statutes of Arizona, Florida, Illinois, New York, Ohio and Texas unique in certain aspects with respect to both the 1956 Act and the 1985 Act, although their statutory provisions for licensing sales agents closely track both acts and all states use the Central Registration Depository ("CRD") for the processing of the licensing applications. The authority of a state to require occupational licenses, including the licensing of persons who offer services to its citizens, is a fundamental state function tied to the police powers of a state.³ All states, however, even those with unique provisions in their statutes, are uniform in the manner in which they license agents: all licenses are processed using the CRD;⁴ all states require the same form, Form U-4, as the only application for licensure; all licenses expire on December 31 of each year and;⁵ all states process applications efficiently. A more detailed discussion of these and other uniform state licensing processes and requirements is set forth within.

State licensing authority over securities agents is exercised in several different instances. State licensing authority is invoked when a state receives new applications of persons initially entering the industry, applications of agents already in the industry who seek renewal of their license, or applications evidencing an agent's choice to re-

³ See Exhibit A, Memorandum Regarding Constitutionality of State Licensing Authority.

⁴ A de minimis number of intrastate agents that are not NASD members do not have their licenses processed through the CRD.

⁵ All states have one year licenses with the exception of New Jersey (N.J. STAT. ANN., as amended, §13:47A-5.1) which has a 2 year license and Michigan (MICH. COMP. LAWS, as amended, §451.601(e) (1979)) where a license is effective "until it is withdrawn, terminated, revoked, or canceled."

affiliate with a new broker-dealer firm (this process is generally referred to as a "transfer").⁶

As will be explained more fully within:⁷

- Renewal applications for agents, which represent approximately 66% of all applications, are approved immediately by all states upon the proper filing with the CRD by the broker-dealer of a single application and an electronic fee payment.
- Applications for agents re-affiliating with another broker-dealer and containing no disciplinary history or reportable events, which represent approximately 4% of all applications, are also approved immediately by all states when the applications are processed by the CRD.
- Approximately 10% of all applications received by the states each year are approved immediately because they contain no disciplinary history or reportable items.
- State review is necessary for less than approximately 20% of the total number of applications received by the states each year.

A frequently quoted statistic reveals that approximately 90% of all licensed agents have no reportable events;⁸ therefore, state review and licensure is quite rapid and predominantly occurs within 24 - 48 hours.⁹ Based on the universe of securities agent applications filed each year, states efficiently process agent applications and effectively apply substantive criteria. If an agent application contains disciplinary history or reportable events, state securities agencies provide the value-added service necessary to protect the investing public. (See § III. B., The Substantive Review Criteria Applied by States to Applications, *infra*.) A state has the greatest and most direct interest in protecting its citizens.

⁶ The NASD Rules require that an agent's license be maintained by a broker-dealer registered with the NASD. An NASD firm is not permitted to maintain an agent's license once the agent's employment is terminated. When an agent leaves employment with one firm and associates with another, an updated application disclosing the association with the new firm is required. State statutes parallel this NASD requirement. See Registration of Representatives, NASD Manual, Schedule C to the By-Laws, Part III, (CCH) para. 1785 (1994); UNIF. SEC. ACT §201(b) (1956).

⁷ See Exhibit B, Total Agent Applications Filed with the States in One Year.

⁸ "Out of a universe of approximately 485,000 registered individuals, 50,000 individuals were initially selected because they had reportable incidents noted on their Form U-4." SEC, Report on the Joint Regulatory Sales Practice Sweep, at p. 3 (1996).

⁹ See Exhibit C, New Applications Filed with the States in One Year.

II. AGENT LICENSING - ELECTRONIC PROCESSING AND SUBSTANTIVE CRITERIA

A. Development of the CRD system and User Expectations

On June 20, 1980, NASAA and the NASDAQ, Inc. ("NASDAQ") entered into an agreement for the development of the CRD system. The premise behind the development of the CRD was the commitment by NASAA and the National Association of Securities Dealers, Inc. ("NASD") to create a central electronic database that would process a single uniform application for the registration, transfer, renewal or termination of a securities agent. A one-stop electronic database benefits state securities regulators and the investing public by establishing a comprehensive archive of registered agents that can be used by states as a proactive regulatory tool. In addition, the CRD system provides regulatory efficiency as well as great cost savings to the industry.

Prior to the implementation of the CRD in 1981, multiple and redundant paper applications were required by the states to become licensed as a securities agent in multiple jurisdictions. Advancements in technology, the NASD's commitment to expand its membership services and the states' desire for a more efficient licensing mechanism led to the development of a centralized registration system, the CRD. At that same time, states were provided an opportunity to reevaluate the need for the information they requested, the format of the information they requested, and the timeliness of their access to such information. As a result, a securities agent presently can submit a single application to the CRD system that will be electronically forwarded directly to those states where the agent is seeking licensure without any further initial paperwork being required to be sent to the states.¹⁰ In addition, prior to the CRD, separate fee payments had to be made to each state by an applicant. Now, a single electronic payment can be made to a central location which is allocated to the states as required.

When first implemented, the CRD provided for fifteen initial performance functions¹¹ to generally allow for the licensing, renewal, termination and transfer of

¹⁰ See Exhibit D, Memorandum from National Regulatory Services, Inc. to NASAA Regarding the Use of a Single Form by States for Broker-Dealer Agent Licensing.

¹¹ The first fifteen performance functions implemented on the CRD included: For initial applications; the receipt, recordation and dissemination of information contained on the uniform registration form and fees owed to the states, the performance of a ministerial review of each application for accuracy and completeness, the validation of certain disclosures on the application against archived disclosures and the dissemination of the findings of this edit to the states and the validation that

securities agents through the use of uniform forms and a centralized process. Those forms continue to exist today and are the accepted documentation by the states, the SEC and the self-regulatory organizations (the "SROs"), although modified over time to accommodate revised regulatory and industry needs. The forms include the Form U-4 (Uniform Application for Securities Industry Registration or Transfer), the Form U-5 (Uniform Termination Notice for Securities Industry Registration) and the Form U-6 (Uniform Disciplinary Action Reporting) to be used only by regulators and SROs.¹²

Over the next few years, the initial 15 performance functions were supplemented to expand the functionality of the CRD to accommodate a more efficient transfer process for agents without disclosure items (i.e., the Temporary Agent Transfer Program) and the registration, renewal, termination and reorganization of brokers and dealers. However, subsequent enhancements to the CRD did not keep pace with the demands placed on the system, including its use as a regulatory tool by federal and state regulators and the SROs. Although the CRD has provided a proficient licensing mechanism for the past 16 years, states have experienced a significant reduction in the responsiveness of the system in part due to the increasing amount of data maintained by the system. (See § V., The Growing Demands Placed On the CRD System and Its Diminishing Returns, *infra*.)

States viewed the implementation of the CRD as providing a critically important opportunity, in addition to establishing a streamlined registration process, to develop a centralized database for ongoing regulatory purposes. One example of the regulatory advantages provided by the CRD system is that by having all licensing and disciplinary information regarding any agent readily and centrally accessible, states are able to more efficiently and effectively perform their regulatory function. This system has allowed the states to act as a local "network of regulators" screening out problem agents. This increased efficiency, including the use of a uniform form, a centralized point to remit information and the speed of processing, are passed on as tremendous cost savings to the broker-dealer firms.

qualifying examinations have been met, accommodate both system and state approval or rejection of applications as permitted by the states; For amendments to applications, the amendment or supplementation to existing applications, the receipt, recordation and dissemination of information contained in a uniform termination form, a transfer registration, and a renewal application, prompt notification of the captured data, audit trail capability and the production of various reports based on the data, security against unauthorized access to the system, and access to the original hard copy of data in the system. CRD Contract between NASDAQ and NASAA, §1.03 (incorporating NASAA Resolution of 15 performance functions), June 10, 1980.

¹² See Exhibit E, Form U-4 (Uniform Application for Securities Industry Registration or Transfer); Form U-5 (Uniform Termination Notice for Securities Industry Registration); and Form U-6 (Uniform Disciplinary Action Reporting).

B. The Substantive Review Criteria Applied by States to Applications

The public interest mandates that states have the authority and opportunity to apply substantive review criteria to the licensing applications of securities agents. Due to the uniqueness of each and every application, states must remain flexible in their review, investigation and decision making process. For example, one application may disclose a state cease and desist order, an NASD fine and two settlements. Another may disclose five customer complaints in a eighteen-month period. Yet, another may disclose a single arbitration. However, the circumstances surrounding the arbitration may be so egregious that it is more troubling than an agent with multiple complaints. In addition to reportable events, states also take other factors into consideration during their licensing process such as prior employment history with firms subject to regulatory action, excessive movement among firms of an agent with past disciplinary history and other states' licensing requirements (e.g., special supervision requirements).

Agents do not generally apply for licensure with all states simultaneously. Therefore, some states may receive an application from an agent who is just entering the industry and other states may not get an application from the same agent until several years later. Those states are afforded a better opportunity to evaluate the applicant's performance in the industry and take into consideration actions that have been taken by states having previously licensed the agent.

Each application requires a state to make a determination as to whether to approve the application, deny it, require special supervision or some other type of conditional license,¹³ or recommend the withdrawal of the application. As a result of the limited scope or inadequacies of the information contained on the CRD, often a state needs further information on the reportable events or disciplinary history in order to make an informed licensing decision.¹⁴

Other factors may also need to be considered when evaluating reportable events or disciplinary disclosures. For example, a state may need to evaluate the disclosures in relationship to the number of years or time the agent has spent in the industry, whether the disclosures seem to be tied to the sales of a particular product, whether a pattern of individually minor infractions, considered collectively, demonstrate a trend of abuse due to their type or the time period in which they occurred, or whether disclosure of customer complaints appear to be related to a decline in the market. Any attempt to develop and apply a single standard of review to cover all of the variables and scenarios that are raised in the licensing process would result in either the application of

¹³ See Exhibit F, Example of a Conditional Registration Utilized by the State of Michigan.

¹⁴ See Exhibit G, Example of Additional Information Requested by States Due to Summary Information of CRD Printout.

overbroad and onerous standards of review or extremely narrow and inadequate standards.

It is also important to note that no other regulatory body performs the same or comparable value-added service to investors and the marketplace provided by the states in the licensing area. State regulators screen out agent applications that have unacceptable previous violations and either deny or request withdrawal of the application or require special conditions be met for the license to be issued. The SEC does not license agents, and the CRD system performs only preliminary checks upon which the NASD Regulation, Inc. ("NASDR") relies for its approval. In addition, the NASDR can only deny an application based on statutory disqualifiers, which are limited in scope.¹⁵ The NASDR cannot, for example, deny an application based on the thousands of state administrative actions taken annually, or the thousands of arbitration actions.

The exercise of state licensing authority over agent applications is also subject to statutorily-required due process. Although a state may decide to deny an application based on disciplinary history or disclosable events, the applicant is afforded notice and an opportunity for a hearing. To deny the license, the hearing officer has to make a finding in the public interest and that the applicant has engaged in dishonest or unethical practices or other statutory violations. This finding is then appealable to state court. However, upon making an initial determination to deny an application states will typically provide the agent an opportunity to withdraw. As an alternative to withdrawing an application, some applicants may be given the opportunity to enter into a conditional registration agreement which subjects the agent to increased scrutiny.

The following is a summary of some specific state licensing cases demonstrating the types of licensing decisions state securities regulators are faced with everyday and the types of actions they take on applications. (Other examples are found in Exhibit H.) The actions represent instances in which state securities divisions have denied initial registration based on disciplinary history or reportable events, granted conditional registration (e.g., required heightened supervision, routine disclosure of customer complaints to division), or requested that the applicant withdraw the application. The agents listed below were approved by either the NASD or NASDR (depending upon the date) at the time the state initiated action.

Alabama

- Vernon L. Schisler. Alabama issued a notice of intent to deny Schisler's pending broker-dealer agent application based on numerous customer

¹⁵ See 15 U.S.C. §78c(a)(39).

complaints alleging unauthorized trading. Schisler withdrew his application.

Arizona

- John D. Jacobs. Jacobs, working from a Chicago, Illinois branch office of Oppenheimer, was found to have churned the account of a 63 year-old widow. Jacobs was forced to withdraw his agent license in Arizona and may not reapply for a period of at least three years.

Arkansas

- Elmer Anthony Brown. Brown was found to have engaged in unregistered transactions and engaging in dishonest and unethical business practices. Arkansas denied the application for licensure.

Colorado

- Douglas A. Glaser. Colorado denied Glaser's application for licensure as a broker-dealer agent because Glaser failed to disclose on his Form U-4 the existence of a pending criminal action against him (People v. Douglas A. Glaser, No. 96 F 978 (Arapahoe Cty. Dist. Ct.)).

Connecticut

- George Clark Bryant. While at Merrill Lynch, Bryant's previous firm, he caused the broker-dealer to issue checks drawn on client accounts without client authorization, and "borrowed" \$291,300 from a client without authorization. Connecticut denied Bryant's application for licensure as a broker-dealer agent.

Delaware

- Marc Nemeth. Nemeth's CRD report revealed the existence of 11 disciplinary occurrences, all of which were criminal charges, including two felonies. Delaware denied the application of this agent.

Florida

- Applicant A. A, an agent of a NYSE member firm, was charged by the US Marshall for theft when applicant purchased 20 stolen airline tickets and subsequently resold 12 of them. Florida requested and received withdrawal of A's application.

Georgia

- Norman Gati. Gati, a PaineWebber agent, amassed the following record: a \$27,000 settlement of an unauthorized trading complaint; a pending complaint alleging misrepresentations, unsuitable trades, and unauthorized trading from May 1990; and a NYSE complaint alleging churning and unsuitable transactions. Georgia denied Gati's application due to disciplinary history and reportable events.

Hawaii

- Vaughn Lee Woods. Woods sought registration in Hawaii. Woods was fined \$5,000 and censured by the NASDR for violations of the NASD Rules of Fair Practice. At Hawaii's request, the firm voluntarily withdrew Woods' application for licensure in Hawaii.

Illinois

- Min Gyo Kim. Application for broker-dealer agent license denied. Denial was based on a NYSE Hearing Panel Decision to censure and bar Kim for two months from employment or association with a member organization. The NYSE decision was based upon evidence of unsuitable trades, churning, failure to follow customer instructions, and unauthorized trades.

Indiana

- James B. Chase. The CRD report for Chase revealed numerous customer complaints and arbitration proceedings against Chase regarding matters related to the securities business. In response to Chase's two separate applications for licensure, Indiana twice sent Notices of Intent to Deny Registration to Chase.

Iowa

- Jeffrey Jurrust. Jurrust was the subject of a Delaware administrative action. The decision issued, after hearing, included findings that Jurrust made a willful misrepresentation of material facts in the sale of warrants to a Delaware investor. The Delaware Commissioner revoked Jurrust's license. When Jurrust applied to be licensed in the state of Iowa, the Bureau requested Jurrust withdraw his application based on the Delaware revocation. Jurrust withdrew his application.

Kansas

- Manuel Martin Bello. Bello applied for licensure with Kansas. At the time Bello was approved by the NASD, he had 10 customer complaints alleging unauthorized trading. Bello withdrew his application in Kansas upon receiving notice that staff would recommend denial. Bello amassed five additional complaints alleging unauthorized trading, unsuitable recommendations, and misrepresentations since the time of the denial.

Kentucky

- George Michael Greco. Greco's CRD report indicated that he was subject to a conditional registration by Indiana, and had several customer complaints alleging misappropriation of customer funds and misrepresentations, and was under internal review by his former firm due to outside business activities. Kentucky granted Greco conditional registration.

Maine

- James P. Sheehan. Maine scrutinized Sheehan's disciplinary history and reportable events as part of the application process, which revealed reported incidents involving customer complaints alleging unauthorized trading, unsuitable investments and material misrepresentations. Maine requested and received withdrawal of Sheehan's application.

Maryland

- Michael Pugliese. Pugliese submitted an application to Maryland as an agent of First Union Equities. Pugliese's application disclosed the existence of five customer complaints in a two-month period, one of which alleged unauthorized trading. Maryland offered to grant licensure to Pugliese, conditioned upon the fact that Pugliese receive special supervision regarding his dealings with Maryland clients.

Massachusetts

- Richard Scott Ginsburg. Ginsburg's CRD record revealed 11 customer complaints alleging unauthorized trading, unsuitable trades, material misrepresentations, and the existence of an administrative complaint filed by Florida in 1996 for violating the terms of a conditional registration and a finding by the NYSE of violation of the third party authorization rule in 1993. Ginsburg elected to withdraw his application after discussions with division staff, despite being registered with the NASDR.

Michigan

- Keith Sargent. On October 17, 1996, the Michigan Securities Bureau denied Sargent's application for licensure in Michigan. Michigan found that Sargent failed to provide proper disclosure of certain federal liens, despite a request to do so.

Mississippi

- David Lee Stetson. The division review of Stetson's disciplinary history revealed numerous disciplinary incidents, including a revocation by the State of Illinois based on an NASD suspension finding that Stetson engaged in a trading scheme designed to defraud his employer. The broker's firm withdrew Stetson's application after division inquiries.

Missouri

- Robert S. Finkelstein. Since 1992, Finkelstein applied for licensure with Missouri on three separate occasions. Fourteen of the incidents on Finkelstein's CRD record involved customer complaints, with most either involving either allegations of unsuitability or misrepresentation. On each occasion, and upon Missouri's request, Finkelstein withdrew his application without registration.

Nevada

- Roger Mintzer. Mintzer applied for licensure as a sales representative with Nevada. It was discovered that Mintzer had not disclosed revocation of an insurance license. Nevada granted licensure to Mintzer, subject to a restrictive licensing agreement.

New Hampshire

- Andrew Paul Gonchar. This Oppenheimer & Co. agent applied for licensure with New Hampshire. New Hampshire requested withdrawal of the application based on numerous arbitration proceedings and customer complaints alleging misrepresentation, unsuitable recommendations, and unauthorized trading. Gonchar withdrew his application upon New Hampshire's request.

New York

- Craig Skinner. Skinner applied for agent licensure in New York. His disciplinary history revealed that Skinner was a convicted felon (once for first degree robbery and once for attempted murder in the first degree and attempted assault in the second degree). The New York Attorney General

determined that Skinner was unfit to conduct securities business in the State of New York.

North Carolina

- Robert Frances Fox. Fox applied for agent licensure with North Carolina. A review of the application revealed that the State of Iowa brought fraud charges against Fox for filing documents with Iowa containing material misstatements. North Carolina requested and received withdrawal of Fox's application.

Ohio

- David I. Calicchio. In January, 1997, Calicchio sought licensure with the State of Ohio as a salesman. One month earlier, Calicchio had been placed in a federal pre-trial diversion program for securities fraud, prompting Ohio to deny Calicchio's application.

Pennsylvania

- Leiberbaum & Co. and George Fillippone. Here, the Commission found that Fillippone filed a false and misleading application with Pennsylvania. Specifically, Fillippone and Leiberbaum failed to disclose that Fillippone had been subject of an administration complaint filed by the Massachusetts Securities Division. Leiberbaum was censured and fined and Fillippone's application was terminated.

South Carolina

- John Patrick Clancy. Clancy applied to South Carolina for licensure as a broker-dealer agent. South Carolina denied Clancy's pending application due to the existence of 55 occurrences of disciplinary history and disclosable events.

Tennessee

- James W. Garofalo, Jr. Garofalo applied for licensure with Tennessee. His CRD report disclosed numerous customer complaints and arbitrations alleging various abusive sales practices. While undergoing an enhanced review in Tennessee, Garofalo's firm terminated his application without registration.

Texas

- John C. Hopf. Hopf applied for licensure with Texas. Hopf had been charged and/or convicted of numerous crimes, including possession of

stolen property, felony burglary, disorderly conduct, petit larceny and assault. Hopf withdrew his application after staff opposed licensure based upon his disciplinary history.

Utah

- Karen Sue Smelker. Smelker applied for licensure with Utah. Smelker had been suspended by the NYSE and barred from selling limited partnerships for five years. Smelker was "Terminated Without Registration" in Utah.

Virginia

- Michael Erik Murray. Murray applied for licensure with Virginia. The CRD revealed that Murray was the subject of numerous complaints, had filed for bankruptcy, and was previously fined by the CBOE for misrepresenting the risks of investing in derivative securities. Virginia offered Murray conditional registration. The firm withdrew the application as neither the compliance officer, the branch manager, nor the firm would agree to supervise Murray.

Vermont

- Greg Weisenberg. Weisenberg sought licensure with Vermont. Weisenberg had 16 instances of disciplinary history or reportable events, including actions taken by Illinois, Georgia, and New Jersey, as well as numerous complaints and settlements alleging unsuitable transactions and misrepresentations. Vermont requested withdrawal, and Weisenberg withdrew his application.

Washington

- Jonathan Dru Lyons. This applicant has been named in more than 13 arbitrations and customer complaints since 1993 alleging a variety of securities, RICO, and common law crimes, and has been ordered to pay more than \$500,000 to claimants, with many proceedings still pending. Lyons' application was withdrawn after requests for additional information went unanswered.

West Virginia

- Irvin Goins. A review of Goins' disciplinary history revealed that Goins failed to disclose that he had been charged with bank fraud in 1995. The firm withdrew Goins' application for agent licensure after discussions with staff.

Wisconsin

- Ross Mandell. Fourteen of the incidents on Mandell's CRD record involved customer complaints, with most of these involving allegations of unauthorized trading. Wisconsin forced Mandell to withdraw his application for licensure on five separate occasions, due to the perpetual increase of disciplinary events and disclosable items reported in between the times in which Mandell submitted applications to Wisconsin.

III. STATE PROCESSING OF AGENT APPLICATIONS USING THE CRD SYSTEM

A general description of the state licensing process follows.¹⁶ In addition to discussing the general parameters applicable to all states when processing applications, dependent in large part on the use of the CRD as the processing tool, NASAA gathered statistical data to quantify the time states devote to processing applications. To that end, NASAA surveyed 12 states and is providing the Commission staff, for use in its public record, the statistical data and averages culled from the state responses to the survey. Some of the more relevant statistical data is represented graphically in Exhibits B and C.

States categorize agent applications as one of three type for purposes of processing by the CRD:

- **New applications** -- individuals applying to a state for the first time; agents re-affiliating or transferring to another firm that have reportable items or disciplinary history; and agents who qualify, but do not elect to use TAT.
- **Renewals** -- agents staying at the same firm applying for a license for the new year, because all agent licenses expire on December 31;¹⁷ and
- **Temporary Agent Transfers** (otherwise referred to as the "TAT" program) -- agents re-affiliating with or transferring to another firm that do not have any reportable events or disciplinary history.

The licensing process applied by the states varies depending upon the category of the application and the applicants reportable items or disciplinary history.

¹⁶ See Exhibit I, Flow Chart Relating to CRD Agent Application Processing.

¹⁷ See note 5, *supra*.

A. **New Applications (Represents Approximately 30% of all Applications)**¹⁸

1. **State Licensing Methods**

The CRD system provides states with three methods for reviewing new applications. States are either “manual,” “automatic” or “super-automatic.” The method the state uses dictates which applications will have to be reviewed by state personnel before a license is issued. Currently 30 of the 52 CRD jurisdictions operate as manual jurisdictions.¹⁹ In these jurisdictions, all new applications will be reviewed before a license is granted. Twenty-one jurisdictions operate as automatic jurisdictions.²⁰ Automatic jurisdictions review only those new applications that contain reportable events or disciplinary history, and those that contain no reportable events are licensed concurrently with NASDR approval. A super-automatic state does not conduct any independent state review beyond the NASDR’s review.²¹ Once an application is approved by the NASDR, the applicant is licensed in the state.

2. **NASDR/CRD Approval Process**

The NASDR approval process relies upon the CRD to provide checks on some data fields to ensure they have been answered, determine that certain qualifications have been met and perform a limited check that certain answers are accurate. In addition, the NASDR performs a substantive review of the application, but does not establish the accuracy of most answers, nor does it assure that all answers are complete,²² nor does it have the authority to recognize state administrative actions, such as denials, revocations or cease and desist orders, as part of their qualitative review. Therefore, the NASDR “approves” many persons who have state sanctions against them²³ or disclose other substantial actions. Once the NASDR has approved an application, the CRD forwards notice of the approval to the states. States begin their

¹⁸ See generally Statistical Data, § IV.D., *infra*.

¹⁹ See Exhibit J, List of Manual/Automatic States for Purposes of CRD Processing of New Applications.

²⁰ See *id.*

²¹ California is the only state which operates super-automatically. The California Department of Corporations is currently reevaluating this decision with the expectation of performing more of its own gatekeeping function. The Department is in the process of implementing a systematic agent monitoring program to validate the need for a review process in California.

²² See Exhibit K, Example of Incomplete Application of an NASDR-Approved Agent.

²³ For example, the Iowa Bureau of Securities received an application from an individual whose license was revoked 18 months prior by the Bureau (Mr. Perosi, CRD# 1416831).

review and processing of an application at such time. This coordinated effort accomplished by the CRD's preliminary checks, the NASDR's approval, and the states' value-added review avoids a duplication of efforts. It also prevents the scenario of an agent receiving a state license without being approved by the NASDR.

3. Transmission To The States And Pending Dates

In transmitting the application to the state, the CRD system segregates new applications into two categories, those with reportable items and disciplinary history and those without. Applications without disciplinary history or reportable items are considered "clean-apps" and placed into the states' "clean queue." Applications containing disciplinary history or reportable items are considered "disc-clean apps" and are placed into the "disc-clean queue." Reportable items are determined by the questions on the Form U-4, a coordinated uniform form for the registration of agents used by the states, NASDR, other SROs and the Securities and Exchange Commission.²⁴ Some Form U-4 questions ask for information based on a discrete time period, after which it is not a "reportable event." Reportable events cover the areas of criminal actions disclosures, regulatory disciplinary actions, civil judicial actions, customer complaints, terminations and general financial disclosures such as a declaration of bankruptcy or an outstanding lien.

When an application is approved by the NASDR and appears in either the state's clean or disc-clean queue it is dated with a state pending date. This date is generally considered to be the date upon which a state would begin to act on an application.²⁵ For those states that either by statute or rule have to act on an agent application within a certain time period (e.g., 30 days), the pending date begins the period within which the state must act.²⁶

4. How States Process Applications

State personnel begin the approval process by logging into the CRD system and accessing the state's acceptance queue, consisting of applications in the clean and disc-clean categories. States differ as to the number of work-hours expended to review

²⁴ See Exhibit E, Form U-4 (Uniform Application for Securities Industry Registration or Transfer); Form U-5 (Uniform Termination Notice for Securities Industry Registration); and Form U-6 (Uniform Disciplinary Action Reporting).

²⁵ Several states apply the concept "home state rule." In these states an application is not considered pending, and a state would not generally act on the application, until it is approved in the agent's home state.

²⁶ See e.g., UNIF. SEC. ACT, §202(a) (1956, as amended) ("registration becomes effective at noon of the thirtieth day after an application is filed"); REV. UNIF. SEC. ACT, §208(a) (1985).

applications depending upon application volume,²⁷ the disciplinary history or reportable items contained in the application,²⁸ the need for background checks²⁹ and state personnel resources available.³⁰ As a condition of state licensure, states predominately require that broker-dealer agents pass an examination that tests an applicant's knowledge of state securities laws and regulations, along with various exams required by the NASDR to sell specific securities products.³¹ Applicants' scores for this single uniform examination, the Series 63, are reported to the states over the CRD along with the scores for NASDR-required exams. In some instances, states require a statement or affidavit regarding compliance with state law as a condition of agent licensure.³² The affidavit or statement may address whether an agent has conducted business in the state while unlicensed.

The processing of applications by states includes both the formal granting of a license and reviewing disclosures. Although some states do not approve applications daily, many still process applications on a daily basis, or almost as frequently, because when not approving an application state employees are performing a review or validation of the application.³³ Generally, CRD operators have the authority to approve

²⁷ The volume in some states, like Florida, can be as high as 2,000 applications a week.

²⁸ Significant disclosures require closer review and generally a state requests additional information to the summary disclosure information contained on the CRD. See Exhibit G, Example of Additional Information Requested by States Due to Summary Information of CRD Printout.

²⁹ For example, Texas conducts background checks on in-state applicants to make sure no current state actions are being taken or investigated against the individual.

³⁰ Broker-dealer agent licensing is only one of many responsibilities of state securities agencies. State securities agencies also license broker-dealer firms, investment advisers and investment adviser representatives; conduct examinations, inspections, and audits of broker-dealer and investment adviser firms. Securities and securities transactions are also required to be registered with the states, unless the security or securities transaction is a "covered security" or unless an exemption from registration applies. States also conduct extensive enforcement activities covering all aspects of the securities markets, respond to public inquiries, and provide investor education and small business assistance in their jurisdictions. Some states also oversee other types of activities, such as regulation of franchises, business opportunities and mortgage brokers.

³¹ See Exhibit L, State Examinations Required of Broker-Dealer Agents.

³² For instance, Maryland requires Affidavits of Compliance only for agents staying with the same broker-dealer firm and having a short lapse in their Maryland registration. This procedure provides the state with an opportunity to discern if the agent has conducted unlicensed activity. Missouri also requires Affidavits of Compliance, but only if the agent has an extensive disciplinary history.

³³ Of the 12 states polled, 6 approve applications on a daily basis, including Colorado, Connecticut, New York, Ohio, Pennsylvania, Texas, and Wisconsin. Of the others, Maine and New Jersey approve applications 2 to 3 times a week, Florida approves applications twice a week, Utah does it on a weekly

applications they review that have either no or minimal disciplinary history or reportable events.³⁴ However, applications containing disciplinary history or reportable events generally require a state to request additional information regarding the circumstances surrounding the disclosures so the state can better evaluate the disclosures. In these instances the state usually issues a written request to the broker-dealer or the agent for the additional information.³⁵ In some states, applications containing disciplinary information or reportable events are also reviewed by enforcement personnel or other more senior staff. The physical process to approve applications by the state is done by a keystroke on the CRD terminal.

5. Review of New Applications With No Reportable Items ("Clean-Apps")

State review of new applications having no disciplinary history or disclosable items is dependent on whether a state is an automatic or a manual state. Automatic states do not review new applications that have no disciplinary history or disclosable items.³⁶ Once the NASDR approves the application it is simultaneously approved in an automatic state. Therefore, the clean acceptance queue of automatic states is never populated with applications because no further action is required. Automatic states receive notice from the CRD system of those applicants licensed in their jurisdiction.

Manual states review all new applications.³⁷ This decision gives the state the opportunity to perform a qualitative review even on those applications with no disclosable items or disciplinary history. States have determined that such a review is often needed even for clean applications because some NASDR-approved applications transmitted to the states do not meet cursory levels of completeness, such as incomplete addresses, partial employment histories, or not meeting the state exam requirements.³⁸

basis and California does not approve applications because of their status as a super-automatic jurisdiction.

³⁴ See Exhibit C, New Applications Filed with the States in One Year, indicating that for the states surveyed applications with minimum disclosable events are approved on average in 1.8 days.

³⁵ See Exhibit C, New Applications Filed with the States in One Year, indicating that for the states surveyed it takes on average 4.55 days for the jurisdiction to send out a first notice to the applicant.

³⁶ There are 21 jurisdictions that are classified as automatic and 1 as super-automatic. See Exhibit J, List of Manual/Automatic States for Purposes of CRD Processing of New Applications.

³⁷ There are 30 jurisdictions that are classified as manual. See *id.*

³⁸ See Exhibit M, Letter from New Mexico Outlining its Rationale for Switching from "Automatic" to "Manual" for CRD Processing of New Agent Applications to Neal Sullivan, Executive Director, North American Securities Administrators Association of May 28, 1997. New Mexico switched from being an automatic state to processing new applications manually when it discovered that applicants were being licensed in their state without meeting their exam requirements. The state was no longer confident in the system checks by the CRD and chose to verify for itself that its exam requirements were satisfied.

In some instances, these applications have not yet received NASDR approval.³⁹ In addition, some manual states perform background checks or provide other value-added services in their processing of clean applications. For example, Texas performs background checks on in-state new applicants,⁴⁰ and Maine requires in-state resident applicants new to the industry to participate in a one-hour orientation session focusing on ethics.⁴¹ *In manual states, new applications without reportable events or disciplinary history are on average approved in 1.6 days.*⁴²

6. *Review of New Applications With Disciplinary History or Reportable Events ("Disc-Clean Apps")*

The state review process for new applications with disciplinary history and reportable events is a more involved process and is generally the same in all jurisdictions. The process begins with the CRD operator reviewing those applications in the disc-clean queue on the CRD. A preliminary review will determine if the applicant is not qualified in the specific jurisdiction, whether more detailed information on certain disclosures or disciplinary items may be necessary, or if additional state requirements must be satisfied.

Also, the state review is distinguishable from the NASDR's review because of the limited authority the NASDR has to deny applications based only upon statutory disqualifiers.⁴³ States' authority for denial of agent applications, in most instances, is more expansive than the NASDR's because it includes, for example, a state's ability to base its action upon other state administrative actions.⁴⁴ This basis for denial by states avoids duplication of proceedings and conserves enforcement resources. Also, the heightened review by state authorities provides greater front end investor protections.

³⁹ See Exhibit N, Example of Agent Not Approved by NASDR, Yet Present in State Acceptance Queue Awaiting State Action.

⁴⁰ Texas does background checks of their in-state applicants by running them through the state computer system, looking out for any pending securities enforcement actions or other state investigations.

⁴¹ The Maine orientation sessions are held every two weeks, but exceptions are made and depending upon the circumstances, such as excessive travel time, can be held telephonically. The Maine Administrator made a personal commitment to do this program to impart the importance of ethics in dealing with clients.

⁴² See Exhibit C, New Applications Filed with the States in One Year.

⁴³ See 15 U.S.C. 78c(a)(39).

⁴⁴ See Exhibit H, Examples of the "Value-Added" by State Securities Agencies in Their Licensing of Broker-Dealer Agents.

An application containing regulatory disclosures is generally categorized as having either minimal or significant disciplinary history or reportable events. Examples of an application containing minimal disciplinary history or reportable events may include an application with disclosure of a personal bankruptcy, a non-securities related lien, fines under \$1,000 or one or two minor customer complaints such as late payment of dividends or a lack of timely order execution. Examples of applications with significant disciplinary history or reportable events may include an application with allegations or findings of fraud, numerous and serious customer complaints especially in a short period of time, state actions, numerous arbitrations, injunctions, civil actions, criminal convictions, suspensions or revocations of a license.

Ordinarily applications with either minimal disciplinary history or minor reportable events are approved at the time they are reviewed. The CRD operator reviews the application, makes the determination that the reportable items are minimal, and then approves the license. If the CRD operator does not have the authority to license applicants with minimal disciplinary history or reportable events, often the only additional step is to consult with a supervisor. Rarely does a state ask an applicant with minimal disciplinary history or minor reportable events to submit more information.⁴⁵

Applications containing significant disciplinary history or reportable events are scrutinized thoroughly by state personnel. Often the state will ask for additional information on the disclosures. The survey revealed that on average it took the states under five days to internally evaluate the summary CRD information regarding the significant reportable and disciplinary actions, and put the applicant on notice of the need for additional information or additional consideration. Generally, states issue a formal notice regarding the matter to the applicant and his or her firm, but the state may also call the applicant.⁴⁶ Many of the state personnel surveyed stated that once a request for more information is made, a significant period of time lapses before they receive a response, if at all.⁴⁷ If a response is forthcoming with the additional

⁴⁵ See Exhibit C, New Applications Filed with the States in One Year. The surveyed states that maintained internal statistics reported that it takes on average 1.8 days to approve an applicant with minimum disciplinary history or reportable events, while it takes 1.6 days for a manual state to approve an applicant with no reportable events. The CRD does not distinguish between clean applications and those containing minimal disciplinary history or minor reportable events and therefore cannot provide statistics on state approval times.

⁴⁶ See Exhibit C, New Applications Filed with the States in One Year. The date by a state for first notice or a request for additional information is, on average, for the states responding 4.55 days.

⁴⁷ See Exhibit O, Statistics Regarding Processing Time for Utah to Request Additional Information and Response Time by Firms or Agents. For purposes of this study, the Utah Division of Securities tracked firm and agent response time to requests for additional information for two 2 week periods. The statistics show that the Division predominantly sends out first notice in 3 days requesting additional information, while it took the firms or agents on average over 18 days to respond to the request.

information requested, the state continues its review and a decision is made to approve the application, deny it, grant it with certain conditions, such as special supervisory procedures, or request the applicant withdraw the application.⁴⁸ If the state provides the applicant with notice of its intention to deny the license, state due process and the administrative procedures act requirements greatly impact the time frames involved in arriving at a final disposition on the application.

B. Renewals (Approximately 66% of all Applications)⁴⁹

When a state grants a license, the license is valid for the remainder of the year in which it was issued. Agent licenses expire on December 31, and must be renewed every year.⁵⁰ The process of getting a new license when the current one expires is called "renewal." Agent licenses are renewed on January 1 of the following year and are tied to the renewal of the broker-dealer firm's license. Generally, the firm renews its license and provides a list of those agents that are renewing with the firm for the upcoming year.⁵¹ States handle the end of the year renewal of agents, or the "renewal cycle," super-automatically. Therefore, all agents renewing with the same firm for the following year are licensed in the state immediately when the CRD processes the license and the proper fee is electronically forwarded to the state.

**C. Re-affiliations and the Temporary Agent Transfer ("TAT") Program⁵²
(Approximately 4% of all Applications use the TAT program, the remaining transfers are included in New Applications)⁵³**

State licensing authority is exercised when agents transfer from one broker-dealer to another. This transfer or re-affiliation with a new firm requires the agent to re-apply for a license.⁵⁴ Transfers are processed by all states in the same manner.⁵⁵ The

⁴⁸ In the 12 states surveyed, over 3,700 applicants were denied, withdrew, or were granted conditional licenses in 1996.

⁴⁹ See generally, Statistical Data, § IV.D, *infra*.

⁵⁰ See note 5, *supra*.

⁵¹ Maine's Securities Division provides an additional service to agents renewing in its state. The CRD establishes a date approximately 2 weeks prior to the end of the year that all renewal applications must be submitted to become approved for January 1. Maine allows agents to file directly with the state subsequent to that date but before year end to assure that the renewal becomes effective.

⁵² See generally, Statistical Data, § IV.D, *infra*.

⁵³ Segregating transfers from new applications is impracticable and enormously difficult given the CRD system and the volume of agent applications and transfers received by the states.

⁵⁴ See note 6, *supra*, for a discussion of licenses tied to firm affiliation.

transfer process is dictated by the application either containing disciplinary history or reportable events or in the alternative being a clean application with no reportable events. For those transfers with:

- No disciplinary history or reportable events – the applicant is eligible for the TAT program and the agent is licensed immediately.
- With disciplinary history or reportable events – these agents are precluded from using the TAT program and are reviewed by the states as if they were new applicants.

When the new broker-dealer for a qualified agent utilizes TAT, the transfer is accomplished upon CRD receiving notice of the transfer by telephone or facsimile and the NASDR processing the information. Once received, the agent is given a temporary license and can begin work immediately at the new firm. A final license is issued automatically within 21 days if all the appropriate filings have been successfully submitted.⁵⁶

States participate in the TAT program to permit clean agents to re-affiliate with a new firm immediately. Although states do not review applications of agents transferring through the TAT program, they retain the ability to not issue a permanent license in certain circumstances. A recent example of a state exercising this authority is the New Jersey Bureau of Securities.⁵⁷ Several agents from a firm expelled from the securities industry by the NASD attempted to transfer to another firm.⁵⁸ New Jersey personnel notified the NASD to deny these individuals temporary licenses. The transferring agents then had to go through the regular licensing procedure. This is an example of state license review directed against those firms and agents presenting the greatest threat to investor protection.

⁵⁶ Transfers are not be reviewed in California regardless of disciplinary history. Being super-automatic, all applications are approved in California once the NASD approves the application.

⁵⁴ The appropriate filings for a TAT are the Form U-4, indicating the transfer, and the Form U-5, a notice of termination from the agent's previous employer.

⁵⁷ See Exhibit F, Affidavit by New Jersey Securities Bureau Relating to CRD Transfers.

⁵⁸ The NASD expelled Hibbard Brown & Co. from the securities business for fraudulent mark-ups of share prices. In addition, the company and its owner were ordered to pay over \$8.7 million in restitution and both the firm's owner and head trader were barred from association with any NASD members. Wall Street Journal Staff Reporter, NASD Issues Fines, Ousts Hibbard Brown For Fraudulent Prices, WALL ST. J., July 19, 1994, Section C, p. 13.

If a qualified agent has disciplinary history or reportable events, or has neither but does not utilize the TAT program, the transfer application goes through the same process at the state level as a new application.⁵⁹

D. Amendments

Agents must amend their licenses whenever information that appears on the Form U-4 changes or is incomplete. Amendments are required in a wide range of circumstances, from a change of address to reporting disciplinary actions taken by a regulator. Thus, amendment filings can be very numerous. States do not review amendments because the CRD system does not present a viable review procedure. (See § IV., Diminishing Returns of the CRD, *infra*.) The inability of a state to review amendments in a timely manner, particularly disciplinary matters, can lead to prolonged review when an agent re-affiliates with another firm.

E. Statistical Data

For the purpose of the Uniformity Study, NASAA surveyed 12 of its member jurisdictions to provide statistical data for this submission. The states that participated were: California, Colorado, Connecticut, Florida, Maine, New Jersey, New York, Ohio, Pennsylvania, Texas, Utah and Wisconsin. The primary criteria for selecting these states was to achieve a geographical diversity, mixture of methods for processing applications, and have representative jurisdictions that are considered small, medium and large states in the number of licensed agents, including those key states that represent the highest volume of applications.⁶⁰

The data gathering process was significantly more difficult than first expected. The current CRD system does not maintain many categories of historical statistical data. With the help of several state staff personnel,⁶¹ NASAA was able to construct an

⁵⁹ All new applications with disciplinary history or reportable items will be reviewed by state personnel. In the rare case of a transfer without disciplinary history or reportable events not using the TAT program, their application would not be reviewed in an automatic state but would be reviewed in a manual state.

⁶⁰ Method of processing: 6 manual states - Florida, Maine, New Jersey, Ohio, Texas and Wisconsin; 5 automatic states - Colorado, Connecticut, New York, Pennsylvania and Utah; and 1 super-automatic state - California. Licensed agents for 1996: Large (over 100,000) California, Florida, New Jersey and New York; Medium (between 50,000 and 100,000) Colorado, Connecticut, Ohio, Pennsylvania, Texas and Wisconsin; and Small (under 50,000) Maine and Utah. Number of applications for 1996: Large (over 150,000) California, Florida and New York; Medium (between 75,000 and 150,000) Colorado, Connecticut, New Jersey, Ohio, Pennsylvania and Texas; and Small (under 75,000) Maine, Utah and Wisconsin.

⁶¹ NASAA would like to thank the staff members from the many states who were enormously helpful in providing licensing data and CRD statistics. Specifically, NASAA wishes to thank the following individuals: Denise Alaimo (Texas); Blake Campbell (California); Salvatore Cannata

approach to obtain comparable information from the different jurisdictions. However, some of the information is internal state statistics, some information is estimated, and some of the information is averages derived from responses from less than all of the states because unless certain numbers were maintained internally they are impossible to determine. For each category of information the process used to obtain the number is described. The charts, in Exhibits B and C, are graphic representations of the average amount of time attributable to states in licensing broker-dealer agents, based on the average of the times submitted by the surveyed states.

Because of the difficulty in gathering comparable information, all states were not surveyed. The allocation of resources necessary to work with each state to assure comparable statistics that are based on retrievable state data and some CRD produced data, plus overcoming the terminology barrier created by the various methods of licensing provided by the CRD would have precluded NASAA from making its submission on a timely basis.

A summary of the major categories of statistical data collected for those states identified is provided.⁶² The following is a description of each category and how the statistics were determined:

- **Total Applications**

Description: Total applications represents the total number of applications that each state had authority to act upon in 1996. Total applications includes renewals,⁶³ new applications,⁶⁴ and agents transferring under the TAT program.⁶⁵

(Connecticut); Maurice Cox (California); Pamela Epting (Florida); Michael Gunst (Texas); Kenneth Hojnacki (Wisconsin); Ed Jaffe (New York); Matt Jenkins (Utah); Dale Jewell (Ohio); Verle Johnson (New York); Ron Jones (Michigan); William Leber (Ohio); Sheryl Lemon (Colorado); Melanie Senter Lubin (Maryland); Gary Marquett (Iowa); Martha McVeigh (Rhode Island); Paul Schwartz (Pennsylvania); Rhea Shelton (Virginia); Sonya Still (New Jersey); Greg Toms (Washington) and; Michael Vargon (New Mexico).

⁶² See Exhibit Q, State Survey Data.

⁶³ Renewals represents the agents that renewed their licenses for the 1996 calendar year in each jurisdiction. Agent licenses are valid in most states for only one year, and each agent that wants to continue to be licensed in a jurisdiction must renew his or her license on January 1st for the upcoming year.

⁶⁴ New applications include persons applying to a state for a license for the first time and reaffiliations or transfers not relying or not eligible for the TAT program.

⁶⁵ The TAT program permits agents already licensed in a state without disciplinary history or reportable events to transfer to another firm immediately.

Method: This number is the sum of the state's 1996 Renewal Roster,⁶⁶ internal state numbers for number of new applications for 1996,⁶⁷ and an extrapolation of a two week sample of the number of TATs in each state to cover a one year period.⁶⁸

- **Renewals and TAT**

Description: Renewals and TATs are a subset of the total application category. This number represents the number of agents who have renewed for 1996 and the estimated number of TATs that occurred in 1996. No states review renewals or TATs. Hence, there is no state processing time for these applications. This category of applications represents a majority of all applications that a state can process in any given year. For the 12 states surveyed, renewals and TATs represent over 70% of all applications in a year.⁶⁹

Method: The process to obtain this data is discussed under Total Applications.

- **New Applications**

Description: New applications as defined previously represent the total number of people applying to the state for the first time and transfers that can not or do not rely on the TAT program. Approximately 30% of

⁶⁶ The Renewal Roster is sent to each state by the NASDR early in the calendar year. It lists all the agents that have renewed their licenses for the upcoming year, in this case for 1996.

⁶⁷ The number of new applicants for 1996 is not retrievable from the CRD system. Fortunately all the states surveyed maintained internal statistics on the number of new applications that came through the state. Some minor discrepancies exist in this number. Some states do not keep statistics on the number of applications reviewed but rather on the number of agents approved, withdrawn, or denied licenses. In these instances the state will actually have reviewed more applicants than reported, because some of the applications reviewed in 1996 would carry over into 1997 before a determination was made to approve, recommend withdrawal or deny the application. NASAA believes that the number of these carry-over applicants is insignificant.

⁶⁸ The number of TATs for a one-year period is also not easily retrievable from the CRD system. It is retrievable from state records, but that process would be very time consuming. NASAA decided that because the number of TATs in a year is a very small portion of the total applicants, that estimating this number is sufficient. To estimate the TATs, each state counted the number of TATs in a 2 week period in February and multiplied that number by 26 to arrive at an estimate for the entire year.

⁶⁹ See Exhibit B, Total Agent Applications Filed with the States in One Year.

all applications fall into this category. New Applications are further categorized by the CRD system as being clean, that is having no reportable or disciplinary items, and disc-clean, or having reportable events such as disciplinary.

Method: The method for obtaining this information is discussed in the Total Applications section above.

- **Percentage of New Applications with No Reportable Events of the Total Number of New Applications**

Description: Approximately 30% of all applications a state has the authority to process are new applications. Of that 30%, approximately 85% of those applications have no disclosure items, including disciplinary. The significance of an application containing no disclosure items is that in an automatic state these applications are immediately licensed upon NASDR approval.

Method: This statistic was generated from internal state numbers. It is not obtainable from the CRD system. Seven states responded to the question and of those seven, four of them kept this figure while the other three derived it as an educated guess based on other statistics they kept.

- **Days To Approve New Applications with No Reportable Events**

Description: This number represents the number of business days it takes the surveyed states to grant a license from the time it is pending in their state. For super-automatic and automatic states it takes no time to approve these applications because no state review is necessary. For manual states the days to approve varies depending on any other reviews or checks that are done on the application.

Method: This statistic is based on a state's application review procedure. That is if a manual state cleans out its clean queue on a daily basis and approves the application the same day it takes only one day to approve the application. An example of a state that takes more than one day to approve new applications with no reportable events is Texas. Texas on average takes two days to approve these applications. It takes two days, because the application is printed off on the first day and then later that day a background check is done, and then on the next day, day two, it is approved when the

CRD operator enters the system to retrieve the applications for that day.

- **Percentage of New Applications with Minimal Reportable Events of the Total Number of New Applications**
Description: As discussed in prior sections, reportable events can generally be classified as either minimal or significant. Those applications with minimal reportable events usually do not trigger extensive state review.
Method: This is also an internal state number. This type of information is not gathered or maintained by the CRD system.

- **Days To Approve New Applications with Minimal Reportable Events**
Description: The number of business days it takes a state to approve a license when the application contains minimal reportable events.
Method: This statistic is based on the states' practice for reviewing applications. Many states approve applications disclosing minimal reportable events when they first review the disclosures. That is why this statistic is very close to the approval time for applications with no reportable events.

- **Percentage of New Applications with Significant Reportable Events of the Total Number of New Applications**
Description: This number is the percentage of new applicants that have significant reportable events. Because of the disclosures contained in the application a heightened state review is usually done.
Method: This is an internal state number, but can also be estimated by interpreting the number of requests for additional information (see below) as being those applications that have significant disclosable items.

- **Days to First Notice Sent to Applicants with Significant Reportable Events**

Description: Generally, these agents are requested to provide additional information for the state to base its licensing decision on. This is the number of business days it takes a state to send out a letter or call the agent or firm requesting additional information.

Method: This is an internal state number. Many states send out certified letters requesting the information, while others send the request out in ordinary mail or telephone the agent. State practices differ as to when and how to send the request for additional information. Some states do it the same day they review the application, while others do it on a weekly basis.

- **Total Number of Applications Withdrawn, Denied or Granted a Conditional License**

Description: This number represents the number of new applicants that did not receive licenses or were granted conditional licenses for various reasons, usually because of disclosable items like disciplinary history. Agents usually withdraw their applications on a state recommendation to do so. Denials are based on statutory grounds and sometimes administrative or judicial hearings. Conditional licenses are agreements between the state and the agent to comply with additional requirement(s) to be licensed. Conditional licenses commonly take the form of increased supervision by the firm or restrictions on the agents activities, such as a limit on what types of securities the agent can sell.

Method: This is an internal state number.

IV. THE GROWING DEMANDS PLACED ON THE CRD SYSTEM AND ITS DIMINISHING RETURNS

The total number of licensed agents in 1981 when the CRD began processing agents was 220,000. By 1997, the total number of licensed agents has grown to approximately 550,000. This growth has placed great stress on the CRD system and its technology. As a result, the significant benefits provided by the CRD as a one-stop electronic licensing system are being constantly challenged and diminished by system glitches and the cumbersome technology offered by the current CRD. (But see § V., The

New Redesigned System, *infra*, for an explanation of the increased efficiencies to be provided by the upgraded CRD system to regulators and industry alike.)

Not only has the dramatic increase in the number of licensed agents caused the CRD to maintain an overwhelming amount of data, but the adoption and implementation of new regulatory requirements, such as continuing education requirements, has put additional strains on the system.⁷⁰ The result is a loss of the timeliness and efficiency an electronic system should provide. Despite this overload of information and the desperate need for a significant overhaul of the technology and design of the CRD database, relatively unchanged since its inception, states are still efficient and effective in licensing and monitoring broker-dealer agents. Overall, the current system causes the states to be less responsive to regulatory and investor needs, as well as industry concerns, than if states were provided with more effective tools. A brief description follows of some of the difficulties with the CRD system that cause delays in processing applications; a delayed reaction to disciplinary events; less reliance on the system to perform preliminary checks; and more reliance on internal state processes.

A. Difficulty: Redundant Data Entries and Inability to Profile Data

One of the biggest concerns of states with the current CRD system is their inability to efficiently track and thus, react to either problem individuals or specific types of disclosable items, especially disciplinary events, on a more timely basis. The reason for this is two-fold; (1) the redundant manner in which the data is captured by the CRD, and (2) the fact that the CRD system does not provide states with a practical mechanism to profile the type of disclosable events or individuals that require additional scrutiny.

1. Redundant Data Entries

The repetitive nature of the CRD database makes the review of an agent's application more complicated than one might expect. Due to the manner in which information contained in the regulatory filings is captured by the CRD, a single application becomes part of an agent's comprehensive CRD record which can be extremely duplicative. For example, in addition to the original licensing application, agents are required to file an amendment to their Form U-4 when information previously disclosed becomes either incorrect or incomplete. When an agent files an amendment to report a disclosable item, that same item may be reported on one, if not

⁷⁰ See Exhibit R, State Examples of CRD System Failure. Pennsylvania's inability to retrieve daily statistical data on agents for a six month period and Rhode Island's reoccurring system failures.

several other forms by the employing firm (Form U-5),⁷¹ a regulatory body (Form U-6)⁷² and even a subsequent amended Form U-4 as the agent's response to the Form U-5. Therefore, a single occurrence may result in the CRD capturing the same preliminary information on the particular occurrence many times and not just supplementing the original information with additional information received by additional filings. Thus, a CRD "run" of the information contained on the CRD for any particular agent is extremely redundant and difficult to read and decipher.⁷³ This adds unnecessary time and cost to the industry and the states.

2. Inability to Profile Data for Review

All filings are captured and maintained by the CRD in a central database, with little ability to differentiate among existing and amended information. For example, amendment filings may include address changes, phone number changes, disclosures regarding minor rule violations by SROs, disclosures about minor infractions with the law such as an arrest for disturbing the peace or a misdemeanor conviction for youthful pranks. However, other amendments may relate to disclosures regarding a state action for market manipulation, private litigation relating to fraud, criminal arrests for armed robbery or other egregious actions.

The CRD system segregates amendments that update disclosure items from those amendments that relate exclusively to updating administrative items. The CRD does not permit states to make any distinction between disclosable events that may not be reportable under the Form U-4, those that represent minor disclosable events and those that represent significant disciplinary occurrences. Therefore, a state is forced to either review all such amendments relating to all agents licensed with the state to determine whether the amendment relates to activity that needs to be addressed immediately, or opt to review the amended disclosure at another manageable time. It would be very time consuming, especially for a state with a high volume of applications, to review all amendments as they are filed. Therefore, generally, states review amended disclosures upon the filing of a transfer application or if otherwise made aware of an amendment containing disclosures that raise regulatory concerns. As a result, some disclosures may go unaddressed until such time as an agent transfers firms and a discrete application containing those disclosures is in front of the state rather than isolated amendments. Thus, the lack of functionality of the CRD (i.e., inability to profile) is also burdensome to the industry.

⁷¹ See Exhibit E, Form U-4 (Uniform Application for Securities Industry Registration or Transfer); Form U-5 (Uniform Termination Notice for Securities Industry Registration); and Form U-6 (Uniform Disciplinary Action Reporting).

⁷² See *id.*

⁷³ See Exhibit S, CRD Printout of a Single Agent.

Difficulty: System Provides Only Summary Information on Disclosures

Another inefficiency of the CRD is that the system provides only summary information regarding reported disclosures taken directly off the forms filed by the agents and the firms. The current CRD does not capture and retain the primary documents underlying the disclosures (e.g., complaint letters, settlement agreements, orders, etc.), nor is the accuracy of such information checked. Therefore, a separate, off-line request must be made by the state to the agent or the firm directly to receive more detailed and independent information on such events. Without such information, a state would be forced to make a determination about the significance of the event based only on the summary information.⁷⁴

When a state evaluates an application with disclosures and makes a determination that additional information is necessary, a written request is sent to the agent or the firm. Many states also call applicants to provide them with more prompt informal notice that additional information is necessary. As is demonstrated in Exhibit C, the average time it takes for a state to review an application and make a preliminary evaluation of the disclosures and provide first notice to the applicant that more information is necessary is only approximately five days. After the notice is sent by a state, however, states may not receive a response for a significant period of time and sometimes not at all.⁷⁵

The following specific *state example* puts in perspective the difficulty facing state personnel who attempt to review and act on applications on a timely basis. Furthermore, if a state reviewed all filings, applications as well as amendments containing new disclosure, as they are made, the task would be overwhelming without the ability to categorize CRD data yet to be implemented by the CRD redesign.

The state of Florida has approximately 153,000 licensed agents and receives 1,500 to 2,000 applications each week. As a manual state, each new application must be affirmatively approved, although TATs and renewals are automatic through the CRD. (Reasons for being a manual state and reviewing all applications, as opposed to being automatic and allowing the CRD to clear applications without disclosable events is set forth below.) A significant amount of staff time is necessary to process the large number of applications. The state first must

⁷⁴ See Exhibit G, Example of Additional Information Requested by States Due to Summary Information of CRD Printout.

⁷⁵ See Exhibit O, Statistics Regarding Processing Time for Utah to Request Additional Information and Response Time by Firms or Agents. State tracking response time to request for additional information from broker-dealers and agents. On average it took over 18 business days for a response from the applicant or his or her firm.

determine that the agent is properly qualified and review any disclosures that were required to be made. Depending upon whether any of the applications have any reportable or other disclosable events, the applications may require further review. If significant disclosable events are included, a review of background information relating to these events is necessary. As previously explained, the mere process of sorting through the CRD run summarizing the occurrences is time consuming and many times not very informative. Thus, depending upon the number of applications having disclosable events and the type of events, the amount of staff time necessary for review could be significant because the CRD is not able to profile certain disclosures and receive on-line back-up information. Despite the technological deficiencies, Florida generally approves those applicants with no reportable events within 2.5 days and those with minimal reportable events within six days.

The numerous amendments filed with the CRD that are associated with those 153,000 licensed agents, but would be in addition to the 1,500 to 2,000 applications each week. Furthermore, it is impossible to quantify the actual number of individual CRD screens or actual pages that would relate to those amendments. They too could be numerous per each amendment. In fact, in anticipation of the implementation of the redesigned CRD that promises better functionality for reviewing amendments, several states attempted to test how long it would take to review amendments on a routine basis. None of the states were successful because the system did not allow the states to clear away the backlog of amendments in the system in an attempt to move forward.

A related scenario arises at the end of each calendar year when agents renew. Once again, using Florida with approximately 153,000 licensed agents as an example, it would be virtually impossible for the state to review all renewal applications from the time they are filed before the new calendar year to grant a new license. Therefore, without the more efficient screening tools, states are severely handicapped in their review of filings by the existing computer system.

C. Difficulty: Disappearing Agents

When an agent files an application with the CRD and designates a state for licensure, the application is not filed with that state until the CRD checks the application for certain data deficiencies. The CRD system controls the movement of an application through the clearance process by reading the "date stamp" portion of a particular application at different stages of the process. The date stamp is generated automatically by the system at every level of the application review process. The "disappearing agent" occurs when a state's pending status for any particular application is a date prior to the NASDR approval date and the system does not recognize that state approval has been requested. The application will remain in the state's deficiency queue and unless directly contacted by the firm or the applicant, the state will not be on notice to review

the application because the application does not appear as if it is pending before the state. Thus, the "disappearing agent."⁷⁶

The unfortunate outcome of this system flaw is the time delay to the agents who experience it. Those agents wait for state action on their application only to be frustrated by no response from the state, they eventually call the state to determine the status of their application, at which time it is first discovered that the application should actually be pending before the state and not deficient. Only technological improvements can correct this unfortunate circumstance.

D. Difficulty: Incomplete and Unreliable System Checks

As the front-end processing tool, the CRD system is designed to perform preliminary checks on all applications. This procedure, although helpful to the states in screening applications, does not provide the comprehensive completeness check that many states require, nor does it check the accuracy of most answers, nor are some states confident that the system checks are performed consistently and without error. Due to these concerns, as discussed below, certain states have chosen to be manual approval states rather than automatic approval and all states must be alert to possible glitches in the system that cause a breakdown in the normal processing routine between the CRD and the states.

⁷⁶ The following is a description of the actual systematic problem that causes the "disappearing agent." At the point an application is received by the CRD system, the application is date stamped with an NASDR status date and the application is automatically categorized as deficient by the CRD system. When the CRD clears the filing for certain data fields, the system moves the application from the deficient queue to the NASDR pending queue and the application's status date, established through the date stamp, is updated as of this date. At the same time, the system will check the application to determine what state registrations have been requested and the system will transmit the application to those states by placing it in the states' deficiency queues and creates a date stamp for that date. The states, at that time, are technically in receipt of the application although the application is not yet pending before the states because the NASDR has not yet finished its preliminary review of the filing.

Once the NASDR completes its review of the application for certain substantive disclosures, if any, to determine whether the applicant is disqualified, the agent application is moved from the NASDR pending queue to the NASDR approval queue and the system creates a date stamp of the NASDR approval. The system should then move the application from the states' deficiency queues to the states' approval queues and notify the states electronically that the application is pending and ready for state review. The event which triggers the movement of the application from the states' deficiency queues to the states' approval queues is the NASDR status change from pending to approved. However, periodically the CRD system encounters a system glitch which will make an application seem to the system that it is pending in a state before final NASDR approval (although it is not), and when NASDR approval is received, the application remains deficient with the state with no notice to the state that the application is ripe for state review and processing. States have reported these "disappearing agents" on somewhat of a routine basis.

1. Manual vs. Automatic States

States may select whether they want new applications having no reportable events to be approved automatically by the CRD system ("automatic" states) or only after the state reviews the application and affirmatively approves it ("manual" states). Due to the overwhelming number of applications that have no disclosable events, the additional resources necessary to be a manual state are considerable. Those states that have the ability to allocate personnel resources to perform the "manual" review choose to do so to provide a more thorough evaluation of all applications before them as part of their "gatekeeping" function of licensing agents. In addition, some states have determined that being a "manual" state is necessary because of the lack of confidence offered by the CRD that system checks are being consistently and correctly applied.

Some of the added value manual states are able to provide include: reviewing all disclosures, including those that may be available because of mandatory fingerprinting that are not captured on the Form U-4 (e.g., nonfinancial misdemeanors); performing a "true" completeness check on all questions of the Form U-4 to ensure full answers (e.g., incomplete answers to residential or business addresses);⁷⁷ checking the accuracy of answers to the extent possible by comparing agents responses to any databases the state may maintain internally (e.g., securities enforcement databases, state police databases); and assuring that all state qualifications have been met, such as exam qualifications⁷⁸ or restrictions on dual licensing by an agent with two different broker-dealer firms.

2. Approved But Not Approved: CRD LIMBO

As discussed earlier, most states will not approve an application until all of the CRD data deficiencies and NASDR disciplinary reviews are completed (i.e., when the NASDR application status is approved). States do not consider the application pending for their review until the NASDR review is complete. Some applications, however, are wrongfully moved into the states' acceptance queues while the application is still NASDR-pending. Once the application is moved to the states' acceptance queues for approval, the system does not have the ability to change the NASDR status line from pending to approved. Therefore, the application could maintain an NASDR pending status indefinitely and appear to the states that the application has not yet been approved by the NASDR. The applicant will customarily inquire with the states why action on the application has not yet been taken. As a result of such inquiries states learn that the application has received NASDR approval although that is not the status

⁷⁷ See Exhibit K, Example of Incomplete Application of an NASDR-Approved Agent. Deficiency letters from Iowa to applicants regarding incomplete answers to questions on the Form U-4.

⁷⁸ See note 36, *supra*.

indicated on the CRD system. In those circumstances, the state or the applicant must notify the CRD to place the application back into the NASDR approval queue so it can reflect NASDR approval and so indicate to the states.

Once again, the agent suffers the consequences of this system error and is unable to become licensed by a state until rectified. Reports of these instances are numerous and only technology changes can correct the problem.

E. Difficulty: Inability to Access CRD Data and Generate Reports

Under the current CRD system, a state cannot generate its own printout of CRD information relating to particular criteria -- a report. For example, a state cannot obtain directly from the CRD a report of all agents currently registered with the state, nor can it produce a report of all agents with disclosures relating to criminal convictions. The current system cannot generate reports except upon request to the NASDR creating a "special order." This process is neither quick, nor free; a report can take months to produce and cost the states hundreds of dollars.⁷⁹

F. Difficulties: Miscellaneous

The current CRD periodically demonstrates through other system glitches the strain that is being placed on the present outmoded technology.⁸⁰

V. THE REDESIGNED CRD SYSTEM.

For approximately the past seven years, NASAA has worked with the NASDR on their redesign of the CRD system, which anticipates not only upgraded technology but a new format of the database information to allow more efficient interaction with the data. Although the NASDR conducts the daily operations of the CRD as a system, the concept of the CRD and the database is jointly owned by NASAA, on behalf of the states, and the NASDR. The CRD is the comprehensive archives for state licensing records. As such, the states provide a significant cost savings to the industry because neither the industry, nor the states (although required to meet state open record and record retention laws), are required to maintain separate paper filings, either of which would add costs to the licensing process. Due to the significant changes that have occurred in technology over the past 16 years when CRD was first designed, the size and breadth of the database, and the numerous users of the system, the redesign has

⁷⁹ See Exhibit T, State Examples of Difficulties in Obtaining Reports from the CRD. But see processing form and related costs for generating reports on insurance agents.

⁸⁰ See Exhibit U, Memorandum Regarding State Difficulties with the CRD System from Denise Alaimo to NASAA Legal Department Re: Problems with the CRD System.

taken much longer than expected and has had a few false starts. Most recently, the NASDR determined that a comprehensive technology reassessment was needed on all of the NASDR's databases, including the CRD, to determine the long-term viability of their redesign approach. It appears that as a result of the reassessment, the implementation of the redesigned CRD, could be delayed as much as two additional years.

A description of the enhanced functionality and the new features to be incorporated into the redesign of the CRD system (despite which technological approach is taken) are set forth in an agreement between the NASD and NASAA (the "NASD/NASAA Agreement"). The three most important features of the redesigned system include an improved format for the use, display and retrieval of disciplinary and other regulatory information disclosed by applicants, an expedited relicensing process, and the replacement of paper submissions which need be inputted into the CRD by NASDR staff with electronic filings to be made directly by the industry participants themselves.

A. Improved Formatting, Profiling and Retrieval of Disclosure Information

"The existing CRD system provides regulators with few sophisticated tools to effectively manage and expedite the licensing review process. One of the goals of redesigning the CRD system is to enable both industry and regulators to manage an effective licensing regulatory system. The goal of industry to speed up the registration process need not be inconsistent with the regulator's desire to have an efficient and timely way to regulate this area of the business"⁸¹ This quote from the NASD/NASAA Agreement reflects the need by all users of the CRD for a more efficient system and that such enhanced efficiency will benefit not only the regulators, but the industry as well.

One of the most fundamental changes to be made to the CRD system to enhance its efficiency and effectiveness is the creation of a database that is far more interactive rather than static for the users of the system and one that can profile the data in the system. "Every CRD user group recognizes that the disclosure information maintained in the current CRD system is repetitive and difficult to understand. There is uniform agreement among all CRD users that, in the redesign of the CRD system, disclosure information should be reorganized and presented in a fashion that properly categorizes the type and nature of the information being conveyed."⁸² Without these improvements, the CRD system will remain unable to categorize, retrieve and present data in a manner that could be far more useful to regulators in streamlining their

⁸¹ See NASD/NASAA Agreement, Relicensing Exhibit at 1 (on file at NASAA).

⁸² See NASD/NASAA Agreement, Disclosure Exhibit at 1.

licensing process. The ability of each state to customize CRD information pursuant to their state review criteria is essential new functionality.

In addition, another enhancement scheduled for the redesign is the development of a "pass-through" function. "If documents, or additional details are required by regulators, the CRD system will provide a pass-through function to allow the firms to submit the documentation (electronically or otherwise) to the regulator through the CRD system. Imaging of standard documentation required by regulators (i.e., court documents for criminal convictions) will be utilized to allow the CRD system to maintain these documents, and associate them with an agent's CRD record. Users will be able to determine what documents are on-file with the CRD and may obtain a copy of these documents from the system through some electronic means."⁸³

The NASD has also committed to have the redesigned system provide more timely and informative notifications to the states on new or amended disclosures.⁸⁴ It is evident that these additional enhancements to the CRD will greatly assist state personnel in their licensing process.

B. Expedited Relicensing Process

As previously discussed, the current system is too cumbersome to permit states to review amendments to an initial application at any time other than when an agent transfers or reaffiliates with a new broker-dealer, or if otherwise notified of an amendment relating to disciplinary activity. However, with the reorganization of the CRD database and the additional functionality outlined above, transfer applications could be processed more efficiently. One of the undertakings of the NASD/NASAA Agreement, is for the redesign of the CRD to incorporate an expedited relicensing process for transfers, unavailable currently due to the inefficiencies of the CRD system.

An important feature of the anticipated expedited licensing process is the availability of a Temporary Registration. The Temporary Registration will permit qualified applicants to automatically transfer to the new the broker-dealer and begin transacting business without having their application held up for state review at the time of transfer. The Temporary Registration requires the applicant to sign an acknowledgment that certain requirements have been met by the applicant and understanding and agreeing that the registration is only temporary and can be terminated by a state at any time. Although presently the TAT system exists to allow those applicants without any reportable events to transfer immediately, the Temporary Registration permits states to allow applicants having reportable events to transfer,

⁸³ See NASD/NASAA Agreement, Relicensing Exhibit at 1.

⁸⁴ See NASD/NASAA Agreement, Disclosure Exhibit at 5.

recognizing the registration is only temporary and the state can set parameters for the types of reportable events that might be unacceptable to permit even a Temporary Registration.

The Temporary Registration, and the benefits it provides to agents by allowing them to remain continuously employed, would not be possible without the other enhancements to the redesigned CRD system, especially the reorganization of the disclosure information in a fashion that properly categorizes the type and nature of the information.

C. Electronic Filing

Under the current system, agent applications are submitted to the CRD in paper form. The CRD system, at present, is not capable of receiving the application in electronic form. This necessitates that the information captured on the paper Form U-4 be inputted into the CRD system or "data captured." Currently, NASDR staff perform this function. Thus, before an agent's application can even begin to be processed electronically by the CRD system, some time delay is attributed to entering the application into the system.

The NASDR is committed to redesigning the CRD system to permit direct electronic filing of agent applications by broker-dealers on behalf of their agents. Three of the primary benefits of electronic filing of agent applications include: eliminating the time delay associated with transforming a "paper" Form U-4 into an "electronic" Form U-4; eliminating data redundancy as a result of agents utilizing existing CRD data as the starting point in making a filing; and eliminating the opportunity for errors resulting from the additional handling of the application caused by the need for its data entry into the system.⁸⁵ Other benefits of electronic filing noted in the NASD/NASAA Agreement include: more appropriate disclosure data to be solicited from agents pursuant to revisions made to the Form U-4 in expectation of the redesigned system; application data to be divided into administrative and disclosure categories; and all users will be able to print a copy of an electronic form as of a given time.⁸⁶

As noted above, the redesign of the CRD system is anticipated to resolve many of the issues outlined in the previous section. The states, through NASAA, have committed significant time and resources to the CRD redesign effort in order to bring the new system on-line as soon as possible. As efficient as the states are today in

⁸⁵ As noted in the NASD/NASAA Agreement, "This [electronic filing] process will increase the efficiency of the licensing process both by eliminating the burden of paper processing and by making the filing data available more quickly to CRD States."

⁸⁶ See NASD/NASAA Agreement, Electronic Filing Exhibit, at 3.

licensing agents, the redesign of the CRD will further facilitate agent licensing, as well as provide states with a better regulatory tool to enhance investor protection.

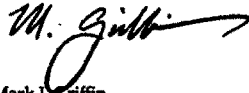
VI. CONCLUSION

States are uniform, "consistent in conduct or opinion,"⁸⁷ in their licensing requirements of broker-dealer agents. All states require the Form U-4 as the uniform form to license agents, all states process applications through the CRD system, all states accept fee payments electronically through the CRD system, and if an exam requirement exists, all states require the Series 63 exam or accept the Series 66 in its place.

Licensing standards are also predominantly uniform amongst all jurisdictions, but in the instances of non-uniformity, the state securities agency is adding a much-needed screening of agents to protect the citizens of the state. States can best monitor the local trends in the industry as the regulator who has hands-on knowledge at the local level because it receives the customer complaints. States can best monitor the local trends and be responsive to those trends as the regulator who is directly accountable to the citizens of the state. The unique position of state regulators as "local cops on the beat" provides these agencies the unparalleled opportunity to be proactive in agent licensing and preventing unmeasurable instances of fraudulent or unlawful conduct.

Ms. Blaine, NASAA appreciates the opportunity to assist the Commission in its study to Congress regarding state licensing processes of broker-dealer agents. Please feel free to contact the undersigned at 801/530-6600 or the NASAA Legal Department at 202/737-0900 should you have any questions or require any additional information.

Sincerely yours,



Mark J. Griffin
NASAA President

cc: The Honorable Arthur Levitt, Chairman

⁸⁷ Webster's Ninth New Collegiate Dictionary (1967).

The Honorable Stephen M. H. Wallman, Commissioner
The Honorable Isaac Hunt, Commissioner
The Honorable Norman Johnson, Commissioner



Testimony

of

Barry R. Goldsmith,

Executive Vice President

NASD Regulation, Inc.

before the

Senate Permanent Subcommittee on Investigations

on

Micro-Cap Stock Fraud

September 22, 1997

The NASD would like to thank the Subcommittee for this opportunity to testify on micro-cap fraud in the U.S. markets, the nature of the problem and our efforts to address it. America's securities markets are essential to the capital formation process and economic well being of our nation. It is our job to work together with the SEC, the states, and others to protect investors and the markets from fraud and abuse of any kind.

Your invitation letter asked for, among other things, our views on the nature of the problem, including recidivist individuals and firms, the role of the states in the licensing process, and any potential need for enhanced responsibilities for clearing firms in this area.

I readily acknowledge that there are some dishonest individuals and firms in the securities business today. However, let me also say that the overwhelming majority of individuals in the securities industry are honest, ethical professionals who treat their obligation to comply with the law seriously and put the individual investor's interest first. The problem firms represent a tiny portion of the more than 5,500 securities firms in this country and are for the most part firms that concentrate their activities in the securities of thinly capitalized, micro-cap companies. While these smaller companies may provide significant growth potential for investors, sales of securities of these companies are also susceptible to abusive practices such as misrepresentations, manipulation, false price predictions, and phony guarantees against loss.

As securities regulators we must adopt a "zero-tolerance" approach to fraud. We must continue to look at ways of improving our enforcement and surveillance, as well as the rules we adopt to protect investors. We must also look at new ways of "investor outreach," so that the individual investor is armed with the information he or she needs to resist the scamsters and make responsible investment decisions. I will speak about these matters today.

THE NASD

Let me briefly outline the role of the NASD in the regulation of our securities markets. Established under authority granted by the 1938 Maloney Act Amendments to the Securities Exchange Act of 1934, the NASD is the largest

self-regulatory organization for the securities industry in the world. Every broker dealer in the U.S. that conducts a securities business with the public is required by law to be a member of the NASD. The NASD's membership comprises more than 5,500 securities firms that operate in excess of 62,000 branch offices and employ more than half a million registered securities professionals.

The NASD is the parent company of NASD Regulation, Inc. (NASDR), and The Nasdaq Stock Market, Inc. These wholly owned subsidiaries operate under delegated authority from the parent, which retains overall responsibility for ensuring that the organization's statutory and self-regulatory functions and obligations are fulfilled. The NASD is governed by a twelve-member Board of Governors, a majority of whom are non-securities industry affiliated. The NASDR subsidiary is governed by a 24 member Board of Directors, balanced between securities industry and non-industry. Board members are drawn from leaders of industry, academia, and the public. Among many other responsibilities, the boards, through a series of standing and select committees, monitor trends in the industry and promulgate rules, guidelines, and policies to protect investors and ensure market integrity.

NASD Regulation

NASD Regulation is responsible for the registration, education, testing, and examination of member firms and their employees. In addition, we oversee and regulate our members' market-making activities and trading practices in securities, including those that are listed on The Nasdaq Stock Market and those that are not listed on any exchange. Although activities involving these securities may be reflected in different quotation media, NASDR is ultimately responsible for regulating the trading activity of its members whether it occurs in The Nasdaq Stock Market, the over-the-counter market, or any other area over which the NASD has jurisdiction.

The 1,600 member staff of NASDR is devoted exclusively to carrying out the NASD's regulatory and enforcement responsibilities. NASDR carries out its mandate from its Washington headquarters and 13 district offices located in major cities throughout the country. Through close cooperation with federal and state authorities and other self-regulators, overlap and duplication is minimized, freeing governmental resources to focus on other areas of securities regulation.

NASDR rulemaking is a widely participatory process with broad input from industry members, trade associations, other regulators, and the public. By the requirements of the Securities Exchange Act of 1934, NASDR rules do not become final until they are filed with and approved by the SEC. The SEC staff carefully reviews each rule filing and publishes NASDR rules for comment in the *Federal Register*.

NASDR has examination responsibilities for all of its 5,500 members. In addition to special cause investigations that address customer complaints and terminations of brokers for regulatory reasons, NASDR has established a comprehensive routine cycle examination program. This program is carried out through a regulatory plan that focuses each District's examination efforts on the firms, individuals, issues and practices that present the greatest regulatory challenges and concerns. Annual on-site inspections are conducted of high priority areas. In addition, NASDR has established an examination frequency cycle for all of its members, which is based upon the type of business conducted by the member, the scope of that business, the extent of customer exposure, method of operation, past regulatory history, and other factors. During 1996, almost 2,400 main office routine examinations were completed and over 5,200 customer complaints and 3,892 terminations for cause were investigated.

Another key factor in NASDR's overall regulatory program involves developing and administering qualifications testing for securities professionals. All sales and supervisory persons associated with NASD member firms must demonstrate a requisite understanding of the products offered by their firms, as well as regulatory requirements for the functions they are to perform for their employer-members. Individuals acting in a management capacity must pass the appropriate principal's examination, while sales personnel must demonstrate specific understanding of the products they intend to sell and the regulations that govern those products. In 1996, NASDR administered its 29 different qualifications tests to 267,000 individuals.

The Nasdaq Stock Market

The Nasdaq Stock Market, Inc., develops, operates, and regulates a variety of marketplace systems and services. The Nasdaq Stock Market is the largest electronic, screen-based stock market in the world, capable of handling trading volume in excess of one billion shares a day. Today, more than one-half of all

equity shares traded in the United States each day are traded on Nasdaq. Companies trading either on Nasdaq's SmallCap Market or the Nasdaq National Market -- the two respective tiers of The Nasdaq Stock Market -- are required to make extensive financial disclosure and meet well-established listing standards. As I will discuss, these standards are being strengthened, particularly in the Nasdaq SmallCap market.

The Over-The-Counter Market

While not part of The Nasdaq Stock market, the NASD has regulatory responsibilities for what is known as the OTC or over-the-counter market. The over-the-counter market is a vast amalgam of publicly traded companies that list neither on Nasdaq nor on any exchange. Contrary to a popular misconception, often perpetuated by unscrupulous operators, the over-the-counter market is not Nasdaq. The two are separate and distinct. It is in the thinly traded, micro-cap securities that characterize the over-the-counter-market where we find great potential for fraudulent activity.

There are several reasons for this. First, thinly traded stocks typically have a small market capitalization. Accordingly, they are more easily subject to manipulative practices by unscrupulous brokers, issuers, and promoters. Second, a significant number of OTC companies report absolutely no information to the SEC, making their financial situation a virtual blank slate to investors. While some of these companies make financial information available, what reaches investors is not required to be subject to accounting auditing standards. Third, there is no minimum price that an OTC company must maintain to trade. Stocks in the OTC market can and do trade for mere pennies, and indeed the OTC is where you find the so-called "penny" stocks.

A part of the over-the-counter market is what is known as The OTC Bulletin Board. While it is a system operated by Nasdaq, the Bulletin Board is markedly different and separate and distinct from The Nasdaq Stock Market. It is an electronic quotation service for subscribing members. While the system displays real-time quotes, last sale prices, and volume information in domestic securities, there is no formal legal relationship between the OTC issuers whose shares are quoted there and Nasdaq. The companies need not meet any listing standards to have their stock included in the Bulletin Board. There are no periodic reporting requirements for continued inclusion in the service; only limited phone, contact,

and address information is available in the OTC Bulletin Board company listings. This system provides a centralized and automated alternative to the Pink Sheets, which historically have been published on paper once each day, but which are now available electronically via market data vendors.

A misperception that is frequently fostered by scam artists is that trading on the OTC Bulletin Board is akin to trading in a highly regulated market such as Nasdaq. They will often refer to an OTC stock as listing on "Nasdaq's OTC Bulletin Board" or on "the Nasdaq OTC" or some other deliberately confusing variation that improperly links the two. As I will describe, we are considering several approaches to more effective regulation of the OTC markets as a whole and the OTC Bulletin Board in particular.

NASD REGULATION'S ENFORCEMENT RECORD

As these hearings demonstrate, we as regulators must redouble our efforts in the micro-cap area. NASD Regulation has already begun to do so. In 1996, we significantly increased the number of staff dedicated to regulation and enforcement by adding more than 150 new positions. By the year 2000, NASDR plans to spend more than \$100 million to enhance its systems for market surveillance and increase examination, surveillance, enforcement, and internal audit staff.

We are already beginning to see the fruits of our investment. In 1996, disciplinary actions brought by the NASD reached 1,200, an increase of 12 percent over the prior year. Last year 394 individuals were barred and 204 were suspended. Disciplinary fines collected increased by almost two-thirds and the number of firms expelled from the NASD increased by approximately 20 percent. In addition to disciplinary fines, orders of restitution to investors reached \$21.8 million in 1996.

Enforcement Cases

In our focus on the microcap market, we have brought many significant cases in recent years, including:

Stratton Oakmont — In December of last year, NASD Regulation expelled Stratton Oakmont from the securities industry. Following our own disciplinary proceeding and prior actions by the SEC and at least 19 different states, NASD

Regulation expelled the firm and barred its president and its head trader from the securities industry. The head trader has appealed the case to the SEC. This case imposed restitution and fines in excess of \$1 million. Another complaint was filed last year against Stratton Oakmont and others alleging that the firm made approximately \$28 million in illegal profits during the first day of aftermarket trading of five small stock offerings. Other enforcement actions against those directly responsible for the firm's actions are contemplated.

Hibbard Brown — Innocent investors are too often the victims of exploitation by aggressive sales tactics. This happened with a shell company called Site-Based Media. Working with the New Jersey Bureau of Securities, the NASD reviewed over 6,000 trades and uncovered fraudulent tactics by the firm of Hibbard Brown that generated \$8.7 million in illicit profits in just eight days.

Hibbard and its sole owner Richard Brown were subsequently expelled by the NASD and ordered to pay \$8.7 million back to retail customers. Additionally, the firm's head trader and Brown were barred and fined. We continue to prosecute former Hibbard employees for their conduct with the firm. The investigation brought to light hundreds of examples of improper sales tactics, ranging from guarantees against loss, to unauthorized trading, to high pressure, intimidating, fully scripted sales pitches. Indeed, sales reps at Hibbard, in addition to being required to read from scripts, were encouraged to call customers continually, even if the customer refused to do business. To date, 13 branch office managers and registered representatives have been barred for their abusive sales practice activities.

A.R. Baron — In May, the Manhattan District Attorney announced the indictment of A.R. Baron & Co., Inc. and the arrest of 13 individuals for cheating thousands of investors out of more than \$75 million. The individuals and the firm, which is now defunct, were charged with participating in a pattern of criminal activity. Included in that pattern were lying to investors to induce them to buy certain low-priced securities; manipulating the markets in certain micro-cap stocks to benefit themselves and their favored customers; making unauthorized trades in the millions of dollars; refusing to honor its customers' directives to sell securities in their accounts; outright thefts from investors; and forging documents to prevent detection of their crimes. Four NASD Regulation examiners from our Chicago office worked closely with the Manhattan DA throughout this important investigation.

NASD Regulation has brought its own cases against A.R. Baron, its principals and reps. In one of those actions, the firm paid more than \$1.5 million in restitution to customers and fines for charging fraudulently excessive markups in more than 200 separate transactions. Other cases against Baron's brokers are still pending.

D.H. Blair — In August, D.H. Blair & Co. Inc., was fined \$2 million for overcharging its customers and for engaging in fraudulent pricing activity. Blair will repay almost \$2.4 million to investors who were overcharged as the result of fraudulent and excessive mark-ups in 16 securities. D.H. Blair's chief executive officer and head trader were also fined a combined \$525,000. More than 3,100 retail customers from 43 states will receive restitution payments.

The firm charged excessive markups in 16 Nasdaq SmallCap securities whose Initial Public Offerings (IPOs) were underwritten by D.H. Blair Investment Banking Corp. NASD Regulation found mark-ups greater than 10 percent (a level considered fraudulent) in 14 of the 16 securities that D.H. Blair Investment Banking Corporation had underwritten. D.H. Blair placed virtually all of the offerings with its own customers and controlled the after-market trading in all 16 securities, in some cases for up to four and a half months after the IPO effective date.

As part of the settlement, D.H. Blair is also required to hire an independent consultant to review and monitor the firm's trading, sales, supervision, and other compliance-related policies and practices for two years. This consultant will also recommend necessary improvements, which the firm must implement.

Test Cheaters — Finally, every investor has the right to expect that his or her broker is honest and understands the securities markets and its regulations. This is the cornerstone of investor protection. To fulfill this responsibility, NASD Regulation last month announced that it had barred, censured, and fined 20 more registered representatives suspected of paying an impostor to take a qualification exam on their behalf. More than \$1.8 million in fines and forfeited commissions were assessed against these brokers. This brings to 41 the number of suspected "test cheaters" we have thrown out of the industry. NASD Regulation has also worked closely with the Manhattan District Attorney's office in the indictments of 52 impostors and others implicated in this matter.

STRENGTHENING INVESTOR PROTECTION

A strong regulatory response is needed to the problems in the micro-cap market. We have already made this area a prime focus of our regulatory program, but we need to expand our efforts even further. The NASD is actively studying this market, particularly the OTC Bulletin Board, to determine what rule changes and enforcement initiatives are needed to address the problems we see. Investors need to have access to more accurate and current information about the companies whose shares trade there. Too often the only information investors have is the misinformation and hype posted on a stock promoter's Web page or the pie-in-the-sky promises made by a brash cold-calling broker.

We must take a hard look at whether there should be higher threshold standards for including a stock in the Bulletin Board. We will look closely at whether a company that is unwilling or unable to provide full and timely disclosure of information to the public or to regulators should be given quotation visibility on this electronic medium. Such a proposal could limit quotation on the OTC Bulletin Board to companies filing periodic reports with the SEC or banking or insurance regulators.

We must also work with the SEC to strengthen the tools we have to keep the shares of bogus companies from being traded in the over-the-counter market in the first place. This can be accomplished by toughening and clarifying the rules we have to prevent broker-dealers from initiating or continuing to quote an OTC security when they do not have current reliable financial and other information about the issuer. In particular, we are considering whether to prohibit broker dealers from recommending a transaction in an OTC security unless they have first reviewed the issuer's current financial statements and reasonably believe that they are accurate.

In addition, we need to explore rule changes that would place tougher new requirements — beyond the existing suitability requirements — on brokers to confirm with their customers, based on objective criteria, that purchases of these types of securities are suitable investments. We are also looking at ways that brokers can be required to disclose to their customer's specific information about these types of investments and their differences from those traded on The Nasdaq Stock Market. We will determine if there is a need for increased regulation on the operation of the OTC Bulletin Board, such as the authority for the NASD to halt

trading under certain circumstances, including when a foreign regulator issues a quote halt in the stock for regulatory purposes.

Finally, we must be more proactive in educating investors on the specific and unique characteristics of the OTC equities markets. The NASD has already begun a program to educate investors about the specific characteristics of the OTC Bulletin Board, the Pink Sheets, and other quotation media. The program will emphasize the distinct differences between those markets and The Nasdaq Stock Market. In addition, the program will describe to investors the risks associated with the OTC equities marketplace, including that certain issuers in this marketplace are not subject to listing or maintenance standards.

REPEAT OFFENDERS

One of the best ways to protect the public from securities fraud is to help ensure that those who have previously broken securities laws are not allowed to do it again. Securities regulators monitor the activities of past offenders to assure that they do not repeat their transgressions and cause more harm to investors. This is accomplished by better regulator and investor access to information on past violations, punishing repeat violators more heavily, and more closely monitoring firms that hire past violators. Coupled with these efforts the NASD has a rigorous process in place that makes it difficult for expelled members or barred brokers to re-enter the industry. Where barred brokers reappear as promoters and officers of companies that are suspected of wrongdoing and are beyond our jurisdiction, we will refer those cases to the SEC and other enforcement agencies.

One of the primary methods of defense against recidivism is to ensure that violators are widely known to those who must license them or who might do business with them. Through the NASD's Central Registration Depository (CRD), all federal and state securities and futures regulators are quickly made aware of an individual's violations. This extensive database, which is presently being revamped, incorporates an individual's disciplinary history as part of his or her permanent record.

This same system also forms the base of the NASD's toll free Hotline, which permits investors — without charge — to check out an individual or firm's regulatory history, including prior violations, before doing business with them.

The NASD's *Sanction Guidelines*, which are used by its disciplinary committees and hearing officers to decide on appropriate punishment for securities violations, also come down hard on recidivism. These *Guidelines* reflect the NASD's belief that a primary objective of its disciplinary process is to deter future violations by imposing progressively escalating sanctions on repeat offenders.

If an individual defies a bar against working in the securities industry, the NASD will then sanction the firm and its responsible principals for employing the violator. The NASD has brought several cases in recent years against firms who have employed barred or disqualified individuals, as well as against individuals who have misrepresented their disciplinary history on their official NASD records. However, since the NASD is a membership organization, it can only sanction its members and their associated persons. Thus, if a barred individual engages in securities fraud outside of a member firm as, for example, a promoter, the NASD must refer the matter to the SEC, state regulators and, in the most egregious cases, criminal law enforcement agencies.

Individuals and firms that are barred from the securities industry are allowed back only through a formal, rigorous process designed to minimize recidivism. Those who have committed specified crimes or have been barred or enjoined by the SEC or barred by a self regulatory organization are disqualified by statute from association with a broker. Reentry into the securities industry after a statutory disqualification is a relatively rare event. For example, in 1996, the NASD barred 394 individuals. During that same year, the NASD received no applications for re-entry from individuals that it had previously barred.

A person is subject to a statutory disqualification if he or she has committed any of the offenses listed under Sections 3(a)(39) and 15(b)(4) of the 1934 Securities Exchange Act or Paragraph II, Section 4 of the NASD's By-Laws. The offenses include any felony conviction within the past ten years and misdemeanor convictions involving securities, theft, false statements, bribery, forgery, and similar crimes. Injunctions obtained by the SEC, Commodity Futures Trading Commission, or state regulators against violations of securities and futures laws and bars imposed by the SEC, CFTC or futures and securities self-regulatory organizations also constitute statutory disqualifications.

Statutorily disqualified individuals can seek re-entry into the securities industry through NASD eligibility proceedings. NASDR Member Regulation

may also bring a proceeding to disqualify from NASD membership a firm that is employing a statutorily disqualified person. In either case, a hearing is held before a hearing panel of the NASDR's Statutory Disqualification Committee. In the case of an eligibility proceeding, the statutorily disqualified individual and his or her proposed supervisors are required to attend. The hearing panel obtains information about the firm, the supervisors, the proposed supervision, and the individual's proposed activities to decide on the individual's proposed or continued employment in the securities industry.

In both eligibility and disqualifications proceedings, the hearing panel will make a recommendation to NASDR's Statutory Disqualification Committee, where it will be reviewed by the NASD's National Business Conduct Committee, the NASDR and NASD Boards and the SEC.

The individual must show that the employment should be permitted in spite of past misconduct, considering the gravity of the disqualifying misconduct, the time since it occurred, the criminal sentence or injunctive restrictions imposed, and the potential for future regulatory problems. The individual's firm must show that it understands the need for — and has the capability to provide — adequate supervision over a person with a statutory disqualification.

On August 7, 1997, the SEC approved important changes in the procedures that the NASD employs to review statutory disqualification applications or to disqualify firms that employ statutorily disqualified individuals. NASDR's staff is now authorized to participate in application and disqualification hearings as a party. This means that NASDR staff will be able to initiate disqualification proceedings and advocate a position that it believes the NASDR Statutory Disqualification Committee should take in eligibility hearings.

NEW NASD RULES TO COMBAT FRAUD IN THE MICRO-CAP MARKET

NASD Regulation combats fraud in the micro-cap market not only with enforcement actions directed at specific firms and registered reps, but through aggressive new rules as well. These rules apply to all of our members and all of their associated persons. While you requested in your invitation letter that we specifically address the issue of the responsibilities of clearing firms, we also need

to report to you on other initiatives, including those involving cold calling, taping requirements, the Internet, and listing requirements.

Clearing Firms

A focus of these hearings has been the responsibility of clearing firms, and your invitation letter specifically requested our views on enhancing the role of clearing firms in the regulation of thinly capitalized introducing firms. This idea is one on which we have been already acting. We are working hand in hand with both the SEC and the New York Stock Exchange to explore imposing, through across-the-board rulemaking, new reporting responsibilities on firms that act as clearing brokers for other firms. These proposals would require clearing firms to provide information that will allow self-regulators to better monitor the activities of the firms on whose behalf they clear trades -- so called "introducing firms." Under proposals that that are being considered by our Board, clearing firms will be required to report to the NASD or other Designated Examining Authority certain written complaints that they receive on activities of the introducing firm, and forward all complaints received to the introducing firm. The clearing firm will also be required to make available to its introducing firms reports and analyses of the introducing firm's own activities.

Taping Rule

When we succeed in putting a recidivist firm out of business, our job is not over. Sometimes the principals in those firms turn around and form new firms under a different name, other times the brokers go in clusters to existing broker-dealers. When a large number of these brokers become employed at another broker-dealer, this raises the risk that their new firm will have significant sales staff who may not have yet forgotten their old bad habits. In addition to our statutory disqualification program I described earlier, the NASD Board last month attacked this problem in a new way by approving and sending to the SEC for its approval a rule that would require brokerage firms to tape all customer sales calls for two years if a certain percentage of the firm's brokers worked for firms that have been expelled for telemarketing fraud or sales practice abuse.

Telemarketing

We have seen too many instances where investors become the unwitting victims of "cold calls" and high pressure sales tactics. These tactics are used by certain brokers to convince an investor to purchase stock over the telephone from a broker they do not know and, in all likelihood, would never want to know. NASD Regulation has responded to abuses of this type by adopting "telemarketing rules." In 1995, we adopted a "cold call" rule that requires NASD member firms to keep "do not call" lists of persons who do not wish to receive telephone solicitations from the securities firm or its brokers. More recently we have strengthened the regulation of this area by prohibiting firms and their brokers from telephoning a noncustomer's residence to sell securities during certain times, unless they have the prior consent of the person. In addition, in making these calls, member firms and brokers must immediately give their names, the name of their firms, their telephone number or address, and state that the purpose of the call is to sell securities or related products.

Electronic Media and The Internet

The use of electronic media -- including the Internet and e-mail -- to disseminate securities related information has grown enormously. This is an area of concern to NASDR. This year we will implement an automated system that will greatly increase the range, speed, and early warning capabilities of our Internet surveillance. In addition to enhancing our technology, we have filed proposed rule changes with the SEC that require member firms to establish written procedures for the review of electronic correspondence.

Nasdaq Listing Requirements

In August, the SEC approved new listing standards for Nasdaq listed companies. These standards will raise financial listing requirements significantly, eliminate issuers with a bid price below \$1.00, and also extend corporate governance standards to all Nasdaq listed companies. These listing standards, which do not apply to companies whose shares trade on the OTC Bulletin Board or the Pink Sheets, will continue to improve the quality of smaller issuers on The Nasdaq Stock Market.

Earlier this year, The Nasdaq Stock Market significantly increased its listing qualifications staff and created and staffed a new Listing Investigations Unit – a group of accountants, investigators and lawyers who will proactively investigate the financial reports, business plans and other filings of companies suspected of potentially fraudulent behavior. Investigations conducted by the Department will focus on issuers that otherwise comply with Nasdaq's listing standards, but may have issued false financial statements or otherwise engaged in fraudulent conduct to become or remain listed on the Nasdaq.

In addition, Nasdaq is completing development of an automated risk scoring system. This system, which uses advanced visualization tools, identifies companies with compliance profiles that suggest the need for heightened scrutiny.

INVESTOR EDUCATION

As you can see, investor protection initiatives through new rule proposals have been one of our highest priorities. We have coupled these efforts with an enhanced investor education and outreach program through our Office of Individual Investor Services. This Office was launched by the NASD in August of 1996 and given a mandate to help focus the attention of the organization and industry on the individual investor. NASD Regulation believes that one of the most effective ways to protect individual investors is to provide them with information they need to make educated and sound investment decisions. Through this Office, the individual investor has a strong advocate within our organization.

The foundation of this program is the NASD Regulation Web site (www.nasdr.com). This site provides investors a basic primer on how the regulatory process works, how investors can avoid problems before they occur, and steps they can take should they run into difficulty. The site contains an overview of NASD Regulation's activities, information on investing wisely, timely messages on current regulatory developments, and descriptions of the arbitration and mediation process. It also allows investors the on-line ability to request disciplinary histories of brokers, file complaints, and comment on proposed rules.

Noting the importance of this information to investors, we have recently expanded the information available to investors about the disciplinary history of a

member firm or an associated person. Earlier this year, new rules went into effect by which we will publicize disciplinary complaints at the time they are filed and non-final "trial level" decisions in cases involving designated investor protection rules and statutory provisions.

Our Web site is complemented by the NASD's Individual Investor Services site (www.investor.nasd.com), which offers training on investment basics, guidance on working with a broker, market research, and a calendar of investor events. In addition, the NASD publishes an investor newsletter, makes presentations, and provides information at investor forums. And, continuing to focus our efforts on the use of electronic media, NASDR initiated an Internet Education program. The key element of this program is a brochure distributed free to investors through the NASD and its member firms either on-line or by mail. This brochure provides guidelines for using securities information on the Internet safely.

Another way in which the NASD is trying to educate investors so that they can protect themselves are two pieces of literature that we have created titled "There are Rules to Protect You When Stockbrokers Call" And "What To Do If A Broker Calls To Pitch An IPO (Initial Public Offering)." These short pieces are designed to be distributed widely to consumers as envelope stuffers or short items in newsletters, to inform them of the requirements placed on brokers making sales calls in general or calls for an IPO in particular. We are now working with utilities in the New York area to include the pieces in their monthly statements.

STATE LICENCING AUTHORITY

Your invitation letter requested our views on whether state authority to license broker dealers and their registered representatives is critical to protecting small investors. Your question is timely because the SEC is now studying this important question under a Congressional mandate from last year's National Securities Markets Improvement Act.

Broker dealers and their registered representatives are licensed by more than one regulator. Federal law requires that all firms doing interstate securities business must register with the SEC and the NASD. Representatives working for those firms must register with the NASD and the stock exchanges, who license them after they complete written exams and background checks.

In addition, states require licensing of firms and representatives that do business in their state. Thus, for example, if a registered representative working in the New York office of a New York firm does a certain amount of business with a resident of Indiana, that representative and firm must be licensed in Indiana. Although most self-regulatory organization and state registration is carried out through the Central Registration Depository system that the NASD operates, not all states apply the same standards to the firms and representatives that they review for licensing.

The SEC's study of this complex issue is due shortly under the National Securities Markets Improvement Act. We believe that the Commission would be best equipped to provide the Subcommittee with assistance on the question that it poses, and would refer you to their upcoming report.

CONCLUSION

In closing, I wish to emphasize that the NASD is committed to providing a fair, well-regulated environment for the trading of all securities, even the most thinly-traded stocks. We must do this while at the same time providing legitimate small, entrepreneurial companies access to capital. Significant enhancements to investor protection have been made in the micro-cap market; however, as these hearings and our own experience demonstrate, we must all do much more. And more will be forthcoming from the NASD. Thank you.



The telephone rings...

It happens to all of us. The telephone rings as you're sitting down to dinner, relaxing with family, or putting the kids to bed. A stranger is selling something.

....is there help or trouble on the line?



It's known as "cold calling." For many businesses, including securities firms, cold calling serves as a legitimate way to reach potential customers. But sometimes serious trouble and financial losses await you at the other end of the line. Dishonest brokers may pressure you to buy a bad investment. Or the investment might be a scam.

Whether the calls are annoying, abusive, or downright crooked, you *can* stop cold callers. The law protects you by requiring cold callers to follow several rules. But you need to take steps to take advantage of these rules and to protect yourself.

This brochure tells you about your legal rights, how to deal with cold calls, how to stop them, and how to evaluate any investment opportunity that comes your way over the telephone.

This brochure is brought to you by



NASAA

Cold Callers Must Follow These Rules

When people from the securities industry call to sell you something, they must:

Call Only Between 8:00 a.m. and 9:00 p.m.

These time restrictions do not apply if you are already a customer of the firm or you've given them permission to call you at other times. Cold callers may call you at work at any time.

Say Who's Calling and Why

Cold callers must promptly tell you

their name,
their firm's name, address, telephone number, and
that the purpose of the call is to sell you an
investment.

Put You on Their "Do Not Call" List, If You Ask

Every securities firm must keep a "do not call" list. If you want to stop sales calls from that firm, tell the caller to put your name and telephone number on the firm's "do not call" list. If anyone from that firm calls you again, get the caller's name and telephone number, note the date and time of the call, and complain to the firm's compliance officer, the SEC, and your state's securities regulator. On page 11 you'll find information on how to make a complaint.

Treat You With Respect

Cold callers can't threaten, intimidate, or use obscene or profane language. They can't call you repeatedly to annoy, abuse, or harass you.

Get Your Written Approval Before Taking Money Directly From Your Bank Accounts

Before investing, you should always get answers to the questions on pages 13 – 14 and written information about the investment. If you do decide to buy from a cold caller, do not give your checking or savings account numbers to the broker over the phone. Brokers *must* get your *written* permission — such as your signature on a check or an authorization form — before they can take money from your checking or savings account.

Tell You the Truth

People selling securities must tell you the truth. Brokers who lie to you about any important aspect of an investment opportunity violate federal and state securities laws.



What Are Signs Of Trouble?

Honest brokers use cold calling to find clients for the long term. They ask questions to understand your financial situation and investment goals *before* recommending that you buy anything. While you may find their cold calls annoying, honest brokers who follow the cold calling rules are acting within their rights.

Dishonest brokers use cold calling to find "quick hits." Some set up "boiler rooms," where high-pressure salespeople use banks of telephones to call as many potential investors as possible. These strangers may charm or hound you to buy stocks in small, unknown companies that are highly risky, or sometimes, part of a scam.

Watch for these signs of trouble

High-Pressure Sales Tactics

Aggressive cold callers speak from persuasive scripts that include retorts for your every objection. As long as you stay on the phone, they'll keep trying to sell. And they won't let you get a word in edgewise.

"You'd hammer them. I always remember this one guy. I mean, I just stayed on the phone for almost an hour, and he finally bought."

— A "boiler room" broker

Beware of brokers who pressure you to buy before you have a chance to think about — or investigate — the "opportunity."

"Top right there! You're a businessman and you make decisions every day. You didn't get where you are by being stupid. . . . Let's confirm the order now. OK?"

— A "cold calling" script

Watch out for brokers who tell you about a "once-in-a-lifetime" opportunity, especially when the caller bases the recommendation on "inside" or "confidential" information.

"My broker said the company was in the process of buying this 100,000 seat radio station. . . . The information wasn't on the street yet, but once the information did go out the stock was going to double or triple."

— An investor in Virginia

Don't fall for brokers who promise spectacular profits or "guaranteed" returns. If the deal sounds too good to be true, then it probably is.

"My broker was speaking of the AIDS epidemic and how much work was going into it with the laboratories and so on. And this particular company, working so close with it . . . he said the stock would go through the roof. And he said it was absolutely a sure thing. . . . It would just continue to rise. Maybe as high as \$20 or \$30 per share."

— An investor in Virginia, who lost \$70,000 while his broker made \$15,000 in commissions



Don't deal with brokers who refuse to send you written information about the investment.

"I asked the broker not once but three times to send me some information. Ted McMahon's been sending you information for years; he hasn't made you any money," was his reply."

— A reporter for the Washington Post

The "Three-Calf" Technique

Some cold callers wait before turning up the heat. In their first call — the "warm-up" — they'll try to build your trust by describing their firm's past successes and the high quality of its research. The callers might ask permission to call again if an "exciting" deal comes along, but won't pressure you to buy.

"I am immensely told there are not sales calls!! They assure me that all they want to do is just along some information concerning their firm and track record, and will get back to me if and when something 'hot' comes along. We have asked about such various things as appointments, risk levels, rich balances, asset allocation and/or diversification, the topic is immediately changed back to their history of high returns for clients."

— An investor in Illinois

In their second call — the "set-up" — they'll whet your appetite, telling you about a fabulous deal they "think" they can get you into. In their third call — the "close" — they'll urge you to "buy now" or miss out.

Bait and Switch

Dishonest brokers lure new customers by encouraging them to purchase well known, widely traded "blue chip" stocks. After you take the bait,

they may pressure you to invest in small, unknown companies with little or no earnings. These stocks tend to be very risky and thinly traded, leaving more investors with losses than profits.

Paying Too Much

Although they may not say so, dishonest brokers who push you to invest in a small, unknown company often work for firms that own large amounts of the stock. Their firm may have been involved in the company's initial public offering. Or the firm may "make a market" in the stock, which means it buys and sells the stock — sometimes called a "house stock" — for its own account. If only one firm or a small group of firms makes a market in the stock, the price can be manipulated and may not reflect the true value of the company. Dishonest brokers often pump up the prices of their house stocks until they get rid of their own holdings at high prices. But when they stop promoting the stock, the price falls, and investors lose their money.

If you're not careful, you may pay too much for "house stocks." Some dishonest brokers overcharge their customers by adding an undisclosed "mark-up" to the price the firm paid for the stock. Although it's illegal for brokers to charge excessive mark-ups, some dishonest brokers mark up the prices of the stocks they sell by as much as 100% or more.



Finding It Hard to Sell

Many investors find that once they buy a "house stock," they can't get what they paid for it, even if they decide to sell right away. Or they find that their brokers simply won't sell the stock at all.

Some firms follow "no net sales" policies where brokers can't execute orders to sell "house stocks" unless they find a customer to buy an equal number of shares. Other firms discourage brokers from selling "house stocks" for their customers by offering low — or no — commissions on those sales.

Dishonest brokers often refuse to take — or return — phone calls from customers who want to sell.

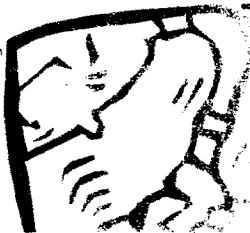
"Whenever I call my broker, I am told that he is in a meeting or out of the office."

—A common investor complaint

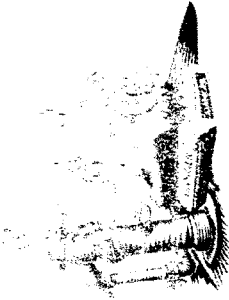
These brokers will use high-pressure tactics to persuade you to keep the stock. Or they will simply refuse to sell it.

"When I told my broker to sell my portfolio, he said I can't do it . . . I can't explain why, but what I'll do is send you the stock and you sell it through another broker."

—An investor in New York



Portrait Of A "Boiler Room"



The SEC and state securities regulators have investigated — and taken action against — numerous firms and brokers who use high-pressure tactics to sell securities. In a recent case, "boiler rooms" were described this way:

The firm was operating a classic boiler room. The brokers sat "check by post" in a room the size of a basketball court. All of their desks were lined up side by side in rows. The firm held mandatory sales meetings every morning at 8:30 a.m. at which time sales techniques were demonstrated and scripts for the firm's "house stock" . . . were distributed. Brokers were expected to follow the scripts and only give customers the information they contained. Brokers were discouraged from doing any outside research, and were told to rely on the firm's research and representations . . .

After the morning sales meeting, brokers were expected to spend the entire day (except for a lunch break) on the telephone. The firm expected a high volume of sales, and if brokers did not stay on the phone, they were fired . . .

One broker conceded that he falsely identified another salesman . . . as the firm's research analyst, and gave a fictitious description of the purported analyst as "fat, bald, and badly dressed." He stated that the reason for the firm's policy of discouraging customer sales was its desire to avoid negative price pressure on house stocks, a circumstance that he did not disclose to customers.

— *From an opinion in a recent SEC enforcement case*

- Brokers in one boiler room defrauded investors by
- lying about the firm's reputation and expertise, claiming it had a "research department" that analyzed stocks when it didn't,
 - refusing to say *anything* negative about the stocks they pushed, including the "risk factors" discussed in the prospectus,
 - making baseless price predictions, promising that certain stocks would double in price within a short time period,
 - impersonating other salespeople at the firm, and
 - discouraging customers from selling the stocks they recommended without regard to the customers' best interests.

Knowing how boiler rooms operate, you should be extremely skeptical when considering any investment opportunity a stranger tries to sell over the phone.

What Can I Do?

Report Abusive Cold Callers

When cold callers use harassing, abusive sales tactics and lie to you about investment opportunities, they violate the cold calling rules and break federal and state securities laws. Don't let them off the hook! To complain about abusive cold callers, write down the name of the caller, the name of the firm, the date and time of the call or calls, what the caller said to you, and what you said to the caller. You can send your complaints to either the SEC or your state's securities regulator.

U. S. Securities and Exchange Commission
Office of Investor Education and Assistance
Mail Stop 11-2
450 Fifth Street, N.W.
Washington, D.C. 20549

Phone: (202) 942-7040
Fax: (202) 942-9634
E-mail: help@sec.gov

Your State's Securities Regulator

Look for that telephone number in the state listings of your telephone book. Or contact The North American Securities Administrators Association (NASAA) for the name, phone number, and address of your local securities regulator.

Toll-free: (888) 846-2722
Website: <http://www.nasaa.org>

Tell Bad Cold Callers Not To Call Again

Some salespeople just don't get it. No matter how many times you've told them "no thanks," they keep calling. If you're annoyed by cold callers, stop them before they start their sales pitch. Tell the caller to put you on the firm's "do not call" list. If anyone from that firm calls you again, complain to the firm's compliance officer, the SEC, and your state's securities regulator.

Don't Warm Up To Bad Cold Callers

Cold callers often try to "warm up" potential customers with flattery or friendship. They might try to put you off guard by chatting about your hometown or the local sports team. Or they might suggest they've spoken with you before. Don't fall for their tactics.

And don't feel compelled to be polite or stay on the line. You don't have to listen if you don't want to, and you don't have to tell cold callers about yourself or your finances. Say "no, thanks" or "I'm not interested" — and then hang up. Don't wait for the caller to end the call. YOU are in control and can hang up at any time. If you get a fraudulent sales pitch, be sure to take notes and report the caller to the SEC and your state's securities regulator.



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What If I Want To Invest?

Never buy an investment based simply on a telephone sales pitch. A wise investor will always slow down, ask questions, get written information about the investment, and investigate the background of the firm and broker. Take notes so you have a record of what the broker told you, in case you have a dispute later. Before making a final decision and handing over your hard-earned money, take the time to investigate. Follow these steps:

Call Your State's Securities Regulator, and Ask

- Is the investment registered?
- Is the broker licensed to do business in my state?
- Have you received any complaints about the broker pushing the investment or the broker's firm? Does either have a disciplinary history? Your state's securities regulator is the best source for this information because they give investors more information than other organizations about the brokers who do business in your state. States pull this disciplinary information from a national computer system, the CRD, the Central Registration Depository.
- Have you received any complaints about the stock, the company, or the company managers?



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You can also obtain a partial CRD disciplinary history of the broker and the firm by contacting the National Association of Securities Dealers' toll-free public disclosure hot-line at (800) 289-9999 or visiting their website at <http://www.nasdr.com>.

Ask Your Broker These Questions

- Is the investment registered with the SEC and the state securities agency where I live?

How long has the company been in business? Is it making money? If so, how? What is its product or service? Have the people who are managing this company ever made money for investors in the past? Will you send me the latest reports that have been filed on this company? How can I get more information about this investment?

- Where does the stock trade? How can I get information about the stock's trading price? How easily can I sell? What price would I get if I decide to sell immediately?

How does this match my investment objectives? What is the risk that I could lose the money I invest?

- What are the costs to buy, hold, and sell this investment?

Do Your Own Research

Get as much written information about the investment as you can. Ask for a prospectus, annual report, offering circular, and financial statements. Your local library may have resources that provide additional information about the

company, such as lawsuits, liens, or recent credit reports. Compare the written information to what you've been told over the phone. Watch out if you're told that no written information about the company is available. If that happens, call your state's securities regulator immediately.

Get a Second Opinion

Talk to a trusted financial advisor or your attorney. Consider calling another firm for a second opinion on the opportunity.

Monitor Your Investment

After you've invested, watch your investment closely. Make sure your broker sends you account statements and written confirmation of all trades. Read these documents carefully to make sure they are correct. Be alert for any transactions you did not authorize.

Complain Promptly

If you have any problems, complain promptly. Contact your broker's supervisor or the firm's compliance officer. If that does not resolve the problem, complain to the SEC or your state's securities regulator. We welcome your letters. Often complaints from investors alert us to wrongdoing in the industry and are the first step in stopping a bad broker or firm. By complaining early, you will have a better chance of getting your money back and protecting your legal rights.

For more tips on how to invest wisely, order these free publications from the SEC.



Call us toll-free at
(800) SEC-0330



or visit our website at
<http://www.sec.gov>

The North American Securities Administrators Association, Inc. (NASAA) also offers free investor education publications.

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(888) 84-NASAA

or visit our website at
<http://www.nasaa.org>

SEC publications include:

- *Ask Questions* — Questions you should ask about your investments, the people who sell them, and what to do if you run into problems.
- *Invest Wisely: Advice From Your Securities Regulators* — How to choose a broker, pick an investment, and look out for trouble.
- *What Every Investor Should Know* — The essentials of investing in securities.
- *Form For Taking Notes* — We've developed a form to help you remember what questions to ask when you talk to your broker.



NASAA publications include:

- *Phone Hucksters Target Investors in Stock* — Telemarketers have been running away with millions of dollars of hard-earned money.
- *How to Spot a Con Artist* — Investing in securities is risky enough without worrying about whether your salesperson is out to fleece you.
- *How Older Americans Can Avoid Investment Fraud and Abuse* — Older Americans are the number one target of investment con artists.
- *Cyberspace Fraud and the Small Investor* — Unwary investors are in danger today of being taken for a ride on the information superhighway.

Senate Permanent Subcommittee
on InvestigationsEXHIBIT # 2**MEMORANDUM**

September 17, 1997

TO: PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
MEMBERSHIP LIAISONSFROM: IAN SIMMONS *for*VIA: TIMOTHY J. SHEA, Chief Counsel/Staff Director *TJS*
Permanent Subcommittee on InvestigationsRE: PSI OVERVIEW HEARING ON MICRO-CAP FRAUD

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I. Introduction

The Permanent Subcommittee on Investigations will hold an overview hearing on Monday, September 22, 1997 at 1:30 p.m. in SD-342 on fraud in the micro-capital or "penny stock" markets. Micro-cap stocks generally are low-priced, high-risk, thinly traded securities of start-up companies. We have asked the prospective witnesses to testify on the following topics:

1. What *kind* of fraud is occurring in the micro-capital markets? How prevalent are cold-calling scams, stock manipulation schemes and unauthorized trades? Has the incidence of such conduct increased in recent years?
2. How does the U.S. Securities and Exchange Commission (SEC) work with the States and self-regulating organizations such as the NASD-Regulation to ensure that repeat offenders stay out of the securities industry? Is there a repeat offender problem in this industry?
3. In connection with the SEC study of State licensing of broker-dealer sales agents as mandated by the National Securities Markets Improvement Act, whether the SEC considers meaningful State authority to license brokerage firms and their representatives critical to protecting small investors?
4. Whether firms that act as clearing brokers for introducing firms should have enhanced responsibilities to ensure that thinly capitalized or otherwise dishonest introducing firms do not remain in the market?

This is an overview hearing of micro-cap fraud, a vehicle by which a panel of three investor victims will describe their experiences and by which the regulators -- the States, the NASD-R and the SEC -- will articulate what they are doing about the problem and where their mutual cooperation works, and where it does not. The Subcommittee has divided its witnesses into three panels:

Panel 1 presents Arthur Levitt, Chairman of the U.S. Securities and Exchange Commission (SEC).

Panel 2 will be comprised of three investor witnesses who were victimized by penny stock scams such as cold calling, stock manipulations and unauthorized trades. These witnesses will set the stage for the hearing, laying out facts typical of penny stock scams.

Panel 3 consists of Mary Shapiro, President of NASD Regulation, Inc. (NASD-R), the regulatory and enforcement arm of the Nasdaq (who will testify about NASD-R's efforts to shut down penny stock scams) and Joseph Borg, Director, Alabama Securities Commission (who will testify about State registration laws as a vehicle for policing the micro-cap markets and who will also testify about shutting down an infamous firm, Stratton Oakmont). This panel also presents a lawyer who represents the Ontario Securities Commission, David A. Hausman, whose testimony will address the BRE-X case in particular (perhaps the most egregious recent instance of penny stock fraud). His testimony also will address the internationalization of penny stock scams and their reported prevalence in Ontario and their impact on American investors.

This memorandum proceeds with background relating to the growth of the stock market and the scams that are victimizing the public. It then touches on some of the regulatory

implications (*e.g.* state registration of broker dealers and the role of clearing firms) of penny stock fraud that ultimately may be predicated on reducing the fraud.

II. Background

A. The Market:

Soaring stock values have directly added more than \$3 trillion in wealth to the balance sheets of U.S. households since 1991, according to March 1997 Federal Reserve data. Add in stocks held by pension plans and life insurers and the 1990s bull market has created more than \$4.5 trillion in household wealth -- equal to about half the total output of the U.S. economy for an entire year.

Indeed, stocks are much more widely held than they were a decade ago. According to the Federal Reserve, more than 41% of U.S. households owned stocks in 1995, the latest period for which figures are available. That was up from 37.2% in 1992 and 31.7% in 1989. The rise among middle-income families has been even more dramatic. Since 1989, stock ownership has nearly doubled for households in the \$10,000-\$25,000 income bracket and increased 44% in the \$25,000-\$50,000 bracket. Though by most accounts institutional investors tend to dominate the financial markets, they hold only about one-half of the total equity in U.S. public corporations. Small investors *not* affiliated with institutional investors such as mutual funds and pensions, still hold a significant part of the balance of publicly held U.S. corporate equities. Within this community of small investors, many are described as savvy and sophisticated. However, a significant number generally are poorly informed and unsophisticated. One securities regulation scholar has observed:

... [w]hile institutional ownership has increased spectacularly in the post-New Deal period, this trend is less important than the far more dramatic increase in individual ownership of U.S. securities

Between 1929 and 1990, the number of U.S. investors increased over thirty-fold, from 1.5 to 51.44 million, and the proportion of the U.S. population owning stock rose from 1.2% to 21.1%. Equally significant is the fact that the vast majority of these investors appears to hold relatively modest portfolios. In 1990, the average size equity portfolio was \$11,400; 34% of individual shareholders had portfolios valued at less than \$5,000. These data are consistent with the further fact that the 1990 median income of adult shareholders was \$43,000 not notably higher than the \$32,000 median income for the adult population in that year. . . .

This data suggest that a considerably greater number of unsophisticated individual investors trade today than did so in the early 1930s

[Seligman, "The Obsolescence of Wall Street: A Contextual Approach", MICHIGAN LAW REVIEW (February 1995) at 659-660.]]

Indeed, it is widely reported that many citizens that are victimized by penny stock fraud are elderly individuals whose savings present an attractive target for scam artists. Many victims also are middle-class individuals with families, who, because of the bull-market and financial pressures, are testing the waters of the equities markets for the first time and thus may be vulnerable to fraud.

B. The Fraud:

This increased entry into the equities market has given rise to enhanced opportunities for fraud, particularly in the micro-capital or "penny stock" markets, defined in section 51(A) of the Securities Exchange Act of 1934 and SEC rule 3a51-1. The New York Attorney General's Office estimates that, according to a 1989 study (the last such study), American investors annually lose \$2 billion a year due to manipulation. In 1989, the Dow Jones Industrial Average was hovering around the 2,500 level. Query how much American investors lose annually to fraud now that the Dow has broken 8,000?

Penny stock and micro-cap stock fraud hardly is a new phenomenon. In the 1940s, worthless shares of mining stocks actively were sold to unsuspecting investors, mostly west of the Mississippi. Beginning in the early 1980s, however, the number of brokerage firms that specialized in low-priced stocks increased dramatically, as did the incidence of penny stock fraud. In the late 1970s and early 1980s, so-called "penny stock" scams were rampant in Colorado and Utah until State securities officials moved in and shut them down. Although today's schemes resemble the scams of that earlier time, there are significant differences. The most obvious difference is the marketplace itself. Today, as noted above, there are far more moderate-income retail investors than ever. One in three U.S. households now owns securities, compared with one in 17 households in 1980. Products are more sophisticated and choices have multiplied. Due to the growth of 401(k) plans and other self-directed retirement programs and fears about the future of social security, people are encouraged to be more "aggressive" in their investments. The marketers of the most legitimate firms down to perpetrators of fraud are singing the same siren song: "you've got to be in the market or you're going to be left behind."

Certainly, when no abuse occurs in micro-cap stock offerings, they can serve an important role in the American economy. Without this source of capital for smaller and riskier companies, many firms would not become viable businesses. Void of manipulation, micro-cap stocks also can provide investors with opportunities for high returns. But, regrettably, all too often this market provides fertile ground for those bent on fraud. The most widely publicized recent examples of micro-cap fraud are a series of actions filed by 20 States. On May 29, 1997 the North American Securities Administrators Association, Inc. (NASAA) announced that 20 State securities agencies¹ filed 36 actions against 14 firms in the largest nationwide crackdown ever by

¹ The 20 States include Alabama, Connecticut, Delaware, Illinois, Indiana, Maryland, Massachusetts, Missouri, New Hampshire, New Jersey, New Mexico, New York, Ohio, Oklahoma, Pennsylvania, Texas, Utah, Vermont, Washington and Wisconsin.

the States aimed at brokers selling stocks over the telephone. The actions' origins date from the fall of 1996 when NASAA's board of directors authorized a special project to address the problem of fraudulent sales practices in the micro-cap marketplace. In January 1997, a strike force comprised of representatives from 12 States was created and divided into teams, each targeting a particular firm. Four systemic abuses were discovered by State auditors and assailed by regulators:

- *Abusive cold calling practices* by which target firms relied on high-pressure, scripted telephone cold calling techniques that included falsifying the broker's experience and performance, as well as outright lies (*i.e.*, reading from scripts). Employees of these firms pressured victims into buying stock in unknown or non-existent companies, then, once the price was driven high enough, insiders sold the stock, making a killing and resulting in spiraling losses to outsiders.

All of the firms and branches relied on high-pressure, scripted telephone "cold calling" practices.² Many were classic boiler room operations with long tables and up to seven telephone stations per table. At one firm, all of the cold callers were on the first floor without any supervision. They "qualified" clients by determining their market assets and interest in the stocks that the firm was pushing. Average pay for cold callers is about \$200 per week. At one firm, there was a score board listing stocks, customers, and other production information. One trade representative told an examiner that he made around 250 calls on a good day, 70 on a bad day.

A branch of Meyers Pollock had 90 telephone banks all selling one illiquid stock from a list that included Creative Medical Development, Princeton Dental Management Corp and SmartServe Online, Inc. A branch's telephone records showed 1 million telephone calls made in one month.

- *Sales practice abuses* (examiners found a swarm of unlicensed solicitors who are accused of falsifying records, conducting unauthorized trades and failing to complete trades). The NASAA characterized unauthorized trading as "rampant" at all of the target firms, along with the falsification of firm and branch records. Customer account forms were marked with the number of the

² "You've got to understand", said the voice on the other end of the telephone, "typically, I don't make these type of calls. I've got people to do that. I've got 11 years in this business and worked my way up to senior vice president with 400 clients and \$40 million dollars under management. I don't need this account, but I want it." The caller was attempting to close a deal for an unknown micro-cap stock by trotting out some of his most impressive facts. But it was all a lie. In fact, he was reading from a script. "Perhaps a return of 100 percent in 20 minutes sounds a bit unrealistic", the scam artist read from another script. "But that's exactly how all our initial public offerings trade. We did three deals last year yielding collectively 34 points within the first ten days of trading. That's a fact! All I ask for is your vote of confidence this one time. I won't let you down."

registered representative who the clients insist they had never spoken to or traded with. Failure to execute sell orders (*no commission is paid on sell orders and there is no market until the next victim is found*), unsuitable recommendations, and other unethical practices were common customer complaints. At one firm, a review of thousands of customer accounts showed that all of the clients had bought only one or two stocks – stocks that only that particular firm was selling to the public. At a time when the NYSE average was being driven by the 50 largest companies in the S&P 500, these firms' clients were investing solely in unknown micro-cap companies.³

- *Failure to report investor complaints* (examiners found hundreds of unreported investor complaints.) Most of the offices audited failed to have centralized procedures for handling and reporting customer complaints, as required by law. Moreover, examiners found fill-in-the-blank forms to respond to unauthorized trade complaints to be filled in with the name of the stock, its value, and the reason for the unauthorized trade. One firm's branch office had reported only one complaint to the NASD since July 1, 1996, yet over 90 complaints were recovered on-site by examiners. Another firm had no complaints on file with the NASD, but State officials found over 300 throughout the office.
- *Evasion of broker-dealer registration requirements* through the use of third party franchise agreements. Stockbrokers and the firms that employ them, are required to register in the State in which they do business. This requirement allows State officials to monitor the activities of the firms in order to insure compliance with laws designed to protect investors. Most of the firms involved in the sweep were employing unregistered agents. Other requirements triggered by registration include keeping proper books and records and supervision of employees. Yet Meyers Pollack Robbins, one problematic penny stock firm, claims that its branches are franchises in order to evade State supervisory requirements.⁴

³ Micro-cap manipulation schemes usually have the following in common: (1) control of the stock by one broker or a small number of brokers; (2) matched purchases and sales of the stock to drive the price up; (3) unauthorized purchases to drive the price up or to "park" the stock; (4) large and excessive spreads between the "bid" and "ask" prices; (5) false and misleading representations about the stock; and (6) the ultimate dumping of the stock at an inflated price by the brokers, insiders and others involved in the scheme.

⁴ With franchise boiler rooms, registered brokerage firms sell their names and licenses to "branches" that operate independently, without supervision. The licensed firm may not have customer records or know about complaints. One firm that engages in this practice, Investors Associates of Hackensack, New Jersey, was the target of 15 States' enforcement efforts. New Jersey issued a cease and desist order and New York is seeking an injunction to bar the firm and its employees from manipulating initial stock offerings, using unlicensed telemarketers and ignoring customer complaints. This apparent loophole in the law is one about which the witnesses should be questioned.

Federal authorities, too, have been very active in attacking stock schemes, the most recent and visible action took place in October 1996, when 45 individuals were charged in the Southern District of New York with inducing brokers to buy stock for their clients in companies whose shares were being manipulated. The charges resulted from an FBI undercover sting operation. At an October 1996 press conference, the United States Attorney for the Southern District of New York, Mary Jo White, said illegal payments were widespread in the market for low-priced stock, where unregulated stock promoters and company officers use them to find buyers for a company's shares. It is a variation on a theme: once the share prices rise, the insiders dump their holdings at an artificial profit.

Many of the firms that deal in these securities employ brokers who jump from one firm to another. Indeed, recidivism is a recurring and troublesome theme. The regulatory process to bar rogue traders is lengthy and even once a trader has been excluded, it appears that the exclusion may be circumvented by becoming a "consultant". It is not uncommon for these brokers to have a history of criminal convictions, arbitrations and an excessive number of customer complaints -- or even to work without being properly licensed. Most of the companies that are being touted as "sure things" and "guaranteed to double your money" are completely unknown to the public until the telephone rings at dinner time and a persistent broker cajoles someone into buying the stock. Indeed, quite often there might not be a market in these stocks without the aggressive telemarketing efforts of the brokerage firm. At some firms, more than 30% of the complaints involved misrepresentations and more than 15% involved brokers' failure to sell a stock when explicitly directed to do by their customers.

III. State Registration of Broker Dealers And The SEC View

On October 11, 1996, President Clinton signed into law the National Securities Markets Improvement Act (the "Act") which directed the SEC to report to Congress on the uniformity of State licensing requirements of securities agents by October 1997. The Act represented the most significant overhaul of the securities regulatory structure in decades. Among other things, the Act divides responsibility for regulation of the financial markets between the Federal and State governments. This is relevant to penny stock fraud because insofar as states are on the 'front lines', the Act indirectly may dilute their ability to counteract fraud.

Thus, the States' special enforcement effort in May 1997 came as Congress, under pressure from many large brokerage firms and mutual fund companies to reduce State regulation, has been examining State actions. Under the Act, the States lost jurisdiction over large investment advisers like mutual funds. Now the SEC is working on a report, required by the Act, on State licensing of individual brokers and firms, which also are governed on the Federal level by the SEC and the National Association of Securities Dealers. Securities firms argue that State efforts duplicate Federal work and waste time and money. Conversely, the States cite numerous instances where their registration process succeeded in keeping out individuals with sub-par records. New York, for example has twice barred a felon who was convicted of first-degree robbery and attempted murder. Ohio recently barred a salesman, approved by the NASD, who faced Federal charges of securities fraud. The NASD can pull brokers' licenses for only very

limited reasons, and cannot take into account State actions, regulators say. Moreover, the States respond to all customer complaints, no matter how small.⁵

The Act, as noted above, in effect, made the regulation of mutual fund disclosures and advertising the exclusive province of the Federal government by preempting State securities issue registration, merit review, and prospectus disclosure requirements for investment companies. Specifically, Title I of the Act preempts State laws governing securities issuance and provides that States may not conduct so-called "merit" reviews of statutorily defined "covered securities".⁶ Merit reviews generally permitted the States considerable discretion into whether an offering was "fair, just and equitable." In addition, the Act prohibits States from placing limits or imposing conditions on the documents used in the offer and sale of "covered securities" (e.g., prospectuses and advertising materials prepared by or on behalf of the issuer). Title I also preempts State laws that impose financial responsibility, record keeping, reporting, margin or custody requirements inconsistent with or exceeding requirements established under the 1934 Exchange Act. As a result, broker-dealers are no longer subject to differing State net capital and records requirements (although they will continue to register with States in which they do business).

Under the Act, however, States *retain* their jurisdiction to require registration of small-cap Nasdaq offerings, regional exchange offerings, and "pink sheet" offerings, as well as other such securities that are not listed on the NYSE, AMEX or Nasdaq. States also keep their jurisdiction over rule 504, rule 505 and Regulation A offerings. (The Act mandates that the SEC study and report to Congress, also by October 1997, on State efforts to achieve uniform regulatory requirements for these categories of securities). States also retain authority to investigate and bring enforcement actions relating to fraud, deceit or unlawful conduct by broker-dealers⁷ "consistent with this section." (This language is intended to prohibit States from indirectly regulating preempted securities through their enforcement authority.) Moreover, the Act divides regulatory responsibility for advisers; the SEC has primary responsibility over investment advisers

⁵ One wonders whether the 'costs' associated with state registration laws as a barrier to entry or restraint on capital formation outweigh the 'benefit' in consumer protection, in light of the explosive growth in the number of broker-dealers in recent years and the equities markets. For instance, through the first five months of 1997 the total volume on the Nasdaq market and the NYSE was over 115 billion shares combined. These five months eclipsed the total volume for 1992 in which fewer than 100 billion shares traded during the entire year. Along with volume, market capitalization has skyrocketed. The market capitalization of listed companies on the NYSE was over \$3.5 trillion at the end of 1995; a greater than 100% increase from five years ago. The market capitalization of the Nasdaq was over \$1.6 trillion at the end of May 1997; more than 8% increase since December 1996.

⁶ "Covered securities" are those (i) listed on the NYSE, American Stock Exchange and Nasdaq/National Market System; (ii) listed on an exchange with substantially similar listing standards as the foregoing (as determined by the SEC); (iii) issued by registered investment companies; (iv) sold to "qualified purchasers" (as defined by the SEC); or (v) sold in "exempt offerings", including certain secondary market transactions, unsolicited brokers' transactions, transactions in exempted securities and private placement transactions.

⁷ Broker-dealers combine the functions of brokers (i.e., agents who handle public orders to buy and sell securities) and dealers (i.e., principals who buy and sell stocks and bonds for their own accounts and at their own risk).

with \$25 million or more in assets under management. Advisers with assets of less than \$25 million under management are prohibited from registering with the SEC and primarily will be regulated by the States.

NASAA believes that "systemic fraud within broker-dealers often begins with the broker-dealer agent. Actions against firms are only one component of the investor protection formula; the other is to prevent initial licensure to the 'bad agents' or revoke licenses after misconduct. In order to meet this charge, State regulators must have efficient and effective licensing tools." Currently, an electronic database -- the Central Registration Depository (CRD) -- provides state regulators with a "one stop" licensing mechanism. But the system has not been updated for 16 years and its technology is overburdened, if not obsolete, as the States readily concede. But the States agree that the redesign of the system must be given the highest priority including allocating all the necessary resources and staffing to upgrade the system as soon as possible.

NASAA argues that State regulation is efficient and uniform, particularly when compared with State regulation of attorneys and CPAs: *all* States use a single uniform application form; a securities agent submits one application to a national electronic database, which automatically transmits the application to those States where the agent is seeking a license; a single electronic payment can be made to a central depository, which directly allocates the fees to the States; States use a uniform qualification exam, which tests the knowledge of State securities laws; and yearly renewals of agents and firms occur automatically.¹ States insist that although the mechanics of licensing have been streamlined, State substantive review demands regulatory discretion and flexibility. For example, one application may disclose a State cease and desist order, an NASD fine and settlements. Another may contain five customer complaints over an 18 month period. Yet another may contain a single, but substantial, arbitration claim. The States contend that they provide the highest quality background review of broker-dealer agents. They argue that the CRD performs certain preliminary data checks and the NASD's attention is based upon remedial regulatory authority while the States focus significant attention on providing a more prophylactic regulatory/gatekeeper function. According to the States, the NASD "approves many persons with significant reportable items or disciplinary history." [*Id* at 2.]

SEC Chairman Levitt is on record that the States perform a critical role in policing the securities markets and he feels that no Commission has ever been more supportive of the States' efforts. But Chairman Levitt also recognizes that there is waste and duplication between the States, the SEC and the Self Regulating Organizations (SROs), thereby requiring that "we ...cooperate more efficiently, divide responsibility more clearly, and use our limited resources more strategically." [See Remarks by Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, "The SEC and the States: Towards a More Perfect Union", (October 23, 1995) at 3.] In those remarks, Chairman Levitt articulates what he terms a "middle ground" in six key

¹ According to NASAA data, 72% of State applications are renewals that are *approved concurrently with NASD approval*. The other 28% of applications are new ones, 24% of which are approved within 24-48 hours and 4% of which are new applications with a disciplinary history that are general processed within 5 days (*i.e.*, a request for additional information).

areas of activity: investment advisers; investment companies; registration of brokers; broker-dealer examination; registration of corporate securities; and enforcement authority.

With respect to *investment advisers*, Chairman Levitt strongly believes State regulation is required. He notes that the number of investment advisers today exceeds 21,000, an increase of more than 500 percent in the last 10 years. Most of them are small-scale advisers, who are examined on average, once every 44 years. Chairman Levitt believes States should assume primary responsibility for examining smaller advisers, coining the phrase "reverse pre-emption". As to *investment companies*, Chairman Levitt believes they are comprehensively regulated at the Federal level and that fund sales are national thus making "a good case for national regulation." In Chairman Levitt's view, investment companies should be exempt from State review, but would continue to file documents with the States and pay the same fees. And the SEC would continue to seek input from NASAA in its rulemaking process with respect to investment companies. Conversely, Chairman Levitt believes "[s]tate regulators have a compelling interest in who is opening up shop in their area", that is, in regulating *brokers*. He believes the States should continue to license brokers doing business within their borders. But he has also states:

At the same time, brokers and firms have a compelling interest in a centralized and predictable registration system. NASAA has made significant efforts to coordinate state registration processes through the Central Registration Depository. But the system remains cumbersome. There's a need for greater uniformity of the criteria state regulators use to decide if a broker can do business in the states. The current system can too often seem arbitrary. [*Id.* at 6.]

He continues:

... [a]s things stand today, a broker can accumulate a number of complaints and trigger no regulatory review as long as he stays with one firm. Because it is legally easier to deny a license than to revoke one, the system focuses your attention on the point in time when a broker changes firms. *Although I understand the reasons for this, investors would be better protected if our response were triggered by complaints, not by job changes.* Technology can be part of the solution. The new CRD will begin to come on line next year, giving you a powerful new tool that will help you focus on complaints when they occur. There will be no reason to wait for a broker to transfer firms before you take action; and from the firms' and the brokers' perspective, the system will be more fair and more predictable. [*Id.*] (Emphasis added.)

Chairman Levitt believes States should continue to *examine broker-dealers* who operate within their borders, but he also believes States should not impose supplemental requirements that exceed Federal and SRO standards with respect to books and records and capital requirements. Chairman Levitt believes that regulators need to be more sensitive to the disruption caused to firms, thus he envisions a new partnership where regulators can coordinate better and share

intelligence. Finally, with respect to *enforcement*, Chairman Levitt believes the States and SEC have worked best together in this area. He cites the Prudential global settlement as emblematic of effective and efficient law enforcement. He states that "[e]nforcement is where the knowledge and skills of the local cop on the beat are especially irreplaceable." [*Id.*]

IV. Clearing Firms: What Is Their Responsibility, If Any?

Some regulators have cited the role of blue-chip clearing firms as a contributing factor in the spate of penny stock fraud. Clearing firms execute transactions and provide other services for smaller brokerage houses that take investors' orders for trades, known as introducing brokers. As New York Attorney General Dennis Vacco recently stated:

... [m]any of these firms use big-name clearing houses whose policies and procedures have, in large part, allowed these practices to exist virtually unchecked. We have seen small brokerage firms aggressively boast of their relationship with well-known larger firms -- almost to the point of stating that they are partners. In fact, trade confirmations and account statements are sent directly to customers with the clearing firm's name prominently printed on the top. Yet when customers cannot get their brokers to sell a stock and turn to the clearing firm itself for assistance, they are usually met with a deaf ear.

Micro-cap brokerage firms can only exist by processing their transactions through the road provided by the clearing firms. Existing regulatory "speed bumps" have proven ineffective. Perhaps it is time to reexamine the responsibilities and obligations of clearing firms in light of the widespread fraud and manipulation involved in the telemarketing of low-priced stock. The "speed bumps" may have to be replaced with regulatory "stop" signs.

[Opening Statement of Dennis C. Vacco, New York State Attorney General, before the New York State Public Hearings on Micro-Cap Stock Fraud (July 29, 1997) at 6.]

In fact, the New York Stock Exchange is considering a rule that would place new reporting responsibilities on member brokerage firms that act as clearing brokers for other firms' transactions. (The NYSE has only 120 clearing firms under its jurisdiction, but they handle the business for about three-quarters of the 5,400 registered brokerage companies in the United States). The new rules presumably would place an enhanced obligation on clearing firms to keep tabs on what their clearing clients are doing. Apparently, under the proposed rules, clearing firms would be required to report complaints against their introducing-broker clients to securities regulators, as well as notify the introducing firms themselves about the complaints. The clearing firms also would have to notify the introducing brokers about available supervisory and compliance reports compiled by the clearing firms that could show irregularities on the part of the introducing brokers -- for instance, if an introducing firm broker was taking an excessive

commission (a clearing firm could produce a report showing how many commissions of more than \$100 a given broker has earned or determine how many customer cancellations a broker has had in a given time period). Brokers can request those forms now, but the NYSE wants more proactive behavior from the clearing firms it governs, i.e., *requiring* clearing firms to tell introducing firms the types of information the clearing firm can generate. That way, in the event of improper conduct, the NYSE can ask why certain information was not sought by the introducing firm, or, if it had the information, why it was not used to uncover the problem.⁹

Admittedly, under current law, clearing firms are neither guarantors of the introducing firms' transactions nor fiduciaries to investors; but the real question, in the words of Mr. Kwalwasser of the NYSE is whether those firms can be "part of the solution rather than part of the problem." [*The Wall Street Journal* (July 30, 1997) at C17.] The NYSE believes the new rules would help regulators catch potential problems at the introducing brokers early on, and create a paper trail for regulators in their investigation of stock fraud at boiler room brokerage operations.

The question of clearing firms' responsibility has attracted increased attention on Wall Street lately, especially with regards to Bear Stearns, a securities firm and clearinghouse, which faces questions about its clearing ties to A.R. Baron Co., a now-defunct securities firm that allegedly defrauded investors out of \$75 million. The proposed rules most likely will be considered by the NYSE's board at its September meeting. If approved, they will be submitted to the SEC and be released for public comment.

V. The NASD

Most of the perpetrators of penny stock fraud fall within the capitalization jurisdiction of the NASD.

Established under authority granted by the 1938 Maloney Act Amendments to the Securities and Exchange Act of 1934, the NASD is the largest self-regulatory organization for the securities industry in the world. Every broker-dealer in the U.S. that conducts a securities business with the public is required by law to be a member of the NASD. The NASD's membership comprises more than 5,500 securities firms that operate over 62,000 branch offices and employ more than 500,000 registered securities professionals. The NASD is the parent company of NASD Regulation, Inc., and The Nasdaq Stock Market, Inc. These wholly owned subsidiaries operate under delegated authority from the parent, which retains overall responsibility

⁹ Apparently, under the proposed rules, clearing firms governed by the NYSE also would have to treat more professionally the funds they hold from third parties that can be controlled by brokers with fund authorization or check-writing authority. For example, if a broker told a clearing firm one of its customers authorized a transaction and called for the appropriate money from the clearing firm, *under the proposed rules, the clearing firm would be required to inform the customer of that transaction, even though the individual is not formally a customer of the clearing firm.* This appears to be a step in the right direction to creating limited oversight responsibilities on the part of clearing firms, and builds on securities laws' reliance on disclosure as a means of preventing fraud.

for ensuring that the organization's statutory and self-regulatory functions and obligations are fulfilled. NASD Regulation is responsible for the registration, education, testing and examination of member firms and their employees. In addition, it oversees and regulates its members' market-making activities and trading practices in the over-the-counter market. The Nasdaq Stock Market, Inc., develops, operates and regulates a variety of marketplace systems and services. The Nasdaq Stock Market is the largest electronic, screen-based stock market in the world, capable of handling trading volume in excess of one billion shares a day. Today, more than one-half of all equity shares traded in the United States each day are traded on Nasdaq. Companies trading on Nasdaq's SmallCap Market or the Nasdaq National Market -- the respective tiers of The Nasdaq Stock Market -- are required to make extensive financial disclosures and satisfy well-established listing standards.

While not formally part of the Nasdaq market, the NASD has regulatory responsibilities for what is known as the over-the-counter market (OTC). The OTC is a vast amalgam of publicly traded companies that list neither on the Nasdaq nor on any exchange. It is in the thinly traded, micro-cap securities that characterize the over-the-counter market where one witnesses the ever-increasing growth in stock fraud. Indeed, a significant number of OTC companies report absolutely no information to the SEC, making their financial situation a virtual blank slate to investors. While some companies make financial information available, what reaches investors is not required to be subject to any auditing standards. In other words, an investor has to take the company's/broker's word for it. There is no minimum price that an OTC company must maintain in order to trade. Stocks in the OTC market can and do trade for mere pennies.

A component of the OTC is what is known as the OTC Bulletin Board. While it is a system operated by Nasdaq, the Bulletin Board is markedly different and separate and distinct from the Nasdaq Stock market. It is an electronic quotation service for subscribing members. While the system displays real-time quotes, last sale prices, and volume information in domestic securities, there is no formal legal relationship between the OTC issuers whose shares are quoted there and Nasdaq. There are no periodic reporting requirements for continued inclusion in the service; only limited phone, contact and address information is available in the OTC Bulletin Board company listings. This system provides a centralized and automated alternative to the Pink Sheets, which historically have been published on paper once each day, but which are now available electronically via market data vendors.

The perception of the public, frequently fostered by scam artists, is that trading on the OTC Bulletin Board is akin to trading in a highly regulated market such as Nasdaq. They will often refer to an OTC stock as listing on "Nasdaq's OTC Bulletin Board" or on "the Nasdaq OTC". Barry Goldsmith, Executive Vice President of NASD-R, admitted in the August 12, 1997, New York State hearing that "there are significant problems in the over-the-counter market and a strong regulatory response is needed." According to Mr. Goldsmith, the NASD actively is studying this market to determine what rule changes are necessary and how investors can access more accurate and current information about the companies whose shares trade there. "Too often the only information investors have is the misinformation and hype posted on a stock promoter's

Web page or the pie-in-the-sky promises made by a branch cold-calling broker." [*Id.* at 5.] Mr. Goldsmith continued:

... [w]e must take a hard look at whether there should be higher threshold standards for including a stock in the Bulletin board. We will look closely at whether a company that is unwilling to even provide full and timely disclosure of information to the public or to regulators should be given quotation visibility on this electronic medium. We must also strengthen the tools we have to keep the shares of bogus companies from being traded in the over-the-counter market in the first place. This can be accomplished by toughening and clarifying the rules we have to prevent broker-dealers from initiating or continuing to quote an OTC security. In addition, we need to explore rule changes that would place new requirements on brokers to confirm with their customers, based on objective criteria, that purchases of these types of securities are suitable investments. In addition, we are looking at ways that brokers can be required to disclose to their customers specific information about these types of investments. [*Id.* at 5-6.]

It has been reported that the NASD plans to toughen the rules for small companies and brokers that trade on the over the counter bulletin board, which has been plagued by stock fraud by raising the listing standards for companies on the bulletin board, requiring brokers to disclose more information about stocks being traded and by confirming with customers that investments made are suitable to their financial objectives. At present, companies on the bulletin board, unlike those that trade in the Nasdaq market, are not required to report financial information about themselves to regulators. They must disclose only certain telephone numbers and addresses. [See *The New York Times* (August 13, 1997).]¹⁰ The bulletin board, run by the Nasdaq market, is an electronic price quotation service that posts real-time quotes, last-sale prices and volume information. Among brokerage firms sanctioned for bulletin board violations in recent years have been Hibbard Brown, La Jolla Capital and Brooklyn Capital Securities and Trading. The NASD also said it is investigating possible organized crime links to 9 brokerage firms and 19 small companies that trade on Nasdaq's O.T.C. Bulletin Board and on the Nasdaq market.

NASD-R has adopted certain rules designed to combat penny stock fraud. Among those rules are:

- *Telemarketing:* In order to combat cold-calling scams, NASD in 1995 adopted a "cold call" rule that requires NASD member firms to keep "do not call" lists of persons who do not wish to receive telephone solicitations from the securities firm or its brokers. More recently, NASD-R strengthened the

¹⁰ Currently, companies that cannot or will not meet listing requirements for markets like the Nasdaq Stock Market can be sponsored by a market maker and traded through the automated OTC Bulletin Board, which is maintained by the Nasdaq stock market or the daily printed Pink Sheets, owned by the National Quotation Bureau. *The Wall Street Journal* (August 13, 1997).

regulation by prohibiting firms and their brokers from telephoning an individual's residence to sell securities during certain times, unless they have the prior consent of the individual. In addition, in making these calls, member firms and brokers must immediately give their names, the name of their firms, their telephone number or address and state that the purpose of the call is to sell securities or related products.

- *Taping Rule:* When NASD-R succeeds in putting a recidivist firm out of business, its job is not over. Sometimes the principals in those firms simply go to another firm. When a large number of these brokers become employed at another broker-dealer, this raises the risk that their new firm will have significant sales staff who may not have yet forgotten their old habits. To attack this problem, the NASD board in late July approved a rule that would require brokerage firms to tape all customer sales calls if a certain percentage of the firm's brokers worked for firms that have been expelled for telemarketing fraud or sales practice abuse.
- *Electronic Media and The Internet:* The use of electronic media -- including the Internet and e-mail -- to disseminate securities related information has grown enormously. This is an area of concern to NASD-R. This year it will implement an automated system that will greatly increase the range, speed, and early warning capabilities of its Internet surveillance. In addition to enhancing its technology, NASD-R filed proposed rule changes with the SEC that require member firms to establish written procedures for the review of electronic correspondence.
- *Nasdaq Listing Requirements:* Pending with the SEC is a proposal to increase the listing standards for Nasdaq listed companies. This proposal will raise the financial standards significantly, and also extend corporate governance standards to all Nasdaq listed companies. These listing standards, which *do not* apply to companies whose shares trade on the OTC Bulletin Board or the Pink Sheets, will continue to improve the quality of smaller issuers on the Nasdaq Stock Market.¹¹

¹¹ The OTC Bulletin Board is owned and operated by a subsidiary of the NASD and provides continuous price information on stocks (over 4,700) that are too small or illiquid to trade on the Nasdaq and other U.S. exchanges. The pink sheets refer to a once-a-day listing of the stock prices of about 10,000 small companies whose stocks are often risky, thinly traded and are generally too poorly capitalized to qualify for exchange listing. The pink sheets are administered by the National Quotation bureau.

VI. Fraud: Some Examples:

Individuals "learn the trade" by working in one fraudulent enterprise and then by moving on to others. Thus, Joseph Borg, the Director of the Alabama Securities Commission who will be a witness at PSI's September 15th hearings, has testified that if regulators shut down one firm, several more spring up, often the progeny of principals from a firm that was just shut down. Indeed, the growing practice of "franchising" allows licensed broker-dealers to shield their own operations from investor complaints by having an interest in branches where they have no direct control over sales practices. Any complaints about fraudulent practices at the branches would not show up on the licensed broker-dealer's record, resulting in the misleading "clean disciplinary" record. Apparently, SEC rules cover franchising but they focus on net capital requirements, not sales practices.

A. Stratton Oakmont: In December 1996, NASD-R expelled Stratton Oakmont from the securities industry. Following NASD-R's disciplinary proceeding and prior actions by the SEC and at least 19 States, NASD-R expelled the firm and barred its president and its head trader from the securities industry. This case imposed restitution and fines in excess of \$1 million. Another complaint was filed last year against Stratton Oakmont and others alleging that the firm made approximately \$28 million in illegal profits during the first day of aftermarket trading of five small stock offerings.

In one Stratton public offering of such a stock, \$12 million was raised, but only \$3 million went to the company going public.¹² The rest lined the pockets of promoters and the sales force, one broker testified. [See *Newsday* (August 6, 1997).] Joseph Borg, Director of Alabama Securities Commission, testified that in its 1993 initial public offering, conducted by the now-closed Stratton Oakmont, Inc., Steve Madden Ltd. (a designer and maker of fashion footwear based in Long Island City) received only \$163,000 out of a total of \$6.9 million raised, with the rest going to Stratton Insiders, who loaned the money to the company. Madden, the company's chairman, called that figure "nonsense". Stratton was "greedy" but they did raise money, he said, adding that no other company was willing to do that when he needed it.

In 1992, the SEC filed a complaint in U.S. District Court for the Southern District of New York against Stratton, charging it with stock manipulation. In 1994, Stratton entered into a consent decree with the SEC in which it neither admitted nor denied the allegations in the

¹² Former boiler room brokers testified in the New York State hearings, stating that commissions are extremely high on "house stocks" or those stocks held in the brokerage firm's own inventory. This gives brokers an incentive to concentrate on selling them. Sales of those stocks give a firm a chance to pocket a "spread" between the bid and the ask price, as well as to benefit its own officers and any insiders who control large blocks of the stock, if that happens to be the case. The brokers described boiler-room callers as not only untrained, but often unlicensed. People who haven't taken the licensing exams used the names of brokers who have taken them in order to open accounts, a violation of securities law, they said. Most use scripted sales pitches, they said. One broker said that he and other callers at his firm targeted potential customers from lists that belonged to Wall Street firms such as Merrill Lynch and were sold to them illicitly by those firms' employees.

complaint, but agreed to pay \$2,055,768 plus \$500,000 in civil penalties. However, Stratton repeatedly violated the decree and, as noted above, on December 6, 1996, the NASD expelled Stratton and its president and head trader from the securities industry. The straw that broke the camel's back was the charge that Stratton took excessive markups in the securities of Master Glazier Karate International and chronically failed to supervise its brokers. As NASD Regulation President Mary Shapiro stated: "This firm has time after time shown a total disregard for customers, the integrity of the market place and the responsibilities they have as a broker-dealer. This is the sanction that is called for." [*The Wall Street Journal* (December 6, 1996) at A10.] Since 1989, the NASD brought 12 disciplinary actions against Stratton. Stratton also was ordered to pay \$416,528 in restitution and a fine of \$500,000.

B. A.R. Baron: Another New York firm that has been prominently featured in the press is A.R. Baron & Co., Inc. In May 1997, the Manhattan District Attorney announced the indictment of the firm and the arrest of 13 individuals for cheating thousands of investors out of more than \$75 million. The individuals and the firm, which is now defunct, were charged with participating in a pattern of criminal activity. Included in that pattern were: lying to investors to induce them to buy certain low-priced securities; manipulating the markets in certain micro-cap stocks to benefit themselves and their favored customers; making unauthorized trades in the millions of dollars; refusing to honor its customers' directives to sell securities in their accounts; outright thefts from investors; and forging documents to prevent detection of their crimes. Between 1991 and 1997, A.R. Baron defrauded approximately 8,000 investors, according to the indictment.

Among other things, the indictment alleges that A.R. Baron misrepresented the value of four initial public offerings to clients and then refused to execute sell orders as the prices of those shares plummeted. The defendants also made unauthorized use of client's money to inflate the prices of the four stocks for their own benefit. For example, in 1993, A.R. Baron made cold calls touting the prospects of Health Professionals, Inc., a Ford Lauderdale health-care company that allegedly was on the verge of discovering a cure for AIDs. The stock later collapsed, plunging to \$2.50 from a high of \$13 per share on the AMEX.

C. BRE-X: The Bre-X minerals fraud may turn out to be the most costly stock market fraud ever. Once again, as a *New York Times* article documents, American investors lost big by purchasing Canadian stocks. It seems that Canada produces more stock market fraud, at least per capita, than do other countries. Canada has no national regulatory agency for securities, but rather leaves the task to the provinces, which pursue oversight with varying degrees of enthusiasm. Efforts at reform have been incomplete. With Bre-X, Canadian stock fraud has hit a new peak in terms of dollars.¹³ At its height last year, Bre-X was valued by the stock market

¹³ Strathcona Mineral Services of Toronto, an independent consultant, had been hired by Bre-X in March 1996 to clear up doubts about the company's estimate that the Busang discovery contained 70 million to 200 million ounces of gold, worth \$70 billion. Instead, Strathcona concluded that "there is virtually no possibility of an economic gold deposit" on Bre-X's Busang site in Borneo. Furthermore, there is considerable evidence that drilling samples had been tampered with to inflate gold estimates. The falsification of samples was said to be done "on a

at more than \$4 billion (U.S.). Bre-X represents an unfortunate tradition with the junior mining company for which the Vancouver and Alberta stock exchanges have been notorious since scandals involving phony Canadian uranium companies erupted forty years ago. The listing rules for junior companies are lax and there have been many companies that traded for far more than they turned out to be worth. Since nearly all the American institutions -- most of them mutual funds -- that bought the stock did so after its peak, it is certain that they lost money and it was substantial. The Chairman of the Toronto Stock Exchange, Mr. Fleming, said "[m]aybe this will act as the much-needed stimulus to get Canada to have a national securities regulator." [*The New York Times* (May 6, 1997) at B1.]

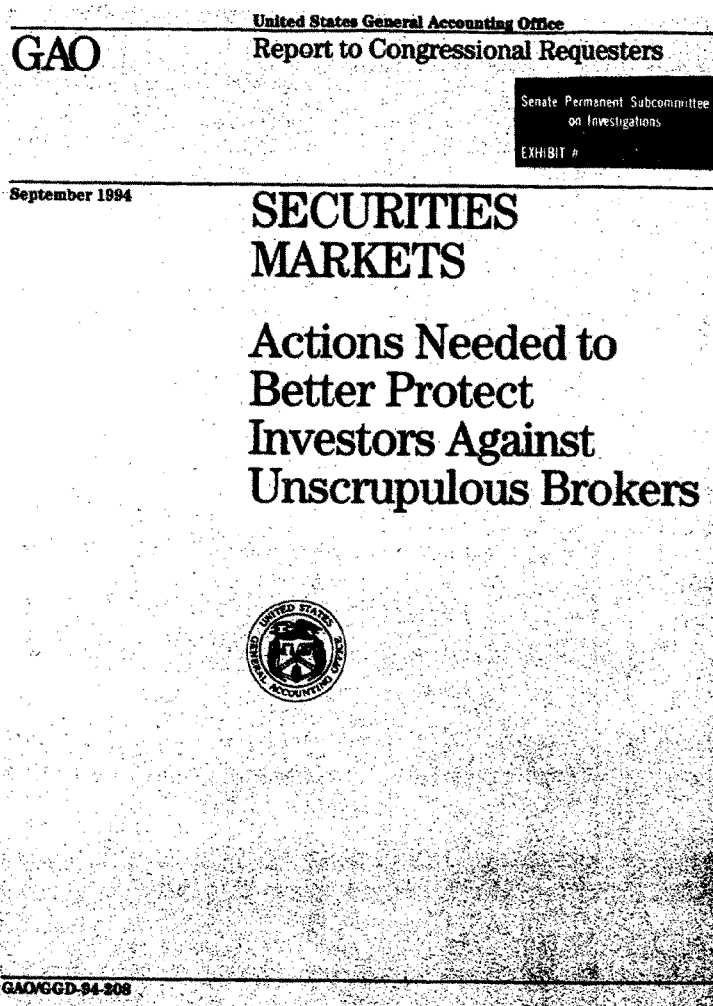
Bre-X is a frighteningly simple set of events: in early 1996, the company claimed to have discovered over 70 million ounces of gold in Indonesia and ultimately raised over \$6 billion in investment. From initial private offerings at 30 cents a share, Bre-X stock climbed to more than \$250 on the open market before a 10-for-1 split in May 1996. But the gold, in fact, did not exist, as reports seemed to confirm by March 1997. All that money was eventually lost -- much of it by institutional investors like pension plans.

Two fatal elements can be pinpointed in this elaborate and tragic ruse. *First*, the investors who originally bought Bre-X's private placements ultimately began selling their shares on the open market. *But their disclosure requirements remained the same as those for the private offering.* Meanwhile, the company was making very optimistic statements, which pushed the estimated size of the gold find from a few million ounces to more than 70 million ounces, the largest gold deposit ever found. Under Canadian law, company officers are not liable for the accuracy of such statements, as they would have been with projections included in a formal prospectus. A recent Ontario Securities Commission report has recommended changes in those rules, recognizing that stocks initially sold through private placements eventually migrate to the public market. Bre-X received up to \$6 billion in market capitalization as its stock circulated among both market-wise investors and less-experienced individuals who bet their savings on the "gold".

Second, it was more than two years from Bre-X's initial public statements about a major gold find on the Indonesian island of Borneo *before someone outside the company independently tested the site for gold.* When mining giant Freeport McMoRan Inc. conducted its own drilling as part of negotiations over a possible partnership with Bre-X, the scheme unraveled. (See *Washington Post* article (May 18, 1997)).

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scale and over a period of time and with a precision that to our knowledge is *without precedent in the history of mining anywhere in the world*", the Strathcona report said. "The gold recovered in samples submitted by Bre-X has originated from a source other than the southeastern zone of the Busang property." "Bre-X: From Rags to Riches, Back to Rags", *The New York Times* (May 6, 1997) at B1.





United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-258276

September 14, 1994

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

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

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

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

Background

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

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

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

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

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

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

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

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and certain customer complaints³ and arbitration⁴ information. In addition to formal disciplinary actions, member firms are required to provide CBO with written notice of employment terminations. Data generally are to be reported within 30 days of the action's occurrence. SRO staff can use CBO information to help determine whether the firm or the broker has violated securities laws or rules.

Results in Brief

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

In our opinion, even a few unscrupulous brokers can cause serious financial harm to investors and have the potential to damage public confidence in the securities industry. Consequently, SEC and industry efforts to ensure effective oversight of brokers and discipline of those who violate laws and regulations need to be as effective as possible. Available evidence, however, points to shortcomings in the detection and discipline of unscrupulous brokers. In particular, according to SEC's 1994 staff report involving 6 U.S. broker-dealer firms, 25 percent of 161 branch offices SEC examined for sales practice abuse had weaknesses in broker hiring and supervision practices.⁵ Further, 40 cases were referred for investigation and possible enforcement action to SEC enforcement staff. The report acknowledged that although it was not possible to generalize its findings because of the small number of firms examined, the disproportionate number of referrals for investigation and enforcement consideration suggested that (1) supervisory and compliance systems needed

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

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

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

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

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

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

Objectives, Scope, and Methodology

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

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

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To assess industry efforts to discipline unscrupulous brokers, we met with officials responsible for examination and enforcement at SEC, NYSE, and NASD. We also discussed these issues with officials of the North American Securities Administrators Association (NASAA) and senior executives at two major broker-dealers. To assess these efforts, we (1) reviewed all 39 SEC inspection reports on SRO examination and disciplinary activities conducted from 1983 through 1993, (2) compiled information on the number of formal disciplinary actions taken by NASD and NYSE from 1990 through 1993 in response to customer complaints, and (3) analyzed SEC, NASD, and NYSE guidelines for sales practice examinations. To solicit views on licensing, monitoring, and disciplinary procedures, we sent a questionnaire to 51 state securities regulators,⁴ 44 of whom responded. In addition, we reviewed the results of the May 1994 SEC staff study on the hiring, retention, and supervisory practices at nine major U.S. broker-dealers.

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

We reviewed the disciplinary histories of 20 brokers who were subject to a statutory disqualification⁵ because of a bar imposed by SEC or an SRO and whose employment status required regulatory review from October 1991 through December 1993. We also attempted to gauge the extent to which

⁴Includes the securities regulator for the District of Columbia.

⁵The definition of statutory disqualification, contained in section 3(a)(39) of the Securities Exchange Act of 1934 generally includes individuals who have been barred by SEC or an SRO; convicted of any felony or certain misdemeanors, such as bribery and forgery, within the last 10 years; or have been enjoined temporarily or permanently from violating securities laws by a court.

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

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

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

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

Extent to Which Unscrupulous Brokers Are Active in Industry Is Unknown

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

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

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

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

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

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

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

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Existing Disciplinary Policies and Practices May Not Adequately Ensure Investor Protection

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

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

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

SEC's staff study on industry practices, issued in May 1994, reported problems with the hiring and supervision of brokers at 26 percent of the 161 branch offices reviewed and made 40 referrals of possible securities law or regulation violations to SEC enforcement staff. The report acknowledged that it was not possible to draw general conclusions regarding the securities industry as a whole because the project involved only a small sample of the total number of securities firms and, of the firms selected, only a small portion of the branch offices and brokers at those firms were examined. However, the report concluded that the disproportionate number of referrals for further investigation and enforcement consideration as compared with that expected from routine examinations suggested that (1) firms' supervisory and compliance systems needed improvement and (2) sanctions for sales practice violations at SROs and SEC needed to be strengthened.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Improvements Needed in Broker Surveillance

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

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

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

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

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

¹¹NYSE member firms are required by NYSE Rule 361 to collect and report to NYSE data on customer complaints. Since 1989, an average of over 11,000 sales practice complaints have been reported annually to the NYSE by member firms.

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

Conclusions

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

Recommendations to the Chairman of SEC

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

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

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

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

Recommendation to the Secretary of the Treasury

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

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

Agency Comments and Our Evaluation

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

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

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

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

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

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

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

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

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

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

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

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

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



James L. Bothwell
Director, Financial Institutions
and Markets Issues

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Abbreviations

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

Appendix I

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

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

(continued)

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

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

(continued)

Appendix 1
Formal Disciplinary Histories for 40 Brokers
With a Bar Active in the Securities Industry
as of November 30, 1993

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

(continued)

Appendix I
Formal Disciplinary Histories for 59 Brokers
With a Bar Active in the Securities Industry
as of November 30, 1988

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

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

^aCRD did not contain data on the nature of the activity.

^bActual length of bar reduced because of retroactive imposition.

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

Source: GAO analysis of CRD data.

Appendix II

Questionnaire Sent to State Securities Regulators

United States General Accounting Office	
 Survey of State Securities Regulators on Oversight of Registered Representatives	
INSTRUCTIONS At the request of Congressman Edward J. Markey, Chairman, House Committee on Energy and Commerce, Subcommittee on Telecommunications and Finance, and John D. Dingell, Chairman, Subcommittee on Oversight and Investigation, GAO is currently evaluating the effectiveness of the disciplinary process used by the securities industry to identify, monitor and, where appropriate, bar registered representatives. The purpose of this questionnaire is to (1) assist us in determining the process utilized by state securities regulators to regulate, monitor, discipline and bar individuals from practicing within the industry as registered representatives, and (2) elicit comments as to whether any changes are needed at the federal level to facilitate these processes. This survey should be completed by this state's chief securities administrator, or by someone else designated by that person. Most of the questions can easily be answered by checking boxes or filling in blanks. Space is provided for any additional comments at the end of the questionnaire. Please return the completed questionnaire in the enclosed preaddressed envelope within 30 days of receipt. In the event the envelope is not returned, please mail the completed questionnaire to: U.S. General Accounting Office Attn: Mr. Jack Burdette 7 World Trade Center Floor 23 New York, NY 10048 If you anticipate any difficulty in returning the questionnaire promptly or if you have any questions, please call Mr. Jack Burdette at (212) 364-8382.	BACKGROUND Please provide the following information so that we can contact you if we need to clarify an answer. Name: _____ Title: _____ Agency: _____ Phone: () _____ 1. Approval of Registered Representatives 2) How many individuals are currently regulated by your agency as securities industry registered representatives to offer securities for purchase or sale within your state? (Check only one box.) 1. ☐ None 2. ☐ 1 - 25,000 3. ☐ 25,001 - 50,000 4. ☐ 50,001 - 100,000 5. ☐ Over 100,000 3) Must an individual be regulated by either the National Association of Securities Dealers (NASD), the New York Stock Exchange (NYSE), the American Stock Exchange (AMEX), or a regional exchange to apply for registration within your state? (Check only one box.) 1. ☐ Yes 5 2. ☐ No 35 3. ☐ Do not know

Appendix II
Questionnaire Sent to State Securities
Regulators

3) Which of the following procedures best describes the process your agency uses to approve an individual's application for license within your state when the individual is already registered with an SRO, but is NOT presently supervised by any other state? (Check only the ONE box most closely describing your process) In approval: 1. ☐ Automatically given, provided all application requirements have been satisfied? 35 2. ☐ Given after a review of the application and the Current Registration Inquiry (CRI)? 1 3. ☐ Given after application and CRI review, and an investigation of disciplinary issues disclosed on the CRI, if any exist? 35 4. ☐ Other procedure? (Please specify) 1 _____ _____ _____	2) Does your agency follow different procedures from those described in question 3 above if the individual representative is seeking employment within your state? (Check one box, and explain if necessary.) 1. ☐ No 35 2. ☐ Yes —> How do the procedures differ? 4 _____ _____ _____ _____
4) Does your agency follow different procedures from those you described in question 3 above if the individual representative is currently licensed in another state? (Check one box, and explain if necessary.) 1. ☐ No 44 2. ☐ Yes —> How do the procedures differ? _____ _____ _____	

Appendix II
Questionnaire Sent to State Securities
Regulators

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

	Very great extent	Great extent	Modest extent	Some extent	Little or no extent	Do not know
a. Presence of a civil restriction 42	4	16	15	2	3	2
b. Criminal conviction 42	27	3			2	
c. SEC/CFTC sanction 42	16	19	5		2	
d. SRO disciplinary action, other than suspension 42	9	13	15	4	1	
e. SRO suspension 42	23	14	3	1	1	
f. Denial of registration by another state 42	16	5	3		1	
g. Revocation of registration by other state 42	23	6	3		1	
h. Disciplinary action by firm 42	2	8	20	9	3	
i. Admonition pending 41	2	2	17	14	6	
j. Admonition issued 41	4	9	16	8	4	
k. Customer complaint 42	2	5	10	15	2	
l. Frequency of switching employer 46	1	3	6	14	17	
m. Typology of employer 46		1	7	13	23	
n. Other (Please specify) 45	5	8	1	1		
o. Other (Please specify) 45	3	1	2			

Appendix II
Questionnaire Sent to State Securities
Regulators

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

1. ☐ No (Skip to question 9.) 37
2. ☐ Yes (Continue with the next question.) 7

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

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

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Appendix II
Questionnaire Sent to State Securities
Regulators

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

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

- 10) In each of the last four years, how many registrations has your agency avoided on the basis of disciplinary history? And how many of these registrations, to your knowledge, resulted in its registration by an SRO today? (Show actual numbers of registrations meeting these two conditions, or provide your best estimate and identify as such.)

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

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

Year	Surrendered or Withdrawn
1990	
1991	
1992	
1993	

Appendix II
Questionnaire Sent to State Securities
Regulators

B. Routine Monitoring

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

1. ☐ All representative records are reviewed on a fixed schedule. (Continue with next question.)
2. ☐ No fixed schedule, but in response to certain events. (Skip to Question 14.) 28
3. ☐ No fixed schedule, but based upon representative's profile. (Skip to Question 14.) 1
4. ☐ No periodic reviews. (Skip to Question 14.) 1
5. ☐ Other procedures/combinations. (Please describe below, and continue with next question.) 3

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

1. ☐ Every 1 to 6 months
2. ☐ Every 7 to 12 months
3. ☐ Every 13 months to 2 years
4. ☐ Less often than once every 2 years
5. ☐ Do not know

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

1. ☐ Civil conviction 26
2. ☐ Criminal conviction 28
3. ☐ SEC/OTC action 37
4. ☐ SRO disciplinary action (not suspension) 29
5. ☐ SRO suspension 26
6. ☐ Denial of registration by another state 35
7. ☐ Revocation of registration by another state 36
8. ☐ Disciplinary action by firm 19
9. ☐ Arbitration proceeding 14
10. ☐ Arbitration award 28
11. ☐ Customer complaint 32
12. ☐ Frequency of change of employer 8
13. ☐ Amended U-4 submission 24
14. ☐ Others. (Please specify) 25

Appendix II
Questionnaire Sent to State Securities
Regulators

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

1. ☐ Press U-4 filing 25
 2. ☐ Press U-5 filing 26
 3. ☐ Press U-6 filing 26
 4. ☐ SEC publication 25
 5. ☐ SRO notification 26
 6. ☐ State contact 29
 7. ☐ Customer complaint 28
 8. ☐ Review of the CSD 23
 9. ☐ All of the above 24
 10. ☐ Other (Please specify) 4

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

1. ☐ Yes 22
 2. ☐ No (Skip to question 18) 23

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

1. ☐ All or almost all (75-100%) 2
 2. ☐ Most (about 75%) 3
 3. ☐ Some (about 50%) 1
 4. ☐ Few (about 25%) 1
 5. ☐ Very few or none (0-10%) 2
 6. ☐ Do not know 13

Appendix II
Questionnaire Sent to State Securities
Regulators

III. Use of the Central Registration Depository (CRD)

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

1. ☐ Very great extent 15
 2. ☐ Great extent 23
 3. ☐ Moderate extent 6
 4. ☐ Some extent 1
 5. ☐ Little or no extent
 6. ☐ No basis to judge

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

	Very great extent	Great extent	Moderate extent	Some extent	Little or no extent	Do not know
Approval of initial applications 43	49	2		1		
Approval of transfer applications 43	37	3	1	1	1	1
Periodic reexamination 48	15	13	5	4	4	
Publicizing agency actions 44	34	15	8	2	3	
Other functions (please specify) 35	21	13	4			
Other functions (please specify) 35	14	11	5			

Appendix II
Questionnaire Sent to State Securities
Regulators

20) To what extent, if at all, do you believe the confidence of the CRO as a regulator is impaired by the following:
 (Check one box in each row.)

	Very great extent	Great extent	Modest extent	Some extent	Little or no extent	Do not know
Misreporting of data by SEC 42	5	7	7	7	5	5
Misreporting of data by SRO's 42	4	7	6	5	7	5
Misreporting of data by states 42	6	7	7	9	5	5
Misreporting of data by firms 42	13	13	10	4		4
Misreporting of data by representatives 42	11	14	10	4		3
Delayed reporting of data by SEC 42	4	7	13	7	5	5
Delayed reporting of data by SRO's 42	4	10	10	8	4	4
Delayed reporting of data by states 42	5	5	5	11	4	7
Delayed reporting of data by firms 42	7	13	14	5	3	4
Delayed reporting of data by representatives 42	9	14	13	5		3
Data retention problems 42	10	5	7	6	6	4
Other limitations (Please specify) 35	5	6	6	1		
Other limitations (Please specify) 11	5	3	3			

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

1. ☐ Very frequently 4
 2. ☐ Frequently 13
 3. ☐ Neither frequently nor infrequently 7
 4. ☐ Infrequently 5
 5. ☐ Very infrequently 4
 6. ☐ No basis to judge 9

Appendix II
Questionnaire Sent to State Securities
Regulators

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

1. ☐ No action necessary 3
 2. ☐ Increase the NASD sanction penalty 34
 3. ☐ Increase the state sanction penalty 36
 4. ☐ Increase the SEC sanction penalty 17
 5. ☐ Allow suspension of the applicant's license 13
 6. ☐ Impose other NASD disciplinary measures (Please specify) 8

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

8. ☐ Other action (Please specify)

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

	Very accurate	Accurate	Neither accurate nor inaccurate	Inaccurate	Very inaccurate	Do not know
Information on Form U-4 46	1	36	10	3		4
Information on Form U-5 46		19	13	6		6

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

1. ☐ Participated in NASD/ASA meetings on redesign 34
 2. ☐ Provided written comments in response to a solicitation 10
 3. ☐ Provided written comments without being solicited 8
 4. ☐ Was solicited, but declined to provide input 1
 5. ☐ Was not solicited, did not provide input 2
 6. ☐ Do not know

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Appendix II
Questionnaire Sent to State Securities
Regulators

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

1. _____

2. _____

IV. Discipline of Registered Representatives

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

		Much too severe	Too severe	Appropriate	Too lenient	Much too lenient	Do not know
SBC	44			28	11	3	2
NASD	44			18	18	6	2
NYSE	42			24	6	5	8
AMEX	44			12	8	5	16
Regional Exchanges	44			19	8	3	22
State	44			29	11		6

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

1. ☐ More aggressive investigation of customer complaints 29
2. ☐ Proactively seek across markets for repeat violators 36
3. ☐ More frequent use of suspensions 23
4. ☐ More frequent use of bar 24
5. ☐ More widely publicize disciplinary actions 22
6. ☐ More frequent discipline of violative representative's supervisors 39
7. ☐ More frequent sanctions against the violative representative's firm 26
8. ☐ Other action (Please specify) 12

Appendix II
Questionnaire Sent to State Securities
Regulators

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

	Very great extent	Great extent	Medium extent	Some extent	Little or no extent	Do not know
Bar by SEC 48	3	1	29	9	3	2
Bar by the SEC's 49	4	3	28	13	2	4

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

	Very great extent	Great extent	Medium extent	Some extent	Little or no extent	Do not know
Bar by SEC 44	22	17	6	5	1	3
Bar by the SEC's 44	21	17	8	4	1	3

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

31. To what extent do you believe that registered representatives with a history of frequent or significant completion of sales practice violations maintain by business without immediate disciplinary action being taken by the SEC? (Check one bar in each row.)

	Very great extent	Great extent	Medium extent	Some extent	Little or no extent	Do not know
Representatives with recurrent completion 45	7	26	5	3		1
Representatives with particularly significant completion 45	2	16	15	30		1

Appendix II
Questionnaire Sent to State Securities
Registrars

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

	Very good extent	Good extent	Modest extent	Some extent	Little or no extent	Do not know
Representatives with numerous disciplinary actions 40	13	28	8	4		1
Representatives with disciplinary action for particularly egregious violations 40	2	22	13	9	1	1

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

	Very good extent	Good extent	Modest extent	Some extent	Little or no extent	Do not know
Representatives with numerous complaints 40	13	22	6	3		1
Representatives with multiple disciplinary action 40	7	23	18	2	1	1

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

	Favor a bar	Oppose a bar	Do not know	IF FAVOR - Describe threshold for bar:
Criminal convictions 42	49	3	1	
Civil convictions 41	29	9	13	
Probationary regulator sanctions 41	38	4	9	
SRO sanctions 39	34	5	18	
Arbitration filings 39	5	23	17	
Arbitration judgments 39	16	9	14	
Customer complaints 39	7	18	14	
Other (please specify)				

Appendix II
Questionnaire Sent to State Securities
Regulators

32) Do you provide information about registered representatives to leading investors?
 (Check only one box.)

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

33) IF PROVIDE INFORMATION:
 Which of the following types of information does registered representatives tell you provide to leading investors? (Check all that apply.)

1. ☐ Employment history 45 2. ☐ Criminal convictions 36
 3. ☐ Civil judgments 37 4. ☐ SEC or SRO disciplinary action 38
 5. ☐ Arbitration awards 39 6. ☐ Pending SEC or SRO disciplinary action 34
 7. ☐ Pending arbitrations 39
 8. ☐ Customer complaints, whether or not resulting in a disciplinary action 38
 9. ☐ Firm disciplinary action 38
 10. ☐ Other (Please specify) 39

34) IF UTILITY AGREEMENTS:
 For which of the following violations, if any, do you utilize such agreements?
 (Check all that apply.)

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

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

Year	Number of agreements
1990	
1991	
1992	
1993	

36) Have states or agencies entered into confidentiality agreements, or similar arrangements, by which a proposed disciplinary action is not publicly reported in exchange for a promise by the registered representative not to contest the action. Does your agency ever enter into confidentiality agreements or similar arrangements?
 (Check only one box.)

1. ☐ Yes --> (Continue with next question.)
 2. ☐ No --> (Skip to question 48.)

Appendix II
Questionnaire Sent to State Securities
Registrars

V. Comments

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

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

GAO/CES-94-104

Appendix III

Comments From SEC

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



UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20540

September 2, 1994

VIA FACSIMILE

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

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

Dear Mr. Rothwell:

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

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

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

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active brokers with "formal disciplinary histories." It is important to recognize that the actions CRO captures in this category are not limited to sales practice violations or even securities law violations, but also include disclosures relating to personal bankruptcies and liens on personal accounts. In addition, disclosures in this category also include indictments and convictions for offenses unrelated to the securities industry, such as driving while intoxicated. However, as the draft report acknowledges, of the almost 470,000 active brokers, only 3,799 (i.e., two percent) had at least one "formal disciplinary action" recorded. From this universe, GAO selected a judgmental sample of 100 brokers to obtain information on the violations leading to the actions. Both the initial universe and the judgmental sample of 100, therefore, included individuals disciplined for violations involving not only sales practice abuses, financial/operational violations, and criminal infractions such as robbery, but also those types of actions that arguably do not affect an individual's ability to act in a fiduciary capacity as a broker. In light of these factors, I believe that care should be exercised in drawing conclusions based on GAO's universe or sample.

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

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

See comment 1.

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See comment 2.
Now on p. 9.

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

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

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

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

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

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

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

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

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

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

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

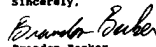
The Division appreciates the opportunity to comment on the draft report. I wish to thank the GAO staff for their efforts to address and integrate oral comments made by the Division's staff during the past week. The Division strongly agrees with the GAO's basic finding that efforts to ensure oversight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

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

Sincerely,


Brandon Becker
Director

Appendix III
Comments From SEC

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

GAO Comments

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

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

Appendix IV

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POLITICS & POLICY

Despite Reforms, Penny-Stock Fraud Is Roaring

By MICHAEL SCHWARTZ

WASHINGTON — When cleaning up after penny-stock scandals of the 1980s, federal regulators acted aggressively to stamp out rampant bilking of small investors that amounted to \$2 billion a year. By 1994, the Securities and Exchange Commission boasted "the current level of penny-stock activity is minimal."

But they're not saying that today. Fueled by the bull market, new technology and regulatory loopholes, penny-stock fraud has come roaring back—bolstered by some of the very remedies designed to prevent abuses. Regulators now estimate annual losses to investors at more than \$6 billion, triple the 1980s peak.

"Let me be blunt: there are significant problems in the [over-the-counter] market and a strong regulatory response is needed," says Barry Goldsmith, head of enforcement for the National Association of Securities Dealers. The NASD is owner and operator of the Nasdaq Stock Market and overseer of the "Bulletin Board" market, which handles relatively cheap, thinly traded "penny" stocks—in practice, those selling for \$5 a share or less.

The new NASD chairman, Frank Zarb, says one of his first initiatives is to clean up the Bulletin Board, an electronic stock listing created in 1990 to supplant the scandal-plagued "pink sheets" used in the 1980s. (That market was a primitive bid-and-ask trading system that printed quotes on flimsy sheets of pastel paper. The Bulletin Board gives brokers access to quotes by computer or phone.) The NASD and SEC may announce other revisions by year end.

However, earlier changes exacerbated the fraud problem by helping scam artists avoid scrutiny, government and industry officials say. In the case of the most visible reform, creating the electronic Bulletin Board, few regulatory requirements apply to companies that use it, and its link to Nasdaq gives its listings credibility with unwary investors. At the same time, on-line technology simplifies the marketing of these stocks.

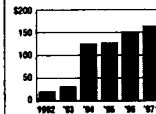
Neither the SEC nor the NASD knows exactly how much fraud exists because few Bulletin Board companies must file public financial statements. But Harry Eisenberg, chairman of Walker's Manual LLC, a Lafayette, Calif., company that tracks small companies, estimates that no more than a quarter of the Bulletin Board's 6,716 stocks are solid and stable. Philip Peigin, Colorado's securities commissioner, says many are "absolute shells or bogus listings."

Policing Penny Stocks

Options that regulators are considering for stocks listed on the electronic Bulletin Board:

- Hold market makers responsible for verifying company financial information and require annual updates.
- Make publicly available the company information market makers file with the National Association of Securities Dealers.
- Require all Bulletin Board companies to file financial reports with the Securities and Exchange Commission.
- Update the penny stock rule, possibly raising the definition of a "penny stock" to \$10 or \$15 a share.
- Give the NASD unilateral authority to halt trading in stocks where fraud is suspected.
- Revise the SEC's registration-exemption rules to close loopholes.

Searing Volume

Over the Counter Bulletin Board
average daily dollar volume,
in millions of dollars

NOTE: Includes both domestic and foreign stocks.

*As of June 1997.

Source: Over the Counter Bulletin Board

Problems in New York

This has made it a playground for the unscrupulous. Many problems arise in New York, which has no state securities-registration requirements and is home to many small companies specializing in cheap stocks. For example, prosecutors allege that loopholes allowed broker Michael Lipkin and associates to sell \$1 million of stock in Mugs Plus Inc., a purported souvenir maker—even after its only asset, a New Jersey warehouse, was gutted by fire and closed by its founders. Andrew Kandel, New York state's assistant attorney general in charge of securities, says such schemes will account for most of the 4,300 complaints his office expects this year.

Such cases help explain why the NASD is considering such revisions as seeking SEC authority to halt trading instantly whenever stock prices and volume shifts suggest fraud. Currently, that process can take weeks. It also may ask that all Bulletin Board companies be required to file financial statements for the benefit of both regulators and investors.

The SEC already monitors more than 13,000 traded companies and isn't eager to add nearly 7,000 from the Bulletin Board. However, SEC Chairman Arthur Levitt says, "If evidence shows that changes are needed, we won't hesitate to take quick action."

Penny-stock fraud exploded in the 1980s, when such stocks generally sold for less than \$1 a share, and in 1980 Congress ordered the SEC to stamp it out. These stocks let small investors ride the bull market cheaply. But unscrupulous brokers, marketing by phone and the Internet,

can push unsophisticated investors into buying shares in companies without real products or operations. Brokers pump up prices long enough to dump their own holdings, then move on to other shells—leaving investors with worthless paper.

The SEC's first move was to make brokers obtain signed releases from all new buyers of penny stocks before a transaction could be completed. That was supposed to make buyers realize they were choosing especially risky stocks.

Second, the SEC endorsed the Bulletin Board as a better-regulated and safer forum for thinly traded small stocks. Both brokers and regulators then could see real-time trading of the smallest companies on computer terminals. In theory, they could spot unusual volume or price spikes that might signal illegal activity. Rule 504.

In 1992, the SEC also promulgated "Rule 504 of Regulation D," which allows small companies to sell up to \$1 million of stock without an SEC registration. Designed to cut red tape for small business, this exemption has become a popular loophole for fraud; qualifying companies don't have to make financial disclosures to regulators and their shares can be traded immediately without restriction.

The reforms, coupled with efforts to purge wrongdoers from the brokerage business, helped for a while. In June 1994, officials said a survey of 129 brokerages found that their penny-stock trading accounted for less than 2% of total business, leaving only "traces" of past abuses. But others already were moving to exploit the Bulletin Board, where trading of U.S. stocks soared last year to \$16 billion.

Back

Companies can use it once a broker-dealer agrees to quote their stock. Further, no corporate financial standards apply, unlike Nasdaq's other listings. Although Nasdaq stresses the Bulletin Board isn't associated with its national and small-cap markets, unwary investors can be fooled.

Consider the case of Mr. Lipkin, a 50-year-old Russian immigrant who has been charged three times in the past two years with civil and criminal fraud. One case, pursued by the New York state attorney general, involved Mugs Plus, the souvenir company. Mr. Lipkin in 1994 set up his own Manhattan firm, Hubert Rosche Inc. In March, 1995, his associates paid the founders of cash-starved Mugs Plus \$20,000 for a 51% interest, state prosecutors say.

The Lipkin group planned to sell new stock to the public immediately, but needed to assure buyers the shares could be resold if desired. That's where the Bulletin Board came in: the group helped arrange for another brokerage to notify the NASD that it would quote Mugs Plus. In fact, the stock never was quoted, but the NASD notification was all the brokers needed to tell buyers that a market existed.

Then the company's factory was destroyed by a chemical fire. The Mugs Plus founders — who weren't part of the scheme — shut it down and New Jersey's environmental agency took over the burnt building. But that didn't stop the Lipkin group from selling shares. Rule 504 meant they didn't need an SEC registration, nor

did they need signed releases from buyers because they set the Mugs Plus price at \$6 a share.

One prospect who heard from them was Robert F. Miller, Jr., a retired oil-plant worker and resident of Apopka, Fla. He says he was told the Mugs Plus price would soon hit \$10 or more. Others were told the company was building a new factory, was the biggest U.S. mug supplier and might be sold to Hallmark Cards Inc. An impressed Mr. Miller paid \$10,000 for 3,000 shares.

All the claims were false — and his investment proved worthless. "The broker was so persistent and believable," he says now, "I got suckered."

He wasn't alone. More than 200 investors from 36 states shelled out about \$1 million for Mugs Plus stock. The money was sent to TriState Auto Market Corp., listed as an auto-parts dealer, according to New York state court records, but actually the address of a Brooklyn apartment rented by one of the brokers. It then disappeared from TriState accounts through checks made out for cash, according to court records.

In July 1994, New York state filed civil charges against Mr. Lipkin and 11 others. In a settlement, the defendants agreed to repay the \$1 million in six monthly installments; they made one payment last year and none this year, prosecutors say.

Mr. Lipkin agreed to be banned for life from the securities business. His lawyer, Maranda Fritz, says her client "was not involved in any way with Mugs Plus nor did he sell any Mugs Plus stock," and agreed to the ban because he already had left the securities business. This month he faces a criminal trial on federal charges of tax evasion in an unrelated fuel-oil scheme.



NASAA

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E-mail: general@nasaa.org<http://www.nasaa.org>Senate Permanent Subcommittee
on Investigations**INVESTOR ALERT:** EXHIBIT # 6**PHONE HUCKSTERS TARGET
INVESTORS IN STOCK**

“You’ve got to understand,” said the voice on the other end of the telephone. “Typically, I don’t make these type of calls. I’ve got people to do that. I’ve got 11 years in this business and worked my way up to senior vice president with 400 clients and \$40 million dollars under management. I don’t need this account, but I want it.”

The caller was attempting to close a deal for an unknown micro-cap stock by trotting out some of his most impressive facts. But it was all a lie. In fact, he was reading from a script supplied by his employer.

“Perhaps a return of 100 percent in 20 minutes sounds a bit unrealistic,” the scam artist read from another script. “But that’s exactly how all our initial public offerings trade. We did three deals last year yielding collectively 34 points within the first ten days of trading. That’s a fact! All I ask for is your vote of confidence this one time. I won’t let you down.”

President: Mark J. Griffin (Utah) • President-elect: Denise Vagel Crawford (Texas) • Secretary: Adrienne Wansell (British Columbia) • Treasurer: Deborah R. Barner (Washington)
Directors: Richard S. Caruso (Vermont) • Craig A. Goettch (Iowa) • Peter C. Hildreth (New Hampshire) • Don Saxon (Florida) • Bradley W. Shalek (Indiana)
Service Chairs: Robert M. Lutz (Pennsylvania) • Robert N. McDonald (Maryland) • Donald J. Rolt (Nevada) • Patricia D. Serock (Wisconsin)
Service Vice Chairs: Joseph P. Berg (Alabama) • Ronald W. Thomas (Virginia) • Franklin L. Williams (New Jersey) • Douglas F. Wilburn (Illinois)
Executive Director: Noel E. Sullivan
Ombudsman: Robert M. Lutz (Pennsylvania)

Taken from an actual script seized by state securities examiners in February 1997 from an *Investors Associates* boiler room, these words encapsulate the danger faced today by investors who purchase shares of stock in unknown companies over the phone from people they do not know. Although the companies are all small, it is not their size that is dangerous, but the dishonest way that the stock is represented and sold. Unfortunately, far too many investors are falling for the lure of this latest trend in boiler room scams. And the telemarketers, playing upon people's desire for ever-greater financial returns, have been running away with millions of dollars of hard-earned-money.

Among the victims: An elderly Connecticut man who was swindled out of \$40,000 and suffered a stroke that his wife claims was directly tied to the loss. A Utah man in his forties who lost \$11,000 through the payment of commissions after being promised that his transactions would be commission-free. A 78-year-old Missouri man who purchased \$6,000 of stock, then was charged with \$24,000 in unauthorized trades, leaving him with \$350.

The States Take Action

In response to a growing pattern of investor complaints against a dozen small, broker-dealers, the Board of Directors of the North American Securities Administrators Association, Inc. (NASAA) authorized a special project in late fall 1996. The mission of the special

project was clear: To address the problem of fraudulent sales practices in the micro-cap marketplace.

In January 1997, NASAA President Mark J. Griffin created a strike force comprised of representatives from 12 states. The strike force was divided into teams, each targeting the headquarters of a particular firm. In addition, branch offices in several other states were also scheduled for audits.

In late February, the teams struck without warning. Their examinations revealed four systematic abuses. They include:

- **Evasion of broker-dealer registration requirements.** Stockbrokers and the firms that employ them are required to register in the state in which they do business. This requirement serves an important purpose: To allow state securities officials to monitor the activities of the firms in order to insure compliance with laws designed to protect investors. When a broker-dealer or its representative is not properly registered, that is a sure sign that something is wrong. Most of the firms involved in the sweep, however, were found to be employing unregistered agents. Other requirements triggered by registration include keeping proper books and records and supervision of employees. Yet *Meyers Pollack Robbins* claims that its branches are franchises in order to evade state supervisory requirements.

- **Failure to report investor complaints.** Most of the offices failed to have centralized procedures for handling and reporting customer complaints. Examiners found fill-in-the-blank forms to respond to unauthorized trade complaints to be filled in with the name of the stock, its value, and the reason for the unauthorized trade. At several firms, complaints were found stuffed in customer complaint files, inquiry files, correspondent files, and stock jacket files. One firm's branch office had reported only one complaint to the NASD since July 1, 1996, yet over 90 complaints were recovered on-site by examiners. Another firm had no complaints on file with the NASD, but state officials found over 300 complaints throughout the office. The following pattern of abuse emerged: After receiving a complaint of an unauthorized trade, a registered representative called the investor and convinced that person to hold onto the trade. The investor was requested to fax a note that indicated the unauthorized trade was accepted. If the investor later changed his or her mind, the rep claimed otherwise. Records of unreported settlements were documented as "clerical errors" without any back-up documentation.
- **Abusive cold calling practices.** All of the firms and branches relied on high-pressure, scripted telephone "cold calling" practices. Many were classic boiler room operations with long tables and up to seven phone stations per table. At one firm, all the cold callers were on the first floor without any supervision. They "qualified" clients by

determining their market assets and interest in the stocks that the firm was pushing. Average pay for cold callers is \$200 per week.

"I sense you like to make money and you think it's a compelling buy, but I think there is another factor here. A psychological comfort factor... I'm a stranger asking you for an order. Let me address that because it's our biggest problem. It's like the first kiss. We're not day traders. We position stocks for the long term." (From a script found during the sweep.)

Clients of several companies were able to recall and identify unregistered cold callers, but had no recollection of speaking or trading with the licensed registered representative who allegedly signed off on the accounts. At one firm, there was a score board listing stocks, customers, and other production information. No one at the office could explain its use to state examiners or the information listed on the board. A registered rep told an examiner that he made 250 calls on a good day; 70 on a bad day. All of his calls had been previously "qualified" by an unregistered cold caller.

- **Sales practice abuses.** Unauthorized trading was rampant at all of the firms. Firm and branch records were falsified. Customer account forms were marked with the number of the registered rep whom the clients insist they had never spoken to or traded with. Failure to

execute sell orders (no commission is paid on a sell order *and* there is no market until the next victim is found), unsuitable recommendations, and other unethical practices were common customer complaints. At one firm, a review of a thousand customer accounts showed that all of the clients had bought only one or two stocks -- stocks that only that particular firm was selling to the public. At a time when the New York Stock Exchange average was being driven by the 50 largest companies in the S&P 500, these firms' clients were investing solely in unknown micro-cap companies.

A Changed Marketplace

In the late-seventies and early 1980s, so-called "penny stock" frauds were rampant in Colorado and Utah until state securities officials moved in and shut them down. Although the scams of today are similar to the swindles of that earlier time, there are significant differences.

The most obvious difference is the marketplace itself. Today, there are far more moderate-income retail investors than ever. One in three U.S. households now owns securities, compared with one in 17 households in 1980. Products are more sophisticated and choices have multiplied. Due to the growth of 401(k) plans and other self-directed retirement programs and fears about the future of Social Security, people are encouraged to be more "aggressive" in their investments. The marketers of the most legitimate firms down to bottom-dwelling

perpetrators of fraud are singing the same siren song: "You've got to be in the market or you're going to be left behind." The message is everywhere. It's hard to pick up a magazine or watch television or listen to the radio without hearing advertisements for mutual funds or other securities products.

To avoid becoming a victim...

1. Ask your state securities agency for help. When you are contacted by a securities industry representative, particularly if you do not know this person or have not heard of the firm, *you must call* your state securities agency in order to learn more about the caller and the firm. The simplest inquiry is to ask if they are registered to do business in your state. But you should also ask about the record of the firm and its representative. Are there any past disciplinary events? Are they subject to past complaints? Are they under active investigation? Are there other customer complaints in your state against this firm or agent? The majority of this information is available if you only ask.

2. Ask questions. Even if everything checks out with the state, don't rely on a company's glossy brochure. You need to ask about the investments themselves. Where is the company traded? Is it listed in the stock tables printed in your local newspaper? Investigate its trading history. Make phone calls. Find out more about it. Ask the salesperson -- who is making a market in the stock? Who else is buying in your area?

Is the salesperson's firm making a market in this company? The reason you want to ask is that they might be the only market maker. And they might be using cold calling techniques to create a buy demand for a stock that insiders will sell when the price is driven high enough.

3. **Send copies of your complaints to regulators.** When you have problems with a firm, you must send a copy of your complaint to your state securities regulator as well as the NASD. Examiners in the February sweep found hundreds of complaints that individual investors wrote to the firms that were never passed on to regulators. Failing to forward a complaint to the appropriate regulator is a violation of the rules for firms. But if they have stolen your money, what good does that violation do for you? If you call to inquire about a firm, and a previous customer's complaint never made it into the system, you won't be protected. So never forget to send a copy of your complaint to the regulators as well.

For more information...

The oldest international organization devoted to investor protection, NASAA was organized in 1919. It is a voluntary association with a membership consisting of the 65 state, provincial, and territorial securities administrators in the 50 states, the District of Columbia, Puerto Rico, Canada, and Mexico. In the U.S., NASAA is the national

voice of the 50 state securities agencies responsible for the promotion of efficient capital formation and investor protection.

If you suspect that you may be the victim of investment fraud, call or write the securities agency in your state, province, or territory immediately. For a phone number or address, call the North American Securities Administrators Association at 1-888-84-NASAA. Contact information is also available on the association's web site at www.nasaa.org.

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Congressional Record entry 20 of 50

TRUSTING AMERICANS SUBJECT TO EMERGING SECURITIES FRAUD (Senate - May 23, 1997)

[Page: 55086]

Ms. COLLINS. Mr. President, as the chairman of the Permanent Subcommittee on Investigations, I want to take this opportunity to highlight a growing problem with securities fraud in this country—a problem which affects thousands of American families who are now investing their hard earned savings in a booming stock market. The problem involves the fraudulent manipulation of the stocks of small companies in scams which can literally wipe out investors who place their trust in unscrupulous brokers and stock promoters.

Fraud in the sale of small company stocks has been increasing at an alarming rate. In the typical case, unscrupulous brokerage firms, often operating through intermediaries, purchase large positions in a company which is worthless or of very limited value and then drive its price higher through manipulation. They do this by aggressively cold calling thousands of unsuspecting individuals, often inexperienced in investing, and persuading them to purchase the company's stock by greatly exaggerating its financial prospects. The inevitable effect of this massive sales campaign is to push the price higher, at which point the brokerage firm dumps its shares, leaving the public holding investments which rapidly become worthless.

According to published reports and court proceedings, these schemes often utilize other illegal or unethical practices, including: The dissemination of false information on which investors rely, the employment by brokerage firms of persons with criminal records, as well as the use of unlicensed individuals whose only activity is ostensibly to prospect for customers but who often participate in making sales for which they are paid under the table; and the bribing of brokers to assist in the manipulation by recommending the stock to their trusting customers.

These securities fraud schemes have been uncovered in recent prosecutions and criminal investigations. At least four grand juries around the country are investigating small-stock manipulation—what may be the financial crime of the 1990's, just as insider trading was the financial crime of the 1980's. Indeed, according to published articles, a Federal grand jury in Los Angeles has even investigated a Federal prosecutor suspected of engaging in securities fraud. And last year, an FBI sting operation in New York City resulted in the arrest of 46 individuals for this type of activity.

In recent years, the soaring stock market has attracted millions of new investors, many of them hard working families trying to save for the future or elderly Americans trying to expand their retirement savings. It is understandable that these individuals, confronted with the prospect of astronomical tuition bills for their children or escalating medical costs for themselves, fall prey to sales pitches promising high returns in what are supposed to be the glamour companies of the future.

Overall, it is estimated that one in three American households have some of their assets invested in the stock market. Most do not have the time or the resources to carefully scrutinize stock offerings to determine which ones are fraudulent, instead putting their faith in brokers, who, because they are licensed by the Government, the public believes it has reason to trust.

Mr. President, some years ago I served as the State of Maine's Commissioner of the Department of Professional and Financial Regulation, and one of the responsibilities of my department was the protection of investors in my State. While that experience taught me that America has the most dynamic and healthiest capital markets in the world, it also taught me that there is no shortage of con artists and fraudulent schemes. What was true then unfortunately appears to be true today, and regrettably, there is evidence that the problem may be more widespread.

While the vast majority of those who work in our securities industry are honest, we must be continually vigilant in safeguarding the integrity of our markets. We must remain committed to combating what appears to be a new wave of securities fraud, involving the intense marketing and subsequent manipulation of the stock offerings of small companies, many with high-tech sounding names. These offerings--when pushed by overly aggressive and fraudulent marketing pitches to average American families and the elderly--present a ripe opportunity to lull the investing public into believing the stock is about to take off. Too often, these stocks do not soar to the heavens but rather fail to the ground.

This fraud must be fought on a variety of fronts. The regulators must continue to enforce existing regulations and to watch for illegal activity. The public must be more careful in investing in the stock market. And the Congress must--and will--closely investigate this growing problem of securities fraud.

As chairman of the Senate Permanent Subcommittee on Investigations, Mr. President, I am concerned about this fraud in the micro-capital markets--about this manipulation of small company stocks by Wall Street bandits. The subcommittee has a long and proud tradition of investigating schemes which rip off innocent consumers and taint the reputations of those who play by the rules. This investigative tradition will continue under my leadership. With more and more Americans entering the stock market each year, the Permanent Subcommittee on Investigations will be looking closely at these matters, investigating how these stock manipulation schemes victimize American investors and how we can arrest this emerging securities fraud.

I look forward to working with my colleagues on the Governmental Affairs Committee and in the Senate to protect the public from unscrupulous operators who would prey on hard working Americans seeking to participate in the American Dream through investment in the stock market. The expanding economic opportunities presented by a booming stock market should not benefit just the most wealthy Americans, but should benefit average American families as well.

As the chairman of the Permanent Subcommittee on Investigations, I promise you that we will vigorously investigate those who abuse the trust of their fellow citizens seeking to invest their hard earned savings. I further pledge that we will be especially relentless in our efforts to expose schemes which exploit the elderly. During my tenure, the subcommittee will use its investigative authority to shine the light of truth on those who operate in the shadowy fringes of America's capital markets.

I thank the Senate for its attention.

I yield the floor.

Mr. ENZI addressed the Chair.

The PRESIDING OFFICER. The Senator from Wyoming is recognized.

Mr. ENZI. I thank the Chair.

(The remarks of Mr. Enzi pertaining to the introduction of S. 802 are located in today's Record under 'Statements on Introduced Bills and Joint Resolutions.')

Mr. ROBB addressed the Chair.

The PRESIDING OFFICER. The Senator from Virginia.

**NASAA
STOCK SCAM
CRACKDOWN**

MAY 29, 1997

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For Immediate Release:
May 29, 1997

Contact: Scott Peterson
or
Craig Budnick
(202)737-0900

Crackdown Aims at Stockbrokers that Fleece Investors Over the Phone

NEW YORK, NY -- The North American Securities Administrators Association, Inc. (NASAA) today announced that 20 state securities agencies have filed 36 actions against 14 firms in the biggest nationwide crackdown ever by the states aimed at brokers selling stocks over the phone.

Reading from scripts, employees of these firms pressure their victims to buy stock in unknown companies," said NASAA President Mark J. Griffin. "Once the price is driven high enough, insiders sell the stock, making fortunes for themselves, and wiping out the savings of innocent investors."

The origins of today's announcement go back to the late fall of 1996, when NASAA's board of directors authorized a special project to address the problem of fraudulent sales practices in the micro-cap marketplace. In January, 1997, a strike force comprised of representatives from 12 states was created and divided into teams, each targeting a particular firm. In addition, branch offices and additional firms in other states were also scheduled for audits. Then, in late February, the teams struck without warning. State examiners discovered four systemic abuses:

- Abusive cold calling practices. Most of the firms and branches relied on high-pressure, scripted telephone cold calling techniques that include falsifying experience and performance, as well as other outright lies.
- Sales practice abuses. Examiners found an army of unlicensed solicitors who are accused of falsifying records, conducting unauthorized trades, and failing to complete trades.
- Failure to report investor complaints. State examiners found hundreds unreported. Most of the offices audited failed to have centralized procedures for handling and reporting customer complaints.
- Evasion of broker-dealer registration requirements through use of third party franchise agreements.

"Historically, when you shine a light on these types of firms, the individuals who organize and participate in them disperse like cockroaches running for cover, only to turn up later. But for those of you who engage in these types of practices, let me tell you, we're going to track you down wherever you go and put you out-of-business," warned Griffin.

The 20 states participating in today's announcement include Alabama, Connecticut, Delaware, Illinois, Indiana, Maryland, Massachusetts, Missouri, New Hampshire, New Jersey, New Mexico, New York, Ohio, Oklahoma, Pennsylvania, Texas, Utah, Vermont, Washington, and Wisconsin. Other actions will follow in the weeks and months to come.

Griffin's entire statement and an Investor Alert that details the scope of the problem have been posted on the NASAA web site at www.nasaa.org.

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The oldest international organization devoted to investor protection, NASAA was organized in 1919. It is a voluntary association with a membership consisting of the 65 state, provincial, and territorial securities administrators in the 50 states, the District of Columbia, Puerto Rico, Canada, and Mexico. In the United States, NASAA is the voice of the 50 state securities agencies responsible for efficient capital formation and grass-roots investor protection.

PARTICIPATING STATES

Alabama:

Target: Investors Associates
Media Contact: Joseph P. Borg, Director Securities Commission, (334) 242-2984

Connecticut:

Target: Investors Associates, First United Equities, Nationwide Securities
Media Contact: Greg Futoma, Communications Specialist, (860) 240-8171

Delaware:

Target: Investor Associates, Kensington Wells
Media Contact: Patricia Dailey, Deputy Attorney General, (302) 577-8926

Illinois:

Target: Investors Associates
Media Contact: Robert Newton, Director Securities Department, (217) 524-8040

Indiana:

Target: Investor Associates, LT Lawrence, Toluca Pacific
Media Contact: Mary Lynn Ricks, Deputy Secretary of State, (317) 323-6535

Maryland:

Target: Investor Associates
Media Contact: Robert McDonald, Securities Commissioner, (410) 576-6362

Massachusetts:

Target: Investor Associates, Meyers Pollack
Media Contact: Jack McCarthy, Chief of Staff, Secretary of State's Office, (617) 727-9180

Missouri:

Target: LT Lawrence & Co., Capital Securities / WB McKee, State Capital Markets, Meyers Pollack
Robbins
Media Contact: Douglas Wilburn, Commissioner of Securities, (573) 751-1858

New Hampshire:

Target: Investor Associates
Media Contact: Peter Hildreth, Director of Securities Regulation, (603) 271-1463

New Jersey:

Target: Investor Associates
Media Contact: Frank Widmann, Bureau Chief, Bureau of Securities, (201) 504-3610

New Mexico:

Target: Sterling Foster
Media Contact: Michael J. Vargon, Deputy Director, Securities Division, (505) 827-7140

New York:

Target: Investor Associates, First United Equities
Media Contact: Andrew Kandel, Assistant Attorney General in Charge, Bureau of Investor Protection and Securities, (212) 416-8989

Ohio:

Target: Investors Associates
Media Contact: Thomas Geyer, Commissioner of Securities, (614) 728-2724

Oklahoma:

Target: Biltmore Securities, William Scott & Company, Euro-Atlantic
Media Contact: Irving Faught, Administrator, Department of Securities, (405) 280-7700

Pennsylvania:

Target: Investor Associates
Media Contact: Arlinda Willis, Supervising Attorney, Securities Commission, (717) 783-4218

Texas:

Target: Investor Associates
Media Contact: John Morgan, Deputy Securities Commissioner, (512) 305-8302

Utah:

Target: LT Lawrence & Co., Meyers Pollack Robbins
Media Contact: Mark Griffin, Director Securities Division, NASAA President, (801) 530-6600

Vermont:

Target: Meyers Pollack Robbins
Media Contact: Richard Cortese, Deputy Securities Commissioner, (802) 828-3420

Washington:

Target: Investors Associates, LT Lawrence
Media Contact: Deborah Bortner, Securities Division Administrator, (360) 902-8797

Wisconsin:

Target: Investors Associates
Media Contact: Patricia Struck, Securities Division Administrator, (608) 266-3432

news/broadcast
NETWORK

FLASH REPORT FLASH REPORT FLASH REPORT FLASH REPORT FLASH REPORT FLASH REPORT FLASH REPORT

PRELIMINARY REPORT OF USAGE:
NORTH AMERICAN SECURITIES ADMINISTRATORS
ASSOCIATION, INC.
"CRACKDOWN ON TELEPHONE STOCK SCAMS"
Video News Release

DISTRIBUTION: Video was distributed via satellite, Thursday, May 29, 1997, with a refeed on Friday, May 30, 1997.

MONITORING: Follow up tracking is performed through Nielsen's SIGMA electronic encoding.

SIGMA data covers broadcasts through 6:00 AM EDT, Tuesday, June 3, 1997.

BROADCASTS	51
STATIONS REPRESENTED.....	30
AUDIENCE	19,604,000

All BROADCASTS confirmed through SIGMA encoding are in a table showing exact half-hour of broadcast and that time period's audience.

All AIRTIMES are local time per market.

LENGTH (LGTH) is the total seconds of video broadcast as tracked by SIGMA. This is not necessarily the total length of the story.

REPORTING SCHEDULE: Updated Flash reports will be provided each Tuesday and Friday by fax. The final report will be available the week of July 14, 1997.

N/BN CONTACTS:

CLIENT SERVICE	Mary del Castillo	202-638-1603
DISTRIBUTION SERVICE	Shari Smilowitz	212-889-0888
REPORTING SERVICE	Tom Hill	909-621-6903

THE NEW YORK TIMES, FRIDAY, MAY 30, 1997

States Lead a Crackdown On Telemarketing Brokers

14 Firms, Most in New York Area, Involved

By LESLIE EATON

Americans who live west of the Hudson may have good reason to hate New York, based on evidence presented yesterday by securities regulators from 20 states who cracked down on stockbrokers pushing penny stocks by phone.

Led by Attorney General Dennis C. Vacco of New York, the regulators filed lawsuits and other enforcement actions against several individuals and 14 firms, almost all based in the New York metropolitan area.

"They operate in the shadow of Wall Street, which lends them an air of legitimacy," said Mark J. Griffin, director of Utah's securities division and head of the North American Securities Administrators Association, which coordinated the sweep. He estimated that there were probably 50 such telemarketing boiler rooms doing business around the country.

Four defrauded investors — none from New York — told of losing their savings to fast-talking, high-pressure stock salesmen who bought and sold shares without their permission and sometimes against their wishes. "They can convince you right away," said Billy Hellums of Roswell, N.M., who added, "Beware!"

Legal actions filed by the state regulators included dozens of scripts used by cold-callers, complete with such stage directions as "pause," "lower voice," "sincerely," and even "chuckle, chuckle." The scripts include lines for breaking down victims' defenses, including flattery ("You are rated as an A+ investor through Dun & Brad Street [sic]"), promises ("My prediction is in 20 minutes you will get a 100 percent return") and even insults ("I'm not asking the color of your underwear, I'm sure it's white").

Regulators say the problem has gotten worse recently. Mr. Vacco said complaints and inquiries to his office jumped by 40 percent since last year, to 2,100. One reason, he said, is that with the soaring stock market, "more investors are coming in, and the pitches are being well received, unfortunately."

The states' special enforcement effort came as Congress, under pressure from many large brokerage firms and mutual fund companies to reduce state regulation, has been attacking state actions. Recently, states lost jurisdiction over large investment advisers like mutual funds.

Now, the Securities and Exchange Commission is working on a report, ordered by Congress, on state licensing of individual brokers and firms, which are also governed on the Federal level by the S.E.C. and the National Association of Securities Dealers. Securities firms argue that state efforts duplicate Federal work and waste time and money.

In a response that the state regulators' association plans to file today, the state officials will argue that their responsibilities cannot be merged.

citizens. New York, for example, has twice barred a felon who was convicted of first-degree robbery and attempted murder. Ohio recently barred a salesman, approved by the N.A.S.D., who faced Federal charges of securities fraud.

The N.A.S.D. can pull brokers' licenses for only very limited reasons, and cannot take into account state actions, regulators say. Moreover, the states respond to all customer complaints, no matter how small. "We're the local cops on the beat — when someone has a complaint, they may write the S.E.C. a letter, but they land up on our doorstep when we open our offices in the morning," Mr. Griffin of Utah said.

In addition to abusive sales practices, the states' regulatory sweep of small firms turned up what some regulators call an alarming new trend: franchise boiler rooms. Registered brokerage firms are said to be selling their names and licenses to "branches" that operate independ-

A bull market in complaints about pressure tactics over the phone.

ently, without supervision. The licensed firm may not have customer records or know about complaints.

One firm that engages in this practice, Investors Associates, was the target of 15 states' enforcement efforts. The firm is based in Hackensack, N.J., and has branches on Long Island and in Florida. New Jersey issued a cease-and-desist order against the firm and its principals; New York sued it in State Supreme Court, asking a judge to bar the firm and its employees from manipulating initial stock offerings, using unlicensed telemarketers and ignoring customer complaints.

Investors Associates said in a statement that it would cooperate with the state regulators to clear its name, adding that it "never condoned any improper sales practice and will take all necessary steps to rectify such inappropriate behavior, should it exist."

The other brokerage firms named by the regulators included First United Equities of Garden City, N.Y.; Kensington Wells Inc. of Syoset, N.Y.; L. T. Lawrence of Manhattan; Toluca Pacific Securities, which has offices on Long Island, and in Florida and California; Meyers Pollock Robbins of Manhattan; Biltmore Securities of Fort Lauderdale, Fla.; and William Scott & Company of Union, N.J.

Executives at the firms either declined to respond to the states' allegations or could not be reached for

By Sharon Walsh
Washington Post Staff Writer

THE WASHINGTON POST

FRIDAY, MAY 30, 1997 G3

States Launch Crackdown on Phone Tactics of Some Brokers

But as he was examining his statement last year, Byrne found that the broker was not telling the truth. He hadn't authorized the sale, and the investors were not holding the returns he had been told they were. Both actions are prohibited, officials said.

Byrne began to get a queasy feeling. "I was fabbergasted to find out how much money I'd lost because of unauthorized trades," he said, finding that the figure was about \$30,000.

"We at Investors Associates have never condoned any improper sales practices and we will take all necessary steps to rectify such inappropriate behavior should it exist," said David Sayid, an attorney for the firm.

State securities officials, citing dozens of examples such as Byrne's, today announced actions against 14 firms—including Investors Associates—in what they called the biggest

crackdown ever by the states against brokers who sell stocks over the telephone. The crackdown is the first since the late 1980s, when the North American Securities Administrators Association, Inc., a grouping of state securities officials, began a special project to target firms that used fraud in selling low-cost stocks over the telephone.

A task force of 12 states was created and divided into groups, with each group targeting a particular firm. In February, the teams began unannounced examinations of the firms.

Their investigations found four abuses that were common to the firms targeted yesterday, the association said:

- High-pressure, scripted "cold-calling" techniques in which stocks were sold with false information, or when any cold-called caller who failed to make a sale conducted unauthorized trades.
- A failure to report investor complaints.
- Evasion of broker-dealer registration requirements.

"Historically, when you shine a light on these types of firms, the individuals who organize and participate in them disperse like cockroaches running for cover, only to turn up later," said NASAA President Mark J. Griffin at a news conference here.

One of three U.S. households now owns securities, Griffin pointed out, compared with one in 17 in 1980. "In this high-flying bull market it's easy for swindlers to make claims of out-

The actions varied widely in the 20 states where they were filed. They mostly involved revoking licenses or stopping the companies from doing business in the state. Some securities officials, who worked with the Federal government's Securities and Exchange Commission and the National Association of Securities Dealers to avoid duplication, do not have the authority to get money back for residents. In most cases, investors will have to hire lawyers and go to court to get any money back.

Byrne, for one, said he will not forget the experience. "I've learned that the experience of being a victim of a scam is not a laughing matter," said Byrne, who has one daughter in college and another who will begin college next year. "I guess I was just a babe in the wood. . . . It's been a very sobering and eye-opening experience."

ragous returns sound plausible," he said.

Investors Associates was named in actions in 16 states, making it the hardest hit among the companies named. Most of them were small brokerages.

Maryland was not one of the states involved in the original task force, but the Securities Division of the Maryland Attorney General's office filed an action seeking to bar Investors Associates permanently from selling securities in the state following complaints from residents about the company.

The customer complaints involved allegations of making unauthorized transactions, using high-pressure sales tactics, selling stocks that were unsuitable for the individual, making unnecessary trades, misrepresenting returns and other fraudulent conduct, according to Maryland's filing.

BUSINESS

20 states move to stop suspect stock sellers

By Richard Melville
Reuters news agency

NEW YORK — Prosecutors and securities regulators in 20 states yesterday unveiled a series of enforcement actions intended as a crackdown on high-pressure penny-stock sales abuses by small brokerages.

Fourteen firms were named in 37 enforcement actions, officials said.

It was the biggest nationwide crackdown by state authorities against brokers selling stocks over the telephone, according to the North American Securities Administrators Association, an umbrella regulator group.

The actions, which followed an investigation that began last fall, centered on telephone sales practices that officials said were used to dupe individual investors into buying stocks.

"Reading from scripts, employees of these firms pressure their victims to buy stock in unknown companies," association President Mark Griffin said.

"Once the price is driven high enough, insiders sell the stock, making fortunes for themselves and wiping out the savings of innocent investors."

The nationwide actions were announced at the office of New York Attorney General Dennis Vacco. New Jersey Attorney General Peter Verniero also participated.

One firm cited in New York and New Jersey was Investors Associates Inc., based in Hackensack, N.J. The firm, which declined to comment, was named in actions in a total of 16 states, making it by far the hardest-hit among those named.

The enforcement actions varied widely from state to state, but in some cases temporary orders to cease business were handed down.

Oklahoma General Counsel and Director of Enforcement Gretchen Harris said her state had temporarily suspended and would seek to revoke the registration of Investors Associates, essentially halting business by the firm

there.

Helen Sprecher, an 85-year-old retired grocer from Philadelphia who appeared at the New York news conference, said she was bilked of about \$99,000 when an Investors Associates broker sold her stake in RJR Nabisco despite orders not to and invested the proceeds in a little-known telecommunications company.

The new stock plummeted, and after her repeated demands to get her money, Investors Associates offered her a settlement of \$12,000, she said. She rejected the offer, and the case is in litigation.

Louis Poggi, a Federal Express delivery driver from Pembroke, N.H., said his life savings were wiped out in a series of unauthorized trades made by a broker at Investors Associates in Melrose, N.Y.

"What ensued was a nightmare," said Mr. Poggi, 45, who was trying to invest money for his retirement and for

college tuition for his five children. In the end, he lost about \$10,000, he said. "I was as cautious as a human being could be, and I still lost out," Mr. Poggi said.

Other firms named in more than one state were Meyers Pollack Robbins and L.T. Lawrence & Co., each cited in four states, and First Equities Corp., cited in two.

The 20 states participating in the sweep were Maryland, Alabama, Connecticut, Delaware, Illinois, Indiana, Massachusetts, Missouri, New Hampshire, New Jersey, New Mexico, New York, Ohio, Oklahoma, Pennsylvania, Texas, Utah, Vermont, Washington and Wisconsin. Additional actions are expected to result from the investigation, officials said.

"This is the overture, not the finale," Mr. Verniero said.

In the interim, he said, consumers must be aware that "an investment that seems too good to be true probably is."

<http://www.usatoday.com>



Money

FRIDAY, MAY 30, 1997

State regulators charge 14 brokerages with fraud

By Lorrie Grant
USA TODAY

Securities regulators from 20 states announced actions against small brokerages Thursday, saying they sold stocks over the telephone using dishonest sales pitches.

In the states' biggest crack-down ever, enforcement actions were filed against 14 firms as a result of the North American Securities Administrators Association's (NASAA) year-long campaign to stop fraudulent practices.

A strike force of state examiners found rampant abuses, such as high-pressure sales tactics and unauthorized trades.

NASAA says firms duped unwary investors by selling them

low-quality securities and lying about the risk. Once the stocks ran up in price, NASAA says, brokers sold the shares they owned at a huge profit, driving the price back down and wiping out investors' savings.

Hackensack, N.J.-based Investors Associates was cited by 15 state regulators. In one case, Helen Sprecher, 85, a retired grocer from Philadelphia, says she lost \$99,000. Sprecher alleges an Investors Associates broker sold her RJR Nabisco stock despite orders not to, then bought stock for her in a telecommunications firm that later plummeted.

David Sayid, a lawyer for Investors Associates, says it will cooperate with investigators and clear its name.

B7C THE WALL STREET JOURNAL MONDAY, JUNE 2, 1997

Securities Regulators Cracking Down On Sales Fraud at Brokerage Firms

NEW YORK (AP) — Securities regulators in 20 states are cracking down on fraudulent stock telemarketing practices, as visions of big returns in the booming stock market are making more people prey for scams.

Fourteen brokerage firms are accused of making unauthorized stock trades and other fraudulent sales practices.

"In this high-flying bull market, it's easy for swindlers to make claims of outrageous returns sound plausible," said Mark Griffin, president of the North American Securities Administrators Association.

NASAA is a private organization representing state securities regulators that spearheaded an investigation into fraudulent stock telemarketing. On Thursday, New York Attorney General Dennis Vacco announced civil suits against the 14 brokerages as part of the multistate crackdown.

The firms were charged with high-pressure calling techniques and outright lies. They also were accused of allowing unlicensed solicitors to falsify records and conduct unauthorized trades, as well as failing to report investor complaints and evading broker-dealer registration requirements.

"They're very impressive when they talk to you on the phone. Like a brother. They get you to feeling very comfortable with them," said Billy Hellums, of Roswell, N.M., who lost about \$1,500 and was on the verge of investing much more.

Mr. Hellums and three other victims of allegedly abusive telemarketing practices joined Mr. Vacco, NASAA's Mr. Griffin and New Jersey Attorney General Peter Verniero at a news conference.

"Unfortunately, far too many investors are falling for the lure of this latest trend in boiler room scams. And the telemarketers, playing upon people's desire for ever-greater financial returns, have been running away with millions of dollars of hard-earned money," Mr. Griffin said.

Brokers at Investors Associates Inc., based in Hackensack, N.J., allegedly absconded with about \$60,000 belonging to Helen Sprecher, 85 years old, of Philadelphia. The money represented 90% of the money saved by Mrs. Sprecher and her husband from a neighborhood grocery store they owned for 40 years.

Mrs. Sprecher said her troubles began when her regular broker took ill and she was contacted by another agent. "He sounded like a nice, friendly grandfatherly man," she said.

In a statement, Investors Associates said it would cooperate with regulators.

"A number of firms have recently been targeted by certain states in connection with allegations of improper sales practices. Investors Associates has never condoned any improper sales practice and Investors Associates will take all necessary steps to rectify such inappropriate behavior should it exist," the statement said.

complaints involved low-priced shares of high-risk stock.

Other New York City brokerage firms named by Griffin were First United Equities, LT Lawrence & Co. and Meyers Pollack Robbins. First United president Douglas Traynor had no comment. The other two firms did not immediately return phone calls for comment.

Mr. Hellums, a New Mexico building contractor, said he invested his money with a broker from the Uniondale, N.Y.-based Sterling Foster brokerage firm. The company did not return a phone call seeking comment.

Mr. Vacco said he had filed civil actions against First United and Investors Associates. A total of 16 states have taken action against Investors Associates, including New Jersey, which has moved to revoke the firm's registration to do business in the state.

Another alleged Investors Associates victim was Louis Poggi, 45, of Pembroke, N.H., who said he lost \$10,000, all of his savings. "I was careful as a human being can be and they did something illegal," the Federal Express driver said.

The 20 states participating in the crackdown are: Alabama, Connecticut, Delaware, Illinois, Indiana, Maryland, Massachusetts, Missouri, New Hampshire, New Jersey, New Mexico, New York, Ohio, Oklahoma, Pennsylvania, Texas, Utah, Vermont, Washington and Wisconsin.

California, Georgia and Florida are expected to announce similar actions against broker-dealer firms in the next month.

ON THE FRINGE

INVESTMENT GUIDE

Never open a brokerage account with a firm that calls with a hot stock. If you think we are being dogmatic about cold-calling, read about these horror stories. They could happen to you.

On Sleazy Street

By Gretchen Morgenson

WHEN LOUIS POGGI picked up the telephone that day in June 1995, Patrick Boyce was on the line again. Boyce, from Investors Associates, had a stock tip: Universal Self-Care, trading over-the-counter at 3%. Poggi, a New Hampshire father of five, makes \$45,000 a year as a tractor-trailer driver for Federal Express and had bought stock only on a few occasions.

"I said no," Poggi recalls. "I tell you the guy was like a robot. He goes right back into the sales pitch again for the third time. I said, look, emphatically, no, I can't do it. I don't know anything about the stock." Poggi hung up, thinking Boyce had gotten the message.

Pitchman Boyce purchased the stock anyway. In a previous phone call, he had gotten Poggi's Social Security number and address—all he needed to enter the trade. Poggi had an account with Investors but had sent no money to Boyce.

When Poggi found out that he now owned 1,000 shares of Universal Self-Care, against his wishes, he told Boyce to sell it. Both Boyce and his branch manager refused and proceeded to browbeat him for payment.

"I lost it," says Poggi. "I just broke down crying. I mean, I'm up here in New Hampshire, these guys are down in New York killing me. You do this kind of stuff to someone who is your worst enemy." Poggi complained to the New Hampshire securities regulators, who sued Investors to revoke its license. After the license was revoked in April, Investors filed a motion for reconsideration.



If there were an award for bucket shop brokerage of the year, Hackensack, N.J.-based Investors Associates would win it. Three states have revoked the firm's license and another 13 are proceeding against it. Allegations: unethical practices, false and misleading statements, fraud. The firm regularly stonewalls regulators, refusing to honor subpoenas, continuing to do business without registering or in defiance of orders to desist.

Investors Associates, state regulators estimate, has relieved customers of at least \$10 million in the past two years. Its tactics are pure boiler room. A sales script recovered from a trash bin at an Investors office reads, "My prediction is in 20 minutes you'll get a 100% return in the stock."

One Investors broker had 30 customer complaints lodged against him. Was he reprimanded? No, because none of the complaints ever made it to the National Association of Securities Dealers, which supposedly keeps an eye on brokerage firms. Instead, they collected dust in a file at an Investors office. When state regulators asked the firm's compliance officer about this oversight, he said, "I have no idea why the guy is still here."

It's a never-ending battle against the cold-callers. They outnumber and outmaneuver the cops. In its ten-month-long Street Sweep, regulators from 20 states—including Connecticut, Illinois, Utah and California—joined to try to shutter the worst of them (*see table, p. 264*). It's worse out there than you think, according to Mark Griffin, president of the North American Securities Administrators Association, which coordinated the crackdown.

Says Indiana Securities Commissioner Bradley Skolnik, "For these firms, financial penalties are a cost of doing business." With mark-ups pretty much whatever they please, crooks can afford to pay penalties. In a case against Biltmore Securities, Skolnik barred the firm from selling any stocks other than those listed on one of the three major exchanges. This eliminated almost all the firm's business.

Bull markets make investors more vulnerable. They read about killings they want in on the action. Andrew Kandel, chief of New York's Investor Protection & Securities Bureau, says that his office recovered more in

ON THE FRINGE

INVESTMENT GUIDE

fines, costs and penalties last year than in 1990 through 1995 combined. Complaints and inquiries from investors were 40% higher last year than the year before. In a 12-month period ending September 1996—the most recent figures available—state regulators like Kandel brought 7,000 enforcement actions against brokerages. The NASD brought 700, the Securities & Exchange Commission, 100. For every case brought, chances are many other victims swallowed their losses silently.

Don't be a willing victim. Information is your best friend. Don't rely on NASD material. You can get a disciplinary file from either a state regulatory agency or the NASD, but the latter's file is likely to be very skimpy. It includes only arbitration cases that have been settled and enforcement actions that have been taken. State regulators also supply information on cases pending against brokers, as well as customer complaints. And because the NASD does not recognize state sanctions against firms or individual brokers when evaluating them, a broker or firm could be sanctioned by 15 states,



and could still have NASD's stamp of approval.

Evasion of broker/dealer registration requirements is a new and growing problem. Regulators say two of the worst offenders are Meyers Pollock Robbins, with 30 branches, and Investors Associates, with 16. Another is Toluca Pacific, with 11 branches. They are basically franchisors who let out their names to independent, thinly capitalized operators. One Meyers Pollock franchisee bought his operation with an \$85,000 loan on which he paid \$30,000 in annual

interest. A branch manager told investigators: "Getting registered as a broker/dealer is too expensive and difficult, so we set up independent franchises."

Brokerage firms are supposed to tell the NASD about customer complaints. Sometimes they don't. Investors Associates had no complaints on file with the NASD for a particular branch office, but examiners found over 300 complaints at the branch during their sweep.

Even the file of 300 was incomplete, an employee explained, because "somebody broke into the branch and stole the customer complaint file." Some 90% of the complaints alleged unauthorized trading.

The 12 firms targeted in the late May sweep all use unregistered cold-callers to locate victims and bring in registered brokers (like Patrick Boyce) only to close a sale. A branch of Meyers Pollock had 90 phone banks all selling one illiquid stock from a list that included Creative Medical Development, Princeton Dental Management Corp. and SmartServe Online, Inc. A branch's phone records showed 1 million phone calls made in a month.

The scripts these frenzied phone callers use would be hilarious if they did not do so much damage. Scripted answer at First United Equities Corp. to a prospective investor who says he's not in the mood to invest: "That's what my wife said last night. You know what? This morning she thanked me."

Or this: A prospect asks for a report on the company being pitched. The cold-caller, without losing a beat, responds: "When Columbus discovered America, he didn't send a report until he actually saw the land. At that point it was history."

Now you see why we say, never, ever, ever buy a stock pitched over the phone from someone you do not know.

Wall Street's Hall of Shame

Here are the worst brokerages in America, singled out by state securities regulators in their recent enforcement actions. If a broker calls you from one of these firms, hang up.

Investors Associates Hackensack, N.J. Branches: 16	
Meyers Pollock Robbins Inc. New York, N.Y. Branches: 30	First United Equities Corp. Garden City, N.Y. Branches: 1
Duke & Co. Inc. New York, N.Y. Branches: 1	12 Lawrence & Co. New York, N.Y. Branches: 1
Biltmore Securities Inc. Fort Lauderdale, Fla. Branches: 3	Toluca Pacific Securities Corp. Toluca Lake, Calif. Branches: 11

Nation

Regulators crack down on fraud

By CATHERINE CROCKER
The Associated Press

NEW YORK — The booming stock market is leading to more telemarketing scams, according to securities regulators in 20 states that are suing 14 brokerage firms for defrauding people with promises of huge returns.

"In this high-flying bull market, it's easy for swindlers to make claims of outrageous returns sound plausible," said Mark Griffin, president of the North American Securities Administrators Association.

The NASAA is a private organization representing state securities regulators who spearheaded an investigation into fraudulent stock telemarketing. On Thursday, Attorney General Dennis Vacco announced civil suits against the 14 brokerages as part of the multi-state crackdown.

The firms were charged with high-pressure calling techniques and outright lies. They also

were accused of allowing unlicensed solicitors to falsify records and conduct unauthorized trades, failing to report investor complaints and evasion of broker-dealer registration requirements.

"They're very impressive when they talk to you on the phone. Like a brother. They get you to feeling very comfortable with them," said Billy Hellums, of Roswell, N.M., who lost about \$1,500 and was on the verge of investing much more.

Brokers at Investors Associates Inc., based in Hackensack, N.J., allegedly absconded with about \$60,000, belonging to Helen Sprecher, 83, of Philadelphia. The money represented 90 percent of the money she and her husband saved from a neighborhood grocery store they owned for 40 years.

Sprecher said her troubles began when her regular broker took ill and she was contacted by another agent. "He sounded like a nice, friendly grandfatherly man," she said.

David Sayid, a lawyer for Investors Associates, said the company had no comment.

First United Equities, L.T. Lawrence & Co. and Meyers Pollack Robbins, all of New York City, were also named by Griffin.

First United president Douglas Traynor had no comment. The other two firms did not return messages seeking reaction.

Hellums, a New Mexico building contractor, said he invested his money with a broker from the Unifondale, N.Y.-based Sterling Foster brokerage firm. The company did not return a phone call seeking comment.

The 20 states participating in the crackdown are: Alabama, Connecticut, Delaware, Illinois, Indiana, Maryland, Massachusetts, Missouri, New Hampshire, New Jersey, New Mexico, New York, Ohio, Oklahoma, Pennsylvania, Texas, Utah, Vermont, Washington and Wisconsin.

California, Georgia and Florida were expected to announce similar actions next month.

D

• • FRIDAY, MAY 30, 1997

14 over-the-phone broker firms disciplined

BY MONIQUE WISE
Arkansas News

NEW YORK — Fourteen securities firms that peddle stocks over the telephone were disciplined Thursday.

Twenty state regulators had accused the brokers of violations including falsifying records, unauthorized trading, failure to complete trades, operating without a license and using high-pressure sales tactics.

Mark J. Griffin, a Utah securities regulator, called the move "the biggest nationwide crackdown ever by states aimed at brokers selling stocks over the phone."

Regulators who belong to the North American Securities Administrators' Association Inc. de-

cided last fall to investigate fraudulent telephone stock sales practices.

The disciplined firms primarily sell stocks listed on the Nasdaq SmallCap Market, and include Syosset, New York-based Kensington Wells Inc.; Fort Lauderdale, Fla.-based Billmore Securities Inc.; Investors Associates Inc. in Hackensack, N.J.; Fofeca Pacific Securities Inc. in Burbank, Calif.; and Sterling Foster & Co. in Melville, N.Y.

The penalties range from cease and desist orders designed to force firms to stop certain practices, to revoking some firms' licenses to do business.

In February, investigators from 17 states audited five New York-

See CRACKDOWN, Page 6D

Crackdown

• Continued from Page 1D
based firms. The investigation expanded to include 20 states and other firms. The states are Alabama, Connecticut, Delaware, Illinois, Indiana, Maryland, Massachusetts, Missouri, New Hampshire, New Jersey, New Mexico, New York, Ohio, Oklahoma, Pennsylvania, Texas, Utah, Vermont, Washington and Wisconsin.

State targets high-pressure stock pitches

Officials warn of securities companies accused of using illegal telemarketing tactics.

By Edward A. Johnson

Joseph Manno was easily what the brokerage were looking for. He had been in the stock market for years and with money to burn in the stock market. He had been in the stock market for years and with money to burn in the stock market. He had been in the stock market for years and with money to burn in the stock market.

He told his tale of how he had been in the stock market for years and with money to burn in the stock market. He told his tale of how he had been in the stock market for years and with money to burn in the stock market.

Thursday at Secretary of State

at the same conference. Officials said the firm had been in the stock market for years and with money to burn in the stock market.

Employees of the firm present at the conference were told that the firm had been in the stock market for years and with money to burn in the stock market.

Officials said the firm had been in the stock market for years and with money to burn in the stock market. Officials said the firm had been in the stock market for years and with money to burn in the stock market.

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HE STORMY Sue Anne Olney claims to describe how he was victimized by high-pressure sales tactics. Also named in the complaints were three Tokyo Agents and two from LT Lawrence.

Trading in one resident's account. L.T. Lawrence said the company served agents, sold unregistered stocks to investors and made a number of other illegal practices. The Securities Division alleged the company had been in the stock market for years and with money to burn in the stock market.

Officials said the firm had been in the stock market for years and with money to burn in the stock market. Officials said the firm had been in the stock market for years and with money to burn in the stock market.

PITCHES

Continued from Page 1

designed to serve as they run into trouble. The firm had been in the stock market for years and with money to burn in the stock market.

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MARKETPLACE

FRIDAY
MAY 30, 1997
THE STATE
JOURNAL REGISTER
SPRINGFIELD, ILLINOIS
Page 37

Bad investments Securities regulators cracking down on brokerage firms

THE ASSOCIATED PRESS

NEW YORK — Securities regulators in 20 states have begun a crackdown against 14 brokerage firms accused of making unauthorized stock trades and other fraudulent sales practices. The move comes as the firms face a series of lawsuits on the phone. "We are looking at you to get very comfortable with them," said Billy Helms, of Roswell, N.M., who lost about \$1,500 and was on the verge of investing much more.

Helms and three other victims of allegedly unauthorized trades filed suit with the state of Montana Thursday to attend a news conference at New York Attorney General Dennis Vacco's office announcing the crackdown. Vacco filed civil actions against the firms, charging them with high-pressure selling tech-

niques as well as outright lies, sales practice abuses in which unlicensed solicitors justified records of convicted securities fraud, failing to report investor complaints and violation of broker-dealer registration requirements.

Vacco was joined by New Jersey Attorney General Peter Verrino and Mark Griffin, president of the North American Securities Administrators Association.

MASAA, a private organization representing state securities regulators, helped lead the investigation into the fraudulent stock telemarketing that resulted in Thursday's announcement.

"In this high-flying bull market," Griffin said, "it's easy for swindlers to make claims of outrageous returns and persuade investors to put their money in."

The crackdown is the latest in a series of actions by regulators to protect investors from fraud and falling for the lure of the latest trend in boiler room scams. And the telemarketers, playing upon people's desire for ever-greater financial returns, have been running away with millions of dollars of investors' money.

Brokers at Investors Associates Inc., based in Hackensack, N.J., allegedly absconded with about \$80,000 belonging to Helen Sprecher, 85, of Philadelphia. The money represented 90 percent of the money saved by Mrs. Sprecher and her hus-

band from a neighborhood grocery store they owned for 40 years.

Mrs. Sprecher said her husband began his first job at age 13 and she was worked by him for 30 years. She said she was married by another agent. "He sounded like a nice, friendly grandfatherly man," she said.

Investors Associates' website counsel, David Sygel, said the company had no comment.

Mrs. Sprecher, many victims were authorized to sell securities and they were not allowed to sell securities of high-risk stock.

Other New York City brokerage firms named by Griffin were First United Equities, 127 Lawrence & Co. and Meyers Pollack Robbins. First United president Douglas Traynor had no comment. The other two firms did not immediately return messages.

Helms, a New Mexico building contractor, said he invested his money with a broker from the Unicom, N.Y.-based Sterling Foster brokerage firm. The company did not return a phone call.

Helms said he had filed civil actions against First United and Investors Associates. A total of 16 states have taken action against Investors Associates, including New Jersey, which has moved to revoke the firm's right to do business in the state.

Ohio gets tough with brokerages

■ *One brokerage was forced to let customers cancel trades while another was denied a dealers' license.*

By Jeffrey Shaban
Dispatch Business Reporter

A California-based online discount stock broker must give thousands of Ohioans the right to cancel trades made since Jan. 1, Ohio securities regulators said yesterday.

In a separate action, Ohio and 19 other states took action against 14 securities firms with histories of high-pressure sales tactics, unauthorized trading and falsifying records.

The online broker, E-Trade Securities Inc. of Palo Alto, Calif., ran into problems with state regulators when it failed to renew its broker-dealer license that expired Dec. 31. The company has been licensed to sell securities in the state since 1992, and called its failure to renew the license an oversight.

Between Jan. 1 and March 31, the unlicensed E-Trade conducted 18,590 stock transactions and opened 1,100 new accounts in Ohio, a violation of state securities laws.

To settle the matter, the Ohio Department of Commerce's Division of Securities agreed to re-

new its license if Ohioans who bought stock through E-Trade were given the option to cancel the trades. Investors who sold stock aren't included in the settlement.

E-Trade also was required to notify customers of the agreement, and give them 30 days to respond.

"We don't consider them to be a problem broker-dealer," said Ohio Securities Commissioner Thomas Geyer, explaining the license renewal.

E-Trade also failed to renew its Nebraska broker-dealer license this year. That state fined the company \$94,000.

"I'd like to think our result was better," Geyer said. "We did something for Ohio investors and didn't just collect a fine."

In the other matter, the Division of Securities denied an application by Investors Associates Inc. of Hackensack, N.J., for a securities dealers' license.

Geyer said Investors Associates was licensed to do business in Ohio for several years. A 1997 license request was denied when a review of the application turned up 12 separate disciplinary actions against the company in other states.

"These are bad people that use high-pressure sales practices," Geyer said. "We said, 'You can't do business in Ohio because of all the problems in the other states.'"

Geyer said Investors Associates deals primarily in low-priced, little-known stocks, "and those are among the most risky securities."

Ohio's action was part of nationwide crackdown on brokers who peddle stocks over the telephone. Securities regulators from 20 states yesterday accused 14 securities firms of violations that include falsifying records, unauthorized trading, failure to complete trades, operating without a license and using high-pressure sales tactics.

The disciplinary actions go back to last fall, when regulators who belong to the North American Securities Administrators Association decided to investigate fraudulent telephone stock sales practices.

Business briefing

STOCKBROKERS

Nationwide crackdown on phone-sales abuses

Reuters

NEW YORK—Prosecutors and securities regulators in Illinois and 19 other states Thursday unveiled a series of enforcement actions intended as a crackdown on high-pressure penny-stock sales abuses by small brokerages.

Fourteen firms were named in a total of 27 enforcement actions, officials said.

It was the biggest nationwide crackdown ever by state authorities against brokers selling stocks over the telephone, according to the North American Securities Administrators Association, an umbrella regulator group.

The actions, which followed an investigation that began last fall, centered on telephone sales practices that officials said were used to dupe unwitting individual investors into buying stocks.

"Reading from scripts, employees of these firms pressure their victims to buy stock in unknown companies," said association President Mark Griffin.

One firm cited in New York and New Jersey was Hackensack, N.J.-based Investors Associates Inc. The firm, which declined to comment, was named in actions in a total of 16 states, making it by far the hardest-hit among those named.

The enforcement actions varied widely from state to state, but in some cases, temporary orders to cease business were handed down.



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(= Interview; GR = Graphic; PC = Press Conference; R = Reader; SI = Studio Interview; T = Ticker; TZ = Teletext Segment; V = Visual)

Monitoring Report

NASAA/ BROKER CRACKDOWN COVERAGE 5/29 To 6/2

- 1) Good Morning America
ABC Network Programming
31.36 R; Broker crackdown. Securities regulators from 20 states say that some stock brokers are taking advantage of bull market enthusiasm. They are suing 14 brokerage firms for defrauding investors through high pressure sales tactics and other telemarketing scams as well. 31.54
5/30/97 7:00-9:00 AM
- 2) CBS Evening News
CBS Network Programming
11.26 TZ; Stock Scam Crackdown. Law enforcement authorities are going after con artists who use the telephone to rip-off investors, especially the elderly. I; Investors, talking about the scams. SB; Mark Griffin, North American Securities Administrators, announcing the crackdown. GR; Stock Scam. Ray Brady reporting. 13.08
5/29/97 6:30-7:00 PM
- 3) Up To The Minute
CBS Network Programming
34.23 Brokers. Some brokers are being investigated for distributing false information. PC; Mark Griffin, North American Securities Administrators, says it is easy for people to believe outrageous returns right now. I; Louis Poggi, investigator, says I Investec and then went through a nightmare. Ray Brady reporting. 36.06
5/30/97 2:00-4:00 AM
- 4) CBS Morning News
CBS Network Programming
20.04 TZ; Brokerage Firms. 20 States targeting stock fraud have accused a dozen brokerage firms of unlawful tactics to get peoples money, some people have lost their entire life savings. SB; Helen Sprecher, investor, says she lost around 30 thousand dollars. PC; Mark Griffin, N. American Securities Administrators, says that they make outrageous returns sound plausible. V; Inside of the NYSE. A people hear that the markets are rising Americans are easy prey for telephone scams. PC; Louis Poggi, investor, says the reason he invested was because of his children, he has 5 of them, the deal turned out to be a complete nightmare. GR; Stock Scam, Pump and Dump. SB; Billy Hellums, investor, says they had him totally convinced that he was going to jail for fraud. Ray Brady reporting. 21.48
5/30/97 6:30-9:00 AM

For dissemination or knowledge of any of the above segments, contact your nearest VMS office

VIDEO MONITORING SERVICES OF AMERICA, LP

Page: 2

NASAA/ BROKER CRACKDOWN COVERAGE Continued....

- 6) **CBS This Morning**
CBS Network Programming 5/30/97 7:00-8:00 AM
 18.09 Stock Telemarketing Firms/Rey Brady. Security regulators have announced a crack down on fraudulent stock telemarketing firms. I; Helen Sprecher, investor, talking about her losses in investing in fraudulent stocks. Attorney General's from 20 states announced the biggest crack down ever. The firms were selling worthless stock over the telephone. PC; Mark Griffin, N. American Securities Admin., says these people were making claims of outrageous returns sound plausible. V; scenes from markets. PC; Louis Poggi, investor, says he invested for his children's education. GR; Stock scam: Pump and Dump. SI; Billy Helms, investor, says he was threatened when he turned down a stock offer. 19.50
- 6) **Inside Opinion**
CNBC Cable Programming 5/29/97 12:00-12:30 PM
 00.07 Dennis Vacco. Two Brokerage firms are being charged with illegal sales practices. The two companies sitel are Investor's Associates and First United Equities Corporation. 20 states buckled down on these companies. SI; Dennis Vacco, NY State Attorney General, says that this crackdown is a result of a coordinated effort by the North American Security Administrator's Association. His firm audited these companies. These suits were brought on to stop these unregistered activities. The firms called unsuspecting investors and sold them over priced products without there being accounts. NJ Attorney General reportedly said that this is the first shot for these brokerage firms. Vacco says that they want to stop these firms from working illegally and if they have to shut down because they can't work legally, then so be it. These unsuspecting investors are promised enormous things. They have had over 100 complaints where the people felt that they were cornered into buying faulty stock. Some of these investors are losing all their money, including retirement money, and going broke. This is telemarketing fraud, basically. Vacco says don't hang up on these firms if they call you, to con you, just get information about them, find out who they are, and call your Attorney General. He also says that they have a Securities and Protection Bureau that you could also call. Vacco says that it is false that the tobacco companies are being offered blanket immunity. He also says that they need to be held accountable for individual smoking addiction. The companies need to do a better job at making cigarettes less harmful. He thinks that they can do more for the health of Americans. He also thinks that they will reach a settlement soon. 08.36
- 7) **Power Lunch**
CNBC Cable Programming 5/29/97 12:30-2:00 PM
 1.06.05 TZ: Brokerage Crackdown. The North American Securities Administrators Assn. and twenty state securities agencies have filed actions against 14 different brokerage firms. This is a crackdown on the telephone sales practices of some small brokerage firms. I; Dennis Vacco, NY State Attorney General, talks about brokerage firms and investors needing to be careful of scams. GR; Brokerage Crackdown. I; Mark Griffin, NASAA President, talks about the nation wide crackdown being the first time, but not the last time such actions will take place. Tim Tindall reporting live from the studio. 1.08.58

For videocassette or transcripts of any of the above segments, contact your nearest VMS office

NASAA/ BROKER CRACKDOWN COVERAGE Continued....

- 8) The Money Wheel
CNBC Cable Programming 5/29/97 2:00-3:00 PM
10.22 Broker Crackdown. State examiners are gunning for unscrupulous brokers, especially those preying on older investors. Today, New York's Attorney General and 20 state securities regulators announced a crackdown on "boiler room scams." I; Dennis Vacco, NY State Atty. Gen., talking about the crackdown. 11.03
- 9) Market Wrap
CNBC Cable Programming 5/29/97 4:00-5:00 PM
16.01 Nationwide crackdown on telephone sales practices of many small brokerage firms. I; Dennis Vacco, NY State Atty. General, there are many people putting their money at risk in the stock market now. I; Helen Sprecher, individual investor, had some IJ Reynolds stock which she sent to broker, plus 3,000 dollars and she lost it all. GR; targets of crackdown. I; Mark Griffin, NASAA President, it's unusual for this many states to take a concerted action like this. Tim Tindall reporting. 19.12
- 10) The Money Club
CNBC Cable Programming 5/29/97 7:00-7:30 PM
02.46 Nationwide crackdown on telephone sales practices of many small brokerage firms. I; Dennis Vacco, NY State Atty. General, there are many people putting their money at risk in the stock market now. I; Helen Sprecher, individual investor, had some IJ Reynolds stock which she sent to broker, plus 3,000 dollars and she lost it all. GR; targets of crackdown. I; Mark Griffin, NASAA President, it's unusual for this many states to take a concerted action like this. Tim Tindall reporting. 05.27.
* * *
- 05.28 SI; Mark Griffin, North American Securities Administration Assn., what investors can do to protect themselves from broker fraud and scams. 08.00
- 11) Before the Bell
CNBC Cable Programming 5/30/97 5:30-6:00 AM
20.36 T2; Broker Crackdown. Securities regulators are accusing 14 small brokerage firms of high pressure calling techniques, unauthorized trades and other sales abuses. V; Interior of New York news conference on the broker crackdown. The investigation began last fall on the high pressure calling techniques used to trick investors I; Dennis Vacco, NY State Attorney General, says the bull market is the reason these scams are succeeding. V; Interior of Investor Associates Inc. office. This company was named in actions by 16 states. This is by far the hardest hit company. PC; Helen Sprecher, investor, discusses how Investor Associates Inc. scammed her out of \$40,000 and sold her RJR Nabisco stock when she told them not to. V; Court documents. GR; Broker Crackdown: high-pressure cold calling techniques, sales practice abuses, failure to report investor complaints, evasion of Broker-Dealer registration requirements. I; Billy Hellums, investor, says the companies will not make money for you. Be weary of cold calls from unknown brokers and amazing returns. pass on information of questionable behavior to state Securities regulator, if it sounds too good to be true it probably is. Tim Tindall reporting. 22.46

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11/05/97 10:11:00

INTERNATIONAL VIDEO MONITORING SERVICES

NASAA/ BROKER CRACKDOWN COVERAGE Continued....

- 12) Market Update
CNN Cable Programming 5/29/97 4:24-4:30 PM
03.22 Brokerage Crackdown. 20 states announced a coordinated crackdown on small brokerages that used questionable tactics to sell stocks, mostly over the telephone. PC: Mark Griffin, President of the North American Securities Admin. Assn., talks about the questionable tactics of small brokerages. 03.56
- 13) Moneyline
CNN Cable Programming 5/29/97 7:00-7:30 PM
09.34 TZ: Crackdown. There was a crackdown unveiled today on companies that use high pressured sales tactics to sell stocks over the telephone. 20 states are in this, to stop firms from using deception. V: Helen Sprecher, whose most money was in RJR Nabisco, and then the firm sold her stock and replaced it with other companies that she didn't want. V: Exterior of RJR building. V: Winston, Salem, and Camel flags. PC: Helen Sprecher, Stock Scam Victim, says she didn't want to sell the RJ Reynolds because of the nice dividend. Investor Associations was the brokerage int he Sprecher scam. PC: Mark Griffin, President, North American Securities Administration Association, talks about the faulty firms they found. GR: Investors Associates Pitch for I.P.O. PC: Loula Foggi, Stock Scam Victim, says they bought the stock for him. Bill Tucker reporting. 11.50.
- 14) Business Day
CNN Cable Programming 5/30/97 6:00-7:00 AM
06.40 GR: European Markets/Todd Benjamin. > The former President of brokerage Nomura Securities has been arrested in connection with a company scandal involving illegal payments to racketeers. 08.08
- 15) News/Inside Business
CNN Cable Programming 5/31/97 4:00-4:30 PM
06.07 TZ: Investors Vs. Brokers. Finding a trustworthy management firm is the tough task of any investor. V: RJR Nabisco. V: Salem, Winston, and Camel flags. I: Helen Sprecher, Stock Scam Victim, says when I called my broker, he changed by stock from RJR to another option. Sprecher lost \$99,000. Investor Associates and 13 others are currently under investigation. IA was Sprecher's firm. PC: Mark Griffin, North American Securities Administration Assoc., says unauthorized trades are some of the charges we have seen. GR: Investors assoc. pitch for I.P.O. Bill Tucker reporting. 08.23

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7/20/97 11:00:00 AM 10/20/97 11:00:00 AM 10/20/97 11:00:00 AM 10/20/97 11:00:00 AM

** 12:00 PM **

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NASAA/ BROKER CRACKDOWN COVERAGE Continued....

- 16) Street Sweep
CNN/Cable Programming 5/25/97 4:00-5:00 PM
34.57 Telemarketing. Across the country, companies using high pressure telemarketing sales pitches are sprouting up, starting today authorities are doing more to crack down. Bill Tucker has more on this story. Officials from 20 states filed civil charges against 14 companies, and criminal charges may also arise. Helen Sprecher, until last summer, had much of her money in RJR Nabisco stock. V: RJR sign. Then her account was switched to a new broker, who allegedly sold the stock without her permission. V: Winston, Camel flags. PC: Helen Sprecher, stock scam victim, says she called them and told them she didn't want to sell the RJ Reynolds stock, and they said she would make money, and wouldn't get the stocks back. She lost \$99,000. PC: Mark Griffin, Securities regulator, says their examiners found an army of unlicensed solicitors accused of falsifying records, conducting unauthorized trades and failing to complete trades as requested by investors. Investor Associates refused to discuss specific cases, but said it will cooperate. GR: Investors Associates pitch for IPO. PC: Louis Poggi, stock scam victim, talks about what happened to him. Bill Tucker reporting. 39.56
- 17) Family Values
CNN/Cable Programming 5/28/97 5:30-6:00 PM
01.14 Stock sales. State securities regulators are cracking down on high pressure tactics to sell stocks over the phone. V: Exterior RJR Nabisco building, a former grocer invested in RJR. V: Winston, Salem and Camel flags. I: Helen Sprecher, Stock Scam Victim, says she told her broker not to sell RJ Reynolds stock. SB: Mark Griffin, North American Securities Administration, says they found an army of illegal solicitors. Helen deals with investor associates. GR: Investors Associates pitch for IPO. I: Louis Poggi, stock scam victim, says he is investor made unauthorized transactions. Bill Tucker reporting. 03.21
- 18) Before Hours
CNN/Cable Programming 5/30/97 7:00-8:00 AM
32.37 TZ: Brokerage Firms. One call from a phoney broker can cost you a lot of money. V: Outside of RGR. She had her money invested in RGR Nabisco, then her account was switched to a new broker, and he sold the stock without telling her. V: Winston, Salem, Camel on flags outside of RJR. The Broker bought stocks that she had never heard of. V: Press Conference scenes. PC: Helen Sprecher, Stock Scam Victim, says she told her broker not to sell the RJ Reynolds, and he told her he was going to make money with the other stock. GR: Court Document. She lost \$8 thousand dollars. PC: Mark Griffin, NA Securities Admin. Assn., says that they found a Army of brokers that are accused of falsifying record and failing to complete trades. V: Outside of Investors Associate, they are the company that Sprecher was with. GR: Investors Assoc. Statement. PC: Louis Poggi, Stock Scam Victim, says he told him he did not want the stock, but they told him he already bought it. Bill Tucker Reporting. 34.40

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NASAA/ BROKER CRACKDOWN COVERAGE Continued....

- 19) Before Hours
CNNfn Cable Programming 5/30/97 8:00-9:00 AM
38.53 Brokerage Firm Scams/Bill Tucker. It has been a bull market in stocks for a long time making easier for stock scam artists to find victims, and dealing with a phony broker can cost you a lot of money. I; Scam victim, who's stock was in V; exterior, RJR Nabisco, her account was switched to a new broker who allegedly sold her stock with out permission and bought a stock she had never heard of. Prosecutor's and Regulator's from 20 states are cracking down on all scam brokers like Investor Associates and 13 others. PC; Mark Griffin, NA Securities Admin, Assn, says they found an army of unlicensed scammers who are accused of falsifying records and unauthorized trade and failing to make trades as requested investor's. V; exterior, Manhattan Building housing Investor Assoc. GR; Investors Assoc pitch for IPC. I; victim, talks about the scam his broker tried on him. 38.55
- 20) In the Game
CNNfn Cable Programming 5/30/97 9:00-10:00 AM
11.01 TZ: Recapping, Brokerage Scams, Before Hours. High Pressure Sale tactics. Regulator's Prosecutor's file suit against 20 states. V; exterior, RJR Nabisco. I; scam victim. PC; Mark Griffin, NASAA, Investor Assoc. GR; statement from Investor Assoc. PC; scam victim. Bill Tucker reporting. 13.20
- 21) Digital Jam
CNNfn Cable Programming 5/30/97 11:00-12:00 PM
03.15 Decision. A decision by a federal court could make it more difficult for investors to bring securities fraud class action suits. Dismissed a case against Silicon Graphics. V; Silicon Graphics. GR; Computers: Amdahl, Unisys, Silicon Graphics. 03.52
- 22) Fox News Now
Fox News Channel Cable Programming 5/30/97 8:00-9:00 AM
33.09 R; Stock Fraud. Security regulator in 20 states are suing 14 brokerage firms in a nationwide crackdown. GR; SEC administers US securities laws. GR; First United Equities among the firms cited. 33.35
- 23) Morning Business Report
PBS Network Programming 5/30/97 6:30-6:45 AM
02.28 Security scandal. The former head of Nomura Securities in Japan has been arrested in a security scandal. 02.57

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24)	All Things Considered NPR Network	5/29/97	4:00-6:00 PM
	19.58 T2: Sales Over The Telephone. Today securities regulators in 20 states announced a major crackdown on brokers who sell penny stocks over the telephone. In many case, they deceived the buyers of the price of the stock, or even sold shares without permission. SB: Mark Griffith. North American Administrators Association, says it's easy to make outrageous returns sound possible. I: Helen Sprecker, investor, says the stocks tumbled, and she said not to sell RJ Reynolds. Investors Associates was the firm that sold to Sprecker. Jim Zarol reporting. 23.30.		
25)	Marketplace PRI Network	5/29/97	6:30-7:00 PM
	01.03 Telephone Solicitors The Trade Organization that oversees stock brokers wants to put a stop to that, by cracking down on brokers who fleece investors over the phone. North America Securities Administrators Association said that court actions have been filed to 14 brokerage firms in 20 states. Brokers press you over the phone to buy stock in an unknown company. I: Marv Griffen, President Securities Administrators Association, says these firms sit in the shadow of wall street. I: Colin Sprecker, says I told him RJ Reynolds was a stock that I had, and I did not want him to sell it, which he went and sold everything from my portfolio, and put me on two stocks that caused me to lose a whole lot of money. Richard Carothers reporting from New York. 03.35		
26)	First Business News8 Cable CH 8 Syndicated	5/30/97	8:30-9:00 AM
	00.63 Securities fraud. Securities officials in 20 states have begun crackdown involving 14 brokerage firms for unethical tactics. R: 01.22		
27)	This Morning's Business WNBC-TV (NBC) CH 4 Syndicated	5/30/97	5:00-5:30 AM
	24.00 T2: Stock Scams. Securities regulators are cracking down on over-the-phone stock sales. They are exposing many small traders of high pressure sales tactics, unauthorized trades and other inappropriate sales practices. I: Dennis Vacco, NY State Attorney General, says that people should not be sucked into scams. V: Investors Associates Inc was named in actions in 18 states. An Investors Associates Inc salesperson sold her stock in RJR Nabisco when she told him not to. PC: Helen Precher. Investor, says that an Investors Associe as Inc man told her to send him her stocks and he would manage them. 3R: Richard Crackdown. I: Billy Helms says that he wanted to invest a xme money. Tim Tindall reporting. 26.25		

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Monitoring Report

BROKER CRACKDOWN COVERAGE 5/29 To 6/2

- 1) **Newsradio 88**
WCBS-AM (CBS) Freq. 880 New York 5/29/97 5:00-6:00 PM
12.45 Small brokerage firms that sell stock over the phone are the targets of criminal investigations in 20 states. I; Dennis Vacco, NY Attorney General. Talking about how one such firm in NYS operated some scams. 13.00
- 2) **Newsradio 88**
WCBS-AM (CBS) CH 880 New York 5/30/97 7:00-8:00 AM
23.00 Other Stories. > Authorities in 20 states have banded together. Firm firm stock brokers. SB; Vacco.
- 3) **Evening News**
WWS-AM (ABC) CH 1010 New York 5/29/97 5:00-6:00 PM
26.00 Money Watch. Larry Kofsky > N' Atty Gen Vacco. Crackdown on telephone sales by brokerage firms. SB; Vacco.
- 4) **1010 Morning News**
WWS-AM (ABC) CH 1010 New York 5/30/97 7:00-8:00 AM
55.28 Money Watch-Lane Tjard > Sales abuses at some stock brokerage firms. SB; NY State Attorney
- 5) **The Morning Show**
WBS-TV (Ind) CH 31 New York 5/30/97 7:00-9:00 AM
07.33 Brokerage companies. State attorney general Dennis Vacco is suing several brokerage companies charging them with civil violations. 08.00
- 6) **News 55 At 10**
WLNY-TV (Ind) CH 55 New York 5/29/97 10:00-11:00 PM
32.15 State regulators Cracking down on security brokers who sell over the phone. SB; Sprecher. Scam victim. Investor Associates. 20 states involved. Typical sales script. SB; Foggi. Stock scam victim. Bill Tucker. 34.18
- 7) **WMAQ All News 67**
WMAQ-AM (CBS) CH 670 Chicago 5/29/97 5:00-6:00 PM
58.46 Broker Crackdown State Attorney Generals are going after tale-brokers who run aggressive cold calling operations that seek to sell bad stocks. 59.07

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BROKER CRACKDOWN COVERAGE Continued....

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|-----|---|---------|----------------|
| 8) | Midday News
WGN-TV (Ind) CH 9 Chicago | 5/30/97 | 12:00-1:00 PM |
| | 43.55 Consumer News. > Securities regulators in 20 states are cracking down on stock fraud. There are law suits on over 14 brokerage firms. | | |
| 9) | NewsRadio 1060
KYW-AM (ABC) CH 1060 Philadelphia | 5/30/97 | 7:00-8:00 AM |
| | 55.00 Business Report > Stock results > 14 stock brokerage firms have been charged with high pressure sales techniques. New York State Attorney General Dennis Vacco-They have to make sure the lure of the bull market doesn't suck people into scams. | | |
| 10) | 12 Tonight
WHYY-TV (PBS) CH 12 Philadelphia | 5/30/97 | 5:30-6:00 PM |
| | 24.26 Business News / Deco Blastovitz State Atty. General's office is having a crack down against scams against investors. This is by non-registered brokers. Intel had softer earnings. 25.45 | | |
| 11) | Channel 7 News
KGO-TV (ABC) CH 7 San Francisco | 5/30/97 | 5:30-7:00 AM |
| | 20.46 Business. Regulators suing 14 firms, charging them with telemarketing fraud. > Toyota. | | |
| 12) | News
WBZ-AM (ABC) CH 1030 Boston | 5/30/97 | 5:55-7:00 AM |
| | 7.40 Securities regulators are suing 14 brokering firms for making fraudulent sales practices. 7.56 | | |
| 13) | The Ten O'Clock News
WLVI-TV (WB) CH 56 Boston | 5/29/97 | 10:00-11:00 PM |
| | 37.08 TZ: Investment scam. M: Phony stock brokers Myers, Pollack, Robbins, rented V; office on Newberry St.; stocks were illegally sold to at least 60 people. SB: William Galvin, Secy of State, admits case is pretty outrageous. 38.29 | | |
| 14) | News 4 Today
WRC-TV (NBC) CH 4 Washington | 5/30/97 | 5:30-7:00 AM |
| | 40.30 TZ: First Business News, Andrew Ickey, CNBC. > Securities regulators are cracking down on unethical brokers. | | |
| 15) | Eyewitness News This Morning
WUSA-TV (CBS) CH 9 Washington | 5/30/97 | 5:30-7:00 AM |
| | 24.40 TZ: Business Journal/Jack Spear. > Securities regulators announcing a crackdown on 14 brokerage houses. R. 25.45 | | |

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BROKER CRACKDOWN COVERAGE Continued....

- 16) News 4 At 5:30
KDFW-TV (Fox) CH 4 Dallas 5/30/97 5:30-6:00 AM
17.45 Scams. T2; V: Security regulator: cracking down on fraud. 14
brokerage firms accused of unauthorized stock trades. 18.05
- 17) 11 News This Morning
KTVT-TV (CBS) CH 11 Dallas 5/30/97 6:00-8:00 AM
42.50 Stock. V; NY: Regulators in 20 states are cracking down on 14
brokerage firms for high pressure sales pitches and unauthorized
trades. V; Wall Street. The scammers buy worthless stocks and market them
over the telephone. V; NYSE banner. V; Fraud victims. 43.45
- 18) Good Day Atlanta
WAGA-TV (Fox) CH 5 Atlanta 5/30/97 7:00-8:00 AM
18.54 Scam. State attorneys general across country are accusing 13 firms
of changing stock in customer portfolios without notifying clients, and
are working together to stop the practice. PC; Helen Sprecher, investor
who says firm traded her shares of RJR Nabisco for unknown stock and
caused her to lose \$99,000, describes what broker said to her. 19.33
- 19) 11 News Today
WXIA-TV (NBC) CH 11 Atlanta 5/30/97 8:00-9:00 AM
21.00 T: City council votes for funding plan for sports arena. Rapper
charges with possessing marijuana with the intent to distribute it. Stock
brokerage firms charged with fraud. 21.10
- 20) 11 News at 5:30
KHOU-TV (CBS) CH 11 Houston 5/30/97 8:30-9:00 AM
13.09 Business. > R: Stockbrokers who sell worthless penny stocks over the
phone are being cracked down on by securities investigators. V;
Securities officials.
- 21) AM Drive News
KTRH-AM (CBS) Freq. 740 Houston 5/30/97 8:00-9:00 AM
8:43 - 14 brokerage firms are being investigated for fraud.
- 22) KIRO News At Noon
KIRO-TV (UPN) CH 7 Seattle 5/30/97 12:00-1:00 PM
12.50 Biz. > T2: Brokerage, crackdown on sales scammers, brokers who use
phones and high pressure sales tactics. T2: Mark Griffin, N. A. Security
Admin., details some frauds: from CNN.
- 23) News At Midday
WTVJ-TV (NBC) CH 6 Miami 5/30/97 11:00-12:00 PM
43.39 Business Briefs /Bob Mayer. > T2: Security regulators in 20 states
are cracking down on stockbrokers that sell stocks over the telephone. V;
New York Attorney General holding a meeting. I; Dennis Vacco, New York
State General Attorney, says unlawful practices are succeeding.

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24)	News Ten AM KXTV-TV (ABC) CH 10 Sacramento	5/30/97	6:00-7:00 AM
	19.03 Scam Artist. A healthy stock market is also attacking scam artists. V; New York stock exchange. Regulators in 20 states are suing 14 brokerage firms for frauding people. 19.34		
25)	KNUS News KNUS-AM (AP) CH 710 Denver	5/30/97	6:00-7:00 AM
	45.00 CNN Business. > Regulators in 20 states have filed suit against 14 brokerage firms for fraudulent stock telemarketing practices.		
26)	Business For Breakfast KTLK-AM (ABC) CH 760 Denver	5/30/97	7:00-8:00 AM
	1.32.20 Business. > Securities regulators in 20 states have started a crack down against 14 brokerage houses.		
27)	1080 News WTIC-AM (CBS) Freq. 1080 Hartford	5/29/97	6:00-6:15 PM
	05.14- Brokers. 14 brokerage firms accused of fraudulently selling stocks over the phone were the target of a 20 state crackdown announced by securities regulators today. -05.26		
28)	1080 News WTIC-AM (CBS) Freq. 1080 Hartford	5/30/97	6:00-6:59 AM
	35.28 Stock Fraud Atty gens in 20 states, including CT, are targeting stock fraud. They have charged 14 brokerage firms. 35.47		
29)	1080 News WTIC-AM (CBS) Freq. 1080 Hartford	5/30/97	7:00-7:59 AM
	31.28 Stock Fraud 20 US atty gens have announced a crackdown on brokers who sell worthless stocks over the phone. I; Mark Griffin, North American Securities Admin. 32.07		
30)	Eyewitness News This Morning WFBS-TV (CBS) CH 3 Hartford	5/30/97	5:30-8:00 AM
	22.35 Stock fraud States targeting alleged stock fraud at brokerage firms. V; Scenes. 23.02 * * *		
	1:09.30 TZ; Stock fraud recap. M; Brokerage firms. 9.53		
31)	Newscenter 6 KDRN-TV (CBS) CH 6 Portland	5/29/97	11:00-11:40 PM
	04.27 Stockbroker. A stockbroker scam is raising red flags. PC; Mark Griffin N.Amer. Securities Administrator, says there are many swindlers making outrageous claims. V; Walt St. P.; Louis Poggi, investor, says it's been a nightmare. GR; scam details. 25.25		

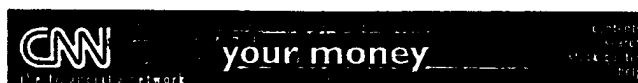
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32)	News 5 Today WLWT-TV (NBC) CH 5 Cincinnati 13.50 Stock fraud. 14 brokerage firms across U.S. are charged with making unauthorized stock trades and other fraudulent practices, including high pressure calling and lies. Regulators are targeting 20 states. R. 14.06	5/30/97	5:30-7:00 AM
33)	Sunrise on 5 WFTV-TV (NBC) CH 5 West Palm Beach 17.18 Business Today. > Brokerage are shutdown. 14 brokerage firms targeted. Accused of unauthorized trading and other fraudulent sales practices. Firms used high pressure sales technique.	5/30/97	5:30-6:00 AM
34)	News 36 Firstcast KXAN-TV (NBC) CH 36 Austin 01.46.48 T2: Business Report. > Brokerage House investigation. 14 firms are being investigated for fraudulent practices.	5/30/97	5:00-7:00 AM
35)	News 36 Firstcast KXAN-TV (NBC) CH 36 Austin 01.46.48 T2: Business Report. > Brokerage House investigation. 14 firms are being investigated for fraudulent practices.	5/30/97	5:30-7:00 AM
36)	Channel 3 News This Morning WCIA-TV (CBS) CH 3 Springfield IL 39.48 Fraud. Fourteen brokerage firm are being sued for selling tactics. R: 30.07	05/30/97	7:00-8:00 AM

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DATE: 11/11/16 TIME: 14:16:16



Cold-call brokers put on ice

Securities agencies from 20 states crack down on risky stock sales

May 29, 1997: 12:49 p.m. ET

NEW YORK (CNNfn) -- State securities agencies from 20 states on Thursday announced a nationwide crackdown on the high-pressure phone sale of extremely risky stocks.

New York Attorney General Dennis Vacco, appearing with representatives of the North American Securities Administrators Association, said 36 actions against 14 companies would be launched.

"Using high-pressure, cold-calling techniques and pre-scripted sales pitches, these firms persuaded people to buy stock in many little-known companies that the insiders sell when the price is driven high enough," Vacco said.

"Needless to say, the investors end up losing most, if not all, of their money."

First United Equities and Investors Associates, along with nine people associated with the two firms, were charged in Manhattan's state Supreme Court with fraudulent sales tactics.

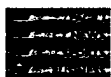
In light of the actions, which are civil rather than criminal, the court ordered the companies to stop "manipulative practices concerning initial public offerings" and cold-calling by unregistered brokers.

The NASAA, an organization of securities regulators, said it initiated its scrutiny late last year because of four recurring problems.

- Abusive cold-calling practices involving high-pressure tactics and falsified statements about experience and performance.
- Sales practice abuses including the use of unlicensed solicitors who conducted unauthorized trades and failed to complete trades.
- Failure to report investor complaints.
- Evasion of broker-dealer registration requirements.

First United, based in Garden City, N.Y. could not be reached for comment and Investors Associates in Hackensack, N.J. said it was unaware of the charges. The two companies are the largest of the 14 firms that face the legal action.

The NASAA said Thursday's actions would be the first in a national campaign against fraudulent

The Hartford Courant**BUSINESS**Friday
May 30

COURANT 100

OUTLOOK '97

ALIBIO

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The Hartford Courant**States press case against broker fraud**

ASSOCIATED PRESS

This story ran in the Courant May 30, 1997

NEW YORK - Securities regulators in 20 states - including Connecticut - have begun a crackdown against 14 brokerage firms accused of making unauthorized stock trades and other fraudulent sales practices.

"They're very impressive when they talk to you on the phone. Like a brother. They get you to feeling very comfortable with them," said Billy Hellums, of Roswell, N.M., who lost about \$1,500 and was on the verge of investing much more.

Hellums and three other victims of allegedly abusive telemarketing practices by brokers came to Manhattan Thursday to attend a press conference at New York Attorney General Dennis Vacco's office announcing the crackdown.

Vacco filed civil actions against the firms, accusing them of high-pressure calling techniques and outright lies; sales practice abuses in which unlicensed solicitors falsified records and conducted unauthorized trades; failing to report investor complaints; and evasion of broker-dealer registration requirements.

Vacco was joined by New Jersey Attorney General Peter Verniero and Mark Griffin, president of the North American Securities Administrators Association.

The association, a private organization representing state securities regulators, helped to lead the investigation into the fraudulent stock telemarketing that resulted in Thursday's announcement.

North American Securities Administrators Association Web site

"In this high-flying bull market," Griffin said, "it's easy for swindlers to make claims of outrageous returns sound plausible."

"Unfortunately, far too many investors are falling for the lure of this latest trend in boiler room scams. And the telemarketers, playing upon people's desire for ever greater financial returns, have been running away with millions of dollars of hard-earned money."

Eric Wilder, an assistant director in the securities division of the Connecticut banking department, said one 24-year-old broker involved in

the scams made \$57,000 in one month alone on commissions. And that was the lowest amount the broker made in a month in a one-year period, Wilder said.

Wilder estimates that the broker made between 200 and 300 calls a day to rake in that much money.

Brokers at Investors Associates Inc., based in Hackensack, N.J., allegedly absconded with about \$60,000 belonging to Helen Sprecher, 85, of Philadelphia. The money represented 90 percent of the money saved by Sprecher and her husband from a neighborhood grocery store they owned for 40 years.

Sprecher said her troubles began when her regular broker took ill and she was contacted by another agent. "He sounded like a nice, friendly grandfatherly man," she said.

Investors Associates' outside counsel, David Sayid, said the company had no immediate comment.

Like Sprecher, many victims were senior citizens, Griffin said, and many complaints involved low-priced shares of high-risk stock.

Other New York City brokerage firms named by Griffin were First United Equities, LT Lawrence & Co. and Meyers Pollack Robbins. First United President Douglas Traynor had no comment. The other two firms did not immediately return messages seeking reaction.

Hellums, a New Mexico building contractor, said he invested his money with a broker from the Uniondale, N.Y.-based Sterling Foster brokerage firm. The company did not return a telephone call seeking comment.

Vacco said he had filed civil actions against First United and Investors Associates. A total of 16 states have taken action against Investors Associates, including New Jersey, which has moved to revoke the firm's registration to do business in the state.

Another alleged Investors Associates victim was Louis Poggi, 45, of Pembroke, N.H., who said he lost \$10,000, all of his savings. "I was careful as a human being can be, and they did something illegal," the Federal Express driver said.

Securities and Exchange Commission investor alert Web page

The 20 states participating in the crackdown are: Alabama, Connecticut, Delaware, Illinois, Indiana, Maryland, Massachusetts, Missouri, New Hampshire, New Jersey, New Mexico, New York, Ohio, Oklahoma, Pennsylvania, Texas, Utah, Vermont, Washington and Wisconsin.

California, Georgia and Florida are expected to announce similar actions against broker-dealer firms in the next month.

Connecticut investors who suspect that they are being targeted by a scam or just have questions should call the securities division of the banking department at (800) 831-7225 or (860) 240-8230. A copy of "Investor Alert," a pamphlet outlining the scams and tips to avoid them, is available by calling or writing the agency at 260 Constitution Plaza,

The Hartford Courant - Business ->...es press case against broker fraud

<http://news.courant.com/article/biz2.htm>

Hartford 06103-1800. "Investor Alert" is also posted on the department's World Wide Web site at <http://www.state.ct.us/doh/pages/investor.htm>.

A staff report is included in this story.

 Email The Editor

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υπονοητὰ δὲ ὑπ' Ἀ++

EQUINOCT

Copay Pharmaceuticals suits

U.S. credit good

American Airlines buys Shuttle

Marketswatch

Thursday, May 29, 1997

Dow Jones Industrial Average
down 27.05 (0.36%) to
7330.18

Money 30 Index:
down 11.37 (0.76%) to
1482.05

New York Stock Exchange
Advances: 1430
Declines: 1048
Volume: 464 million shares

NASDAQ Composite:
down 7.14 (0.5%) to 1403.04

S&P 500 Index:
down 3.13 (0.37%) to 844.08

30-year Treasury bond yield:
down 5 basis points to 6.97%

London gold (afternoon fix)
up \$1.10 to \$343.90

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Web-formation

Statement of Mark Green

Statement of Helen Sprache

Statement of Betty Helburn

THIS FOR
TO YOU A GUY
THE THINGS I WANT
WANT NOT HAVE I
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FOR WANT AT THE
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Sound familiar? State securities examiners sized this handwritten telebroker's script. Click to enlarge.

Today, though, boiler room cold call sales tactics are clearly on the rise -- if the number of abusive practices brought to the attention of New York prosecutors is any guide. They say complaints were up 40% in 1996 over the year before.

That should be no surprise. Given the spectacular performance of the stock market and the growing need for small investors to manage their own money, an increase in the number of con artists was bound to follow.

Recently, though, state securities cops have begun to strike back. In the past few weeks, securities watchdogs in 20 states filed 36 civil actions against 14 firms in "the biggest nationwide crackdown ever aimed at brokers selling stocks over the phone," according to Mark Griffin, president of North America Securities Administrators Association (NASAA).

Most of the firms operate in or near New York City, "in the shadow of Wall Street which lends an air of legitimacy to their operations," says Griffin. "Playing on people's desires for ever greater financial returns, they have been running away with millions of dollars of hard earned money."



Print Club



Money's privacy guidelines

During a press conference in New York Thursday,

Griffin outlined the typical approach used by high pressure cold callers.

"Reading from scripts, employees of these firms pressure their victims into buying stock in unknown companies," says Griffin, whose Washington-based group represents securities regulators in the fifty states. "Once the price is driven high enough, insiders sell, making fortunes for themselves but wiping out innocent investors' life savings."

Griffin says an investigation begun in January found four "systemic" types of abuses by brokers.

- Questionable cold calling practices

Brokers relied on scripted cold calling techniques that included "falsifying their experience and performance, as well as other outright lies."

- Questionable sales practices

Griffin says the investigation found "an army of unlicensed solicitors who are accused of falsifying records, conducting unauthorized trades, and failing to complete trades as requested by investors."

- Failure to report investor complaints

State examiners found "most of the offices audited failed to have centralized procedures for handling and reporting of customer complaints," says Griffins.

- Failure to register

Brokers used third party franchise agreements to avoid broker-dealer registration requirements, says Griffin.

Once investors were drawn into setting up an account, stocks were then bought and sold without their permission, often costing investors thousands of dollars, says Griffin.

"The pattern is always the same," he says. "First they tell you what they need to tell you to get their money regardless of whether or not it is true. Second, they execute trades without your permission. Third, when you complain, they route you around the firm and give you the royal run around and you can't get your money back." Griffin says that several of the brokers investigated "seemed to treat this money as if it were their own."

Several small investors at the press conference described how they had lost money investing with brokers who cold-called them.

"I'll be 79 years old later this year, and you would think I wouldn't be dumb enough to do what happened to me," lamented Emile Murnan, who lives in the suburb of St. Louis.

He claims brokers at L.T. Lawrence & Company bought and sold stocks for him and even set up a \$20,000 margin account in his name without his permission. "That is something I would never do. He didn't ask me, he didn't tell me, he didn't confer with me. He did it. The first I know about it, I am getting these confirmations." Murnan says trading in his account ran his initial investment of \$6040 down to \$292.

Ruthann Niosi, an attorney for L.T. Lawrence, says the firm follows securities regulations and will not "litigate any customer allegations in the press."

Another investor who says she was deceived by brokers from a firm called Investors Associates is  Helen Sprecher, an 85 year-old Pennsylvania resident. She says brokers sold her position in RJR Reynolds without her permission, and then bought small cap stocks which promptly "tumbled" in value.

"I called them and said 'I told you not to sell the RJR Reynolds,'" she says. "It gave me a nice dividend. He said 'You are going to make money with this and you will send me a dozen roses when you find out how much.' After a few weeks the stock kept going down." Sprecher says her complaint against the firm is still in litigation.

David Sayid, a lawyer who works for Investors Associates says the firm has "never condoned any improper sales practice, and will take all necessary steps to rectify such inappropriate behavior should it exist." He says the company is "anxious to comply and cooperate with the various states and regulatory agencies to clear its name."

Law enforcement officials offered the following advice to anyone approached by a broker over the phone.

- Be very suspicious when a broker says you must "act now" to catch a good investment
- Hang up the phone if a salesman is too offensive or pushy

- Remember that if it sounds too good to be true, it probably is
- Investigate all investment proposals thoroughly by yourself before buying stock
- Deal only with brokers you know

"When they call you, they talk to you like they are your brother," says  Billy Hellums of New Mexico, who claims he lost money after getting duped by a cold caller promising big profits in small cap stocks. "But the quick money these people convince you that you can make is just not there. You are better off going to Las Vegas."

[Return to top](#)

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1 of 3

...Dennis A. Wenzel & Jonathan, And I'll
 Tell You. Really, As I Said 200 Miles
 Away, In Response To A Letter That I'd
 From About 210 Miles In 34, February,
 And Enclosed, This, Only, Ready To
 Go, On The Numbers Along, Not For, I Told
 When Mike Told Them, Not, As I Said,
 We Have An Answer, From, Now,
 We're Not To, We're Not To, We're Not To,
 Every, And, The, My, My, My, My,
 Like, You, As, With, The, I, I, I, I,
 Got, I, I, I, I, I, I, I, I, I, I,
 Is, They, By, Us, To, To, To, To,
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 Not, After, For, The, I, I, I, I,

Statement of
Billy Hellums

05/30/97 13:08:21

TITLE: SECURITIES REGULATORS CRACK DOWN ON PHONE SALES
 BYLINE: Bloomberg Business News
 EST. PAGES: 1
 DATE: 05/30/97
 DOCID: FLSS71490599
 SOURCE: Sun-Sentinel Ft. Lauderdale; FLSS
 EDITION: FINAL; SECTION: BUSINESS; PAGE: 2D
 ORIGIN: NEW YORK
 (Copyright 1997)

Twenty state securities regulators unveiled a nationwide crackdown on brokers, including those at a Fort Lauderdale firm, who peddle stocks over the telephone.

The regulators accused 14 securities firms of violations that include falsifying records, unauthorized trading, failure to complete trades, operating without a license and using high-pressure sales tactics.

Mark J. Griffin, a Utah securities regulator, called the move "the biggest nationwide crackdown ever by states aimed at brokers selling stocks over the phone."

The actions announced Thursday began last fall, when regulators who belong to the North American Securities Administrators Association Inc. decided to investigate telephone stock sales practices.

As part of the crackdown, investigators from 12 states audited five New York-based firms in February. The investigation expanded to include other firms and 20 states.

Regulators took a wide range of actions, from starting investigations to issuing cease and desist orders and revoking some firms' licenses to do business.

Fort Lauderdale-based Biltmore Securities Inc. was among those named in the actions.

"An inquiry has recently started, no charges have been filed and none have been threatened to our knowledge," said William Nortman, Biltmore's general counsel, in an interview.

Last month, Indiana's securities division ordered Biltmore to pay \$175,000 in fines and reimburse five investors for \$495,000 in losses for allegedly misleading them, the Indianapolis Star reported.

DESCRIPTORS: SECURITIES REGULATION VIOLATION STOCK

TITLE: CRACKDOWN HITS BROKERS WHO SELL STOCKS OVER THE PHONE
 BYLINE: Reuters
 EST. PAGES: 1
 DATE: 05/30/97
 DOCID: ORSE71490681
 SOURCE: Orlando Sentinel; ORSE
 EDITION: METRO; SECTION: BUSINESS; PAGE: B5
 ORIGIN: NEW YORK
 (Copyright 1997)

Prosecutors and securities regulators in 20 states Thursday unveiled a series of enforcement actions intended as a crackdown on high-pressure penny-stock sales abuses by small brokerages.

Fourteen firms were listed in a total of 37 enforcement actions, officials said. The securities firms being disciplined include Fort Lauderdale-based Biltmore Securities Inc.; Syosset, N.Y.-based Kensington Wells Inc.; Investors Associates Inc. in Hackensack, N.J.; Toluca Pacific Securities Inc. in Burbank, Calif.; and Sterling Foster & Co. in Melville, N.Y.

It was the biggest nationwide crackdown ever by state authorities against brokers selling stocks over the telephone, according to the North American Securities Administrators Association, an umbrella regulator group.

The actions, which followed an investigation that began last fall, centered on telephone sales practices that officials said were used to dupe unwitting individual investors into buying stocks.

"Reading from scripts, employees of these firms pressure their victims to buy stock in unknown companies," said association President Mark Griffin. "Once the price is driven high enough, insiders sell the stock, making fortunes for themselves and wiping out the savings of innocent investors."

The nationwide actions were disclosed at a news conference at the office of New York Attorney General Dennis Vacco. New Jersey Attorney General Peter Verniero also participated.

One firm cited in both New York and New Jersey was Investors Associates. The firm, which would not comment, was identified in actions in 16 states, making it by far the hardest-hit among those listed.

The enforcement actions varied widely from state to state, but some temporary orders to cease business were handed down.

Oklahoma General Counsel and Director of Enforcement Gretchen Harris said her state had temporarily suspended and would seek to revoke the registration of Investors Associates.

Helen Sprecher, an 85-year-old retired grocer from Philadelphia who appeared at the New York news conference, said she was bilked

of about \$99,000 when an Investors Associates broker sold her holding in RJR Nabisco despite orders not to and invested the proceeds in a little-known telecommunications company.

The new stock plummeted, and after repeated demands to get her money, Investors Associates offered her a settlement of \$12,000, she said. She rejected the offer, and the case is in litigation.

Louis Poggi, a Federal Express delivery driver from Pembroke, N.H., said his life savings were wiped out in a series of unauthorized trades made by a broker at Investors Associates in Melrose, N.Y.

"I was as cautious as a human being could be, and I still lost out," Poggi said.

SEQN: 71490681

REGION: US NME; UNITED STATES; NORTH AMERICA

OTHER TERMS: INVESTMENT INDUSTRY US; OPERATION; LIST

TITLE: U.S. cracks down on penny-stock sale abuses
 BYLINE: Reuter
 EST. PAGES: 1
 DATE: 05/30/97
 DOCID: FINP2648550
 SOURCE: The Financial Post; FINP
 EDITION: Daily; SECTION: 1, News; PAGE: 16
 CATEGORY: NEWS
 ORIGIN: New York, NY
 (Copyright The Financial Post)

Prosecutors and securities regulators in 20 states yesterday unveiled a series of enforcement actions intended as a crackdown on high-pressure penny-stock sales abuses by small brokerages.

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The nationwide actions were disclosed at a news conference at the office of New York Attorney General Dennis Vacco. New Jersey Attorney General Peter Verniero also participated.

One firm cited in New York and New Jersey was Hackensack, N.J.-based Investors Associates Inc. The firm, which declined to comment, was named in actions in 16 states, making it by far the hardest-hit among those named.

Other firms named in more than one state included Meyers Pollack Robbins and L.T. Lawrence & Co., each cited in four states, and First Equities Corp., cited in two.

Additional actions are expected to result from the investigation, officials said.

"This is the overture, not the finale," Verniero said. In the interim, he said, consumers must be aware that "an investment that seems too good to be true probably is."

*** Infomart-Online ***

DESCRIPTORS: SECURITIES INDUSTRY; INVESTMENT DEALERS; INVESTIGATIONS; LAWS
AND
REGULATIONS; UNITED STATES
ORGANIZATION: North American Securities Administrators Association; Investors
Associates Inc.; Meyers Pollack Robbins; L.T. Lawrence & Co.; First
Equities Corp.

TITLE: Crackdown on Penny Stock Firms / About 50 brokerages nationwide engage in 'boiler-room' sales tactics, according to securities regulators.
 BYLINE: By Susan Harrigan. STAFF WRITER
 EST. PAGES: 2
 DATE: 05/30/97
 DOCID: NDAYS26085
 SOURCE: Newsday; NDAY
 EDITION: ALL EDITIONS; SECTION: BUSINESS; PAGE: A65
 (Copyright Newsday Inc., 1997)

Fourteen brokerage firms, including several with Long Island headquarters or branch offices, were accused yesterday by 20 state regulators of using fraudulent, high-pressure telephone tactics to sell penny stocks. The securities regulators called it the biggest such crackdown ever.

Some of the firms already have been investigated by other regulators. At least two are out of business. The potential penalties announced yesterday included fines, license revocation proceedings and temporary orders to cease certain activities.

Mark Griffin, president of the North American Securities Administrators Association, an umbrella group of regulators that held the news conference, said that nationwide, about 50 brokerages engage in so-called "boiler-room" sales tactics, such as scripted "cold-calling," misleading statements about securities and failure to respond to consumer complaints. Dennis Vacco, New York State's attorney general, said that such firms are likely to be located in the New York City area because it helps them impress customers.

The firms named in yesterday's crackdown that have Long Island headquarters are:

- First United Equities Corp. of Garden City, temporarily restrained by Vacco from a number of acts including making the sale of shares of initial public offerings contingent on a promise to buy more later, and using unregistered securities salesmen to make cold calls. No one answered the phone at First United yesterday.

- Sterling Foster & Co., of Melville, notified that the state of New Mexico intends to bar it from doing business there due to customer complaints of unauthorized trading in their accounts, sometimes by salesmen who allegedly weren't registered as brokers in the state.

Ira Sorkin, an attorney for Sterling Foster, said he couldn't comment because he hasn't seen the charges. He said Sterling Foster has "ceased doing business for all practical purposes." The firm has been sued by the Securities and Exchange Commission and it is the subject of a civil action by the National Association of Securities Dealers.

- Kensington Wells Inc., formerly headquartered in Syosset.

notified that its license to do business in Delaware will be revoked. Delaware officials said they understand the firm has been out of business since November. Brokerage officials couldn't be reached for comment.

Additionally, Investors Associates Inc., a Hackensack, N.J., firm sued by Vacco, used to have a number of Long Island branches and still has at least two. Vacco temporarily restrained the firm from a number of activities relating to initial public offerings and telephone sales. David Sayid, outside counsel for the brokerage, said the firm "never condoned any improper sales practices" and will cooperate with authorities "to clear its name."

DESCRIPTORS: SECURITY; INDUSTRY; STOCKS; FIRST UNITED EQUITIES CORP; STERLING FOSTER & CO; KENSINGTON WELL INC; INVESTORS ASSOCIATES INC; FRAUD; SECURITIES ADMINISTRATORS; DENNIS VACCO;; STOCK NEWS

TITLE: New Jersey Securities Firm Barred by State
 BYLINE: Danny M. Boyd
 CREDIT: Staff Writer
 EST. PAGES: 1
 DATE: 05/31/97
 DOCID: OKC1987433
 SOURCE: The Daily Oklahoman; OKC
 SECTION: BUSINESS; PAGE: 27
 (Copyright 1997)

The Oklahoma Securities Department is barring a New Jersey firm from doing business in the state as part of a multistate crackdown on questionable practices of telemarketers selling penny stock investments.

Securities Administrator Irving L. Faught issued a summary order barring Investors Associates Inc. of Hackensack, N.J., from conducting securities business in the state.

The company, which does not have offices in Oklahoma, has 15 days to respond or the temporary ban becomes permanent, Faught said.

Investors Associates and others are hawking penny stocks and other micro-cap stocks over the phone and may be engaged in illegal or improper high-pressure or "boiler room" sales tactics, he said.

Improper practices could include artificially hyping a stock to influence its value, or telling consumers to buy or sell stocks so the firm can generate additional commissions when holding a stock may be in the consumers' best interest.

Improper sales tactics can also include promoting investments considered unsuitable for the consumer, such as a high-risk investment for an elderly person.

The action against the New Jersey company and investigations of others stemmed from actions begun by the North American Securities Administrators Association.

Officials at Investors Associates were unavailable for comment early Friday evening.

The department is investigating three other out-of-state firms for possibly engaging in similar practices. The firms are William Scott & Company of Union, N.J.; Biltmore Securities of Fort Lauderdale, Fla., and Euro-Atlantic Securities of Boca Raton, Fla.

The department is issuing an "Investor Alert" that offers tips to consider before investing. For a free copy, potential investors can write to: Stock Scams, The Oklahoma Securities Commission, Suite 860, First National Center, 120 N Robinson, Oklahoma City, OK, 73102 and at <http://www.oklaosf.state.ok.us/~osc/invalert.html>

TITLE: States cracking down on stock phone scams
 BYLINE: From staff ; wire reports
 EST. PAGES: 1
 DATE: 05/30/97
 DOCID: CINP188586
 SOURCE: The Cincinnati Post; CINP
 EDITION: FINAL; SECTION: BUSINESS; PAGE: 6C
 ORIGIN: NEW YORK
 (Copyright 1997)

The booming stock market is leading to more telemarketing scams, according to securities regulators in 20 states that are suing 14 brokerage firms for defrauding people with promises of huge returns.

"In this high-flying bull market, it's easy for swindlers to make claims of outrageous returns sound plausible," said Mark Griffin, president of the North American Securities Administrators Association.

The NASAA is a private organization representing state securities regulators who spearheaded an investigation into fraudulent stock telemarketing. On Thursday, Attorney General Dennis Vacco announced civil suits against the 14 brokerages.

The firms were charged with high-pressure calling techniques and outright lies. They also were accused of allowing unlicensed solicitors to falsify records and conduct unauthorized trades, failing to report investor complaints and evasion of broker-dealer registration requirements.

In Ohio, the Securities Division of the state Commerce Department denied a license to Investors Associates Inc., of Hackensack, N.J., on Thursday based on a number of customer and regulatory complaints.

TITLE: BRIEFCASE
 COLUMN: BRIEFCASE
 EST. PAGES: 1
 DATE: 05/30/97
 DOCID: HARR1104879
 SOURCE: The Harrisburg Patriot; HARR
 EDITION: FINAL; SECTION: BUSINESS; PAGE: B7
 (Copyright 1997)

TAKING STOCK OF FRAUD: The Pennsylvania Securities Commission was among 20 state securities agencies filing actions yesterday against 14 firms in a nationwide crackdown aimed at brokers selling fraudulent stock over the telephone.

Pennsylvania's action was filed against Investors Associates Inc. of Hackensack, N.J.

The state's order alleges that the firm sold clients' securities without authorization, and failed to sell or delayed investors' instructions to sell for as long as three months.

The state further charged that the company recommended unsuitable, speculative stock to elderly Pennsylvania clients whose primary investment objective was conservative growth and income with minimum risk.

The North American Securities Administrators Association Inc. said that the 37 actions filed against the firms by 20 states represents the biggest nationwide crackdown ever against brokers selling stock over the phone.

To help educate the public about the latest trend in securities fraud, the state commission is releasing an Investor Alert that outlines the scope of the problem and offers tips to consider before investing. For a free copy, readers may call (800) 600-0007, or write to the commission at 1010 N. Seventh St., Harrisburg, 17102-1410.

NAME CHANGE: Sears, Roebuck and Co. will change the name of its Harrisburg area Tire America stores to National Tire and Battery on Sunday.

The local stores are at 4521 Jonestown Road, Lower Paxton Twp.; and 6051 Carlisle Pike, Hampden Twp. The company also is changing the name of its Tire America stores in Lancaster and York.

The name change is part of Sears' plan to convert some 275 stores to the National Tire and Battery concept by Aug. 1.

All stores will carry 3,000 national brand name and private label tires, including Goodyear, Michelin, Pirelli and custom wheels. The stores also will sell batteries and related starting and charging accessories.

In addition, they'll offer services such as brake, shocks, struts,

TITLE: State pulls license of N.Y. broker
 Says firm defrauded clients, seeks fines
 BYLINE: Charles Stein, Globe Staff
 EST. PAGES: 1
 DATE: 05/30/97
 DOCID: BOGL1289189
 SOURCE: The Boston Globe; BOGL
 EDITION: City Edition; SECTION: ECONOMY; PAGE: C1
 (Copyright 1997)

State securities regulators yesterday accused a New York investment firm of engaging in high-pressure sales tactics to fraudulently sell speculative "penny stocks" to Massachusetts investors.

Secretary of the Commonwealth William Galvin suspended the license of Meyers Pollock Robbins Inc. and 14 employees of the firm. Galvin also plans to seek fines against the company and win restitution for any local investors who were defrauded.

Yesterday's action was part of a nationally coordinated crackdown on firms that sell low-priced stocks to investors over the telephone. It involved 20 states working with the North American Securities Administrators Association, the umbrella group for state securities agencies. Last fall the group created a special project to combat the growing problem of dishonest sales practices in the marketplace for so-called microcap companies.

"With the booming stock market, many people feel they are missing out," said Galvin at a news conference yesterday. "That mentality fuels the opportunity for fraud."

Galvin's formal complaint accuses Meyers of running a classic "boiler room" operation in its New York office. Phone representatives reading from prepared scripts pressured unsophisticated investors to buy stocks. According to Galvin, the brokers frequently lied about their experience in the investment business and promised investors they would make large profits. In one case a potential investor was told he could turn one dollar into five dollars within a year.

At least two investors who refused to buy stock had stock purchased in their name anyway, according to the complaint. In another case a Meyers broker refused to sell stock when an investor instructed him to.

A woman answering the telephone at Meyers's New York office yesterday said no one was available to respond to the charges.

Galvin said his office knows of about 60 investors who believe they were cheated by Meyers, but he estimated the number could rise in the coming days. Investors with complaints are urged to call Galvin's office at 800-269-5428.

Galvin used yesterday's news conference to caution would-be investors about similar high-pressure sales schemes. "Investors need to be aware of who they are dealing with," he said.

Galvin suggested that investors get all information in writing before making a commitment to invest. He said investors could also call his office to check whether the firm they are dealing with is registered to do business in Massachusetts.

Investors can also check to see whether individual brokers have been disciplined for securities violations in the past.

TITLE: CRACKDOWN ON PUSHY BROKERS SLAMS FIRM WITH LOCAL OFFICE
 BYLINE: From Staff and Wire Reports
 EST. PAGES: 2
 DATE: 05/30/97
 DOCID: BPNW71500342
 SOURCE: Buffalo News; BPNW
 EDITION: CITY; SECTION: BUSINESS; PAGE: A-9
 (Copyright 1997)

A securities firm that formerly operated a branch office in Buffalo is one of 14 brokerages named Thursday in what is considered the largest nationwide crackdown ever against brokers selling stocks over the telephone.

Hackensack, N.J.-based Investors Associates Inc., which had an office in Buffalo from at least 1992 through 1996, is the target of legal actions in a total of 16 states, making it by far the hardest-hit among those named. The firm said it will cooperate with investigators.

The North American Securities Administrators Association (NASAA), an umbrella regulator group, said the actions, involving charges in 20 states, follow an investigation that began last fall. That probe centered on telephone sales practices that officials said were used to dupe unwitting individual investors into buying stocks.

"Reading from scripts, employees of these firms pressure their victims to buy stock in unknown companies," said association President Mark Griffin. "Once the price is driven high enough, insiders sell the stock, making fortunes for themselves and wiping out the savings of innocent investors."

The nationwide actions were disclosed at a news conference at the office of New York Attorney General Dennis Vacco. New Jersey Attorney General Peter Verniero also participated.

Andrew Kandel, assistant attorney general in charge of the Division of Investor Protection and Securities in New York City, said the AG's office has received more than 100 inquiries and complaints from state residents about Investors Associates.

"In the enforcement action we filed in State Supreme Court in Manhattan, we allege they duped investors, many of them elderly, by selling low-quality, high-risk stocks, greatly misrepresenting the risks," Kandel said.

The prosecutor was not able to provide information as to whether any Buffalo-area residents fell victim to the firm's tactics, but he said it appears all Investors Associates offices operated in a similar fashion.

The Buffalo office of the Better Business Bureau said Thursday it received nine requests for information about the firm between

1994 and 1997, but no complaints were filed.

Investors Associates had operated out of offices at the Buffalo Hilton, 120 Church St. Salvatore John Cannatella, who was barred from the securities business by the National Association of Securities Dealers for 10 years because of his 1979 felony convictions for bankruptcy fraud and conspiracy to commit bankruptcy fraud, was a major figure at the Buffalo office. A Rochester office has stayed open.

Helen Sprecher, an 85-year-old retired grocer from Philadelphia, said she was bilked of about \$99,000 when an Investors Associates broker sold her holding in RJR Nabisco despite orders not to and invested the proceeds in a little-known telecommunications company.

The new stock plummeted, and after repeated demands to get her money, Investors Associates offered her a settlement of \$12,000, she said. She rejected the offer and the case is in litigation.

"Historically, when you shine a light on these types of firms, the individuals who organize and participate in them disperse like cockroaches running for cover, only to turn up later," Griffin said.
DESCRIPTORS: TELEPHONE SALES

TITLE: Interview: Mark Griffin, president of the North American Securities Association, discusses how to protect yourself from investment fraud
 EST. PAGES: 2
 DATE: 05/29/97
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 SOURCE: The Money Club; YRPF
 CNBC, Inc.
 Burrelle's Information Services
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BRENDA BUTTNER, host:

Now with more on the subject and what you can do to protect yourself from investment fraud, Mark Griffin. He's president of the North American Securities Association. Mark joins us now from our New York bureau.

Hi, Mark. Thanks for joining us.

Mr. MARK GRIFFIN (North American Securities Administrators Association): Good evening.

BUTTNER: Mark, what could these victims have done to avoid this situation?

Mr. GRIFFIN: Well, Brenda, a number of things that they could do. First of all, each state has a securities regulator in that state and--and brokers are supposed to be licensed with those regulators. If you call your state securities regulator before you do the trade, while they are pressuring you, you can find out a number of things. You can find out how long they've been registered with the state, what disciplinary history they might have and any other bugs that might crawl out from underneath kicking over a few stones.

BUTTNER: Now aren't--these are things that we've been telling investors to do for years. Are these scams just getting better?

Mr. GRIFFIN: Yes, they are getting better. They're honing their pitches. These--these firms are using scripts that are so finely tuned they have an answer for just about every other objection. Our major concern is that--that--that people need to understand that the telephone is kind of like a little money vacuum cleaner that reaches right into their home. And they need to be very, very careful at giving out information. They need to do their homework first before they do trades with these firms.

BUTTNER: What are the top two red flags in any telephone conversation that you should be warned about?

Mr. GRIFFIN: Any--any sort of pressure i--pressure to invest today. What they're trying to do is they're trying to get your money under their control. Even if they sell you, to start with, a recognized stock, quickly they will flip you into something that you

don't recognize. And one of the patterns that we saw was a lot of unauthorized trading. That is a big red flag. If you have something that has been put into your account by a broker without your authorization, immediately report that.

BUTTNER: And it's not just the elderly who are being targeted here, is it?

Mr. GRIFFIN: No. No, I--I think that--that we're seeing a lot more younger people getting involved. These market levels are--are attracting a lot of interest of relatively unsophisticated investors. It doesn't matter what their age it. But they're coming to the markets because they expect the types of returns that the...

BUTTNER: Mmm.

Mr. GRIFFIN: ...that the markets are offering right now. And--and there's a lot of fraud that's hidden by a bull market.

BUTTNER: And--and is this just the tip of the iceberg or is there more out there?

Mr. GRIFFIN: This is. This is our first wave. It involved initially only five firms. We wound up with actions against 14 firms. I think that later on in the summer you can expect some more of this activity.

BUTTNER: Mmm. All right, we'll be watching. Thanks, Mark. Mark Griffin...

Mr. GRIFFIN: Thank you.

BUTTNER: ...president of the North American Securities Administrators.

And still to come on THE CLUB, confused about the different types of mortgages available? Well, when we come back, we'll show you if fixed- or adjustable-rate is right for you. Plus, certified financial planner Tama McAleese will be here to take your phone calls, so start dialing. The number is 1 (800) 752-CNEC.

Announcer: But up next, you keep hearing about a summer rally, but some experts say right now is the worst time to start investing. We'll find out why when THE MONEY CLUB continues.

Program Time: 7:00-7:30 PM

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Transcript

DATE May 29, 1997
TIME 4:00-6:00 PM (ET)
NETWORK National Public Radio
PROGRAM All Things Considered

Robert Siegel, anchor:

Today, securities regulators in twenty states announced a major crackdown on brokers who fraudulently sell so-called penny stocks over the telephone. Officials accused fourteen brokerage firms of a variety of abusive and misleading sales practices. In many cases, the brokers allegedly deceived their customers about the value of a stock or even sold their shares without permission. NPR's Jim Zarroli reports.

Jim Zarroli reporting:

Officials said this was the biggest crackdown ever on brokers who sell stocks over the telephone. Regulators say there's been a big increase lately in the number of people who complain that they were defrauded by such brokers. In New York state alone, officials say the number of complaints has risen forty percent in just two years. Mark Griffith is the top securities regulator in Utah and the president of the North American Securities Administrators Association, which represents regulators.

Mark Griffith (North American Securities Administrators Association): In this high-flying bull market, it's easy for swindlers to make claims of outrageous returns sound plausible. Unfortunately, far too many investors are falling for this lure.

Zarroli: Regulators say many of those cited today operate the same way. They pressure small investors into buying a stock in an unknown company in order to drive up the price. Once the price peaks, insiders sell all their own shares at a profit. That sends the stock tumbling, leaving the small investors with huge losses. Many of the investors lodging complaints about such firms tell similar stories about how they were taken in. Often they received a cold call from a broker who, reading from a script, persuaded them to send money to buy an especially hot stock. Later they found out trades had been made without their permission.

For a videocassette (TV) or audio cassette/radio of this news segment contact your nearest VMS office.

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VIDEO MONITORING SERVICES OF AMERICA, LP

Page: 2

Eighty-five-year-old Helen Sprecker (sp), a retired grocer from Philadelphia, invested nearly a hundred thousand dollars in savings with a broker from New Jersey-based Investors Associates. The broker persuaded her to buy stock in two small companies.

Helen Sprecker (Investor): Both stocks tumbled and as they went down, at the end of the month, when I got my statement, I called him and said I didn't- I told you not to sell the R.J. Reynolds. It gave me a nice dividend. He said, well, you're going to make money with this. I said I didn't want it, I- Well, he said, you have it now, but you'll send me a dozen roses when you find out how much money you can make. So, after a few weeks, the stock came- kept going down.

Zarrolli: After repeated demands to get her money back, Sprecker said the firm offered to return about an eighth of her investment. She refused the offer and has taken the firm to court. Investors Associates declined to comment on the allegations. The firms cited today face a variety of civil charges, charges that regulators say could lead to criminal sanctions at some point. Some have been ordered to stop telephone sales altogether. Mark Griffith says regulators are determined to put fraudulent brokerage firms out of business, although he also added a note of caution about these efforts.

Griffith: Historically, when you shine a light on these types of boiler room firms, the individuals who organize them and participate in them disperse like cockroaches running for cover. They only turn up later in another firm selling different product, but by the same means, and by the same solicitations.

Zarrolli: Griffith said small investors must learn to be wary about stock pitches made by strangers over the telephone and to be suspicious about deals that sound too good to be true.

This is Jim Zarrolli reporting.

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NASAA

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FACTS

- NASAA's board of directors authorized a special project to address the problem of fraudulent sales practices in the micro-cap marketplace in late fall 1996. In January 1997, a strike force comprised of representatives from 12 states was created. Other states scheduled coordinated audits. In late February, the teams struck without warning.
- Twenty state securities agencies have filed 37 actions against 14 broker-dealers in today's first-round. Other actions will follow in the weeks and months to come.
- The 20 states participating today include Alabama, Connecticut, Delaware, Illinois, Indiana, Maryland, Massachusetts, Missouri, New Hampshire, New Jersey, New Mexico, New York, Ohio, Oklahoma, Pennsylvania, Texas, Utah, Vermont, Washington, and Wisconsin.
- The 16 states taking action against Investors Associates are Alabama, Connecticut, Delaware, Illinois, Indiana, Maryland, Massachusetts, New Hampshire, New Jersey, New York, Ohio, Oklahoma, Pennsylvania, Texas, Washington, and Wisconsin.
- Four states taking action against L.T. Lawrence & Co. include Indiana, Missouri, Utah, and Washington.
- Other firms targeted include Meyers Pollack Robbins (4), First United Equities Corp. (2), Kensington Wells (2), Biltmore Securities (1), Capital Securities/W.B. McKee (1), Nationwide Securities (1), R.D. White (1), Sterling Foster (1), Toluca Pacific (1), Euro-Atlantic (1), State Capital Markets (1), and William Scott & Co. (1).
- There were 6,840 anti-fraud enforcement actions by the states in 1995.
- Collected enforcement settlements by the states in 1995 totaled \$136,008,485. The amount offered or returned after fines and expenses was \$85,686,890.
- On April 28, 1997, a ten-point plan was approved by the membership at the NASAA Spring Conference that is designed to protect the ever-increasing numbers of consumers that use the services of small investment advisers and financial planners.
- Over 600 pages of relevant information is available at NASAA's Internet web site that can be found at www.nasaa.org
- The oldest international organization devoted to investor protection, the North American Securities Administrators Association, Inc. (NASAA) was organized in 1919.
- In the U.S., NASAA is the voice of the 50 state securities agencies responsible for efficient capital formation and grassroots investor protection.

05/28/97 12:16 PM

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Chicago Tribune

Business

SUNDAY, JUNE 8, 1997

As market soars, so do complaints over brokers

By John Schmeltzer
TRIBUNE STAFF WRITER

Kenneth Greenwalt remembers the call as if it were yesterday.

"Good morning," said the voice on the other end of the phone. "Two to three times a year, we at Investors Associates get our preferred customers involved with a niche area of the market where we can potentially turn a six-, seven-figure profit within the course of a few trading hours."

It was a call that made him sit up and take notice.

After all, it was late 1995, and the stock market already was up more than 30 percent for the year.

"Wouldn't it be great," the resident of Marion, in southern Illinois, remembers thinking, "if I could help out with my grandkids' college fund?"

But Greenwalt, who had retired as a vice president of First Financial Management Corp., an Atlanta-based data processing company that had been acquired a few months earlier by First Data Corp., got a rude introduction to a part of Wall Street that state regulators now are trying to shut down.

'We're now getting 2,000 complaints a year.'

Robert Newton, director of the Illinois secretary of state's securities department

First it was the stock of Interiors Inc., a Mt. Vernon, N.Y., distributor of decorative home accessories. Then it was the stock of Bev-Tyme, a Brooklyn, N.Y., beverage distributor; then Compare Generiks, a Hauppauge, N.Y., distributor of dietary supplements, and, finally, Microenergy Inc., a Carol Stream-based manufacturer of high-frequency power supplies.

Despite a high-flying market, in which virtually everyone was making money, the stocks picked by the brokers from Investors Associates all fell in value.

And the greeting is suspected of being part of a script used by Investors Associates brokers calling Illinois residents with whom they'd never before spoken.

Greenwalt filed a complaint last

SEE STOCKS, PAGE 7

Stocks

Continued from Page 1

year with the Illinois secretary of state's securities department against the brokers from the Investors Associates office in Melville, N.Y., alleging that they misrepresented the investments. By then, he'd lost \$500,000 from his 401(k) account.

But the complaint by Greenwalt, 65, was only the tip of the iceberg.

Thomas Donovan of Oak Lawn and William and Nancy Broecker of Chicago told state officials that they, too, had been victimized for thousands of dollars.

State securities regulators around the country discovered that Investors Associates brokers were behind complaints in 15 states. Most of them now are moving to revoke the company's license.

Already, the Hackensack, N.J.-based firm has been barred from doing business in Indiana, Alabama and New Hampshire, and Illinois officials will consider revoking its state license at a hearing Aug. 20.

Repeated attempts to reach Investors Associates officials for comment were unsuccessful.

In the past year, Illinois has revoked the licenses and closed the Chicago-area offices of A.R. Barov & Co., Stratton Oakmont Inc., Nationwide Securities Inc. and the L.C. Weyard Co. All dealt heavily in so-called penny stocks—speculative, low-priced issues.

"We're now getting 1,000 complaints a year," said Robert Newton, director of the Illinois securities department.

And the number of enforcement actions against brokers and brokerage companies by the securities division has nearly doubled, to nearly 400 actions, in the past two years. The actions range all the way from reprimands to revocations of the licenses of firms or their brokers.

Since the beginning of 1995, the Dow Jones industrial average has rocketed past 4000, 5000, 6000, 7000 and now is knocking loudly at 7500.

The retirement plans of thousands of Americans are tied directly to the rapid growth in the stock market. Where 17 years ago, one in every 17 households owned securities, now one out of every three does.

"In this high-flying bull market, it's easy for swindlers to make claims of outrageous returns sound plausible," said Mark Griffin, director of the Utah securities department and president of the North American Securities Administrators Association.

Twenty years ago, regulators were warning of the dangers of penny stocks. Today, it's the initial public offering in a virtually unknown company that worries regulators.

Increasingly, regulators say they're finding brokerage companies artificially boosting a stock by rapid trading and then allowing the price to collapse once all the intended victims have purchased shares.

Traditionally, Illinois residents have been targeted heavily by brokers pushing penny stocks or other securities that brokers promise will record phenomenal growth.

But Griffin said no one area of the country is more heavily targeted than another.

That may be true, said Newton,

but senior citizens are more frequently victimized because they, more than others, have readily accessible disposable income that can be lapped.

Two weeks ago, the securities association, to which the Illinois securities department belongs, announced the filing of 26 actions against 14 companies, including Investors Associates. They were the result of an enforcement sweep of small brokerage offices by 20 state securities agencies.

Virtually all, according to Griffin, rely upon the type of script that was used to victimize Greenwalt, Donovan and the Broeckers.

Last week, the National Association of Securities Dealers, which regulates brokers, and the Securities and Exchange Commission indicated they may begin to force large firms that clear trades for small firms such as Investors Associates to report signs of suspicious trading activity.

Griffin said the pattern is for small firms to locate in some well-known area and then affiliate with a brand-name firm.

Under current rules, the firms that clear trades, a lucrative but little-known Wall Street business, only relay to the small firms complaints they receive about trading activities. Under the new rules, the SEC is expected to require that copies of the complaints be filed with regulators.

Increasingly, Griffin and Newton said, regulators suspect that telemarketing firms are being used to sell the securities rather than registered brokers, as required by law.

Although some small firms are reputable, Griffin said, the ones under scrutiny almost uniformly rely upon so-called "cold-calling practices," a technique in which names are chosen from purchased calling lists that indicate a person's willingness to take risks or other types of demographic data.

"Most of the firms and branches rely on high-pressure scripted telephone cold-calling that includes falsifying experience and performance, as well as other lies," Griffin said.

In fact, one of the complaints involves a Utah investigator who used an SEC computer to check a broker's claims as he breathlessly touted a particular stock.

"No matter how sophisticated you are, you can get taken in a cold-calling situation," Griffin said. "The idea is to keep people on the phone and get the vacuum cleaner down into your wallet."

There's only one way to fight it, he said: "Hang up the phone."

Complaints directly from consumers should grow as well, since the SEC was required by law to add a toll-free complaint hotline. The NASD toll-free hotline is getting more press as well. And the SEC, NASD and NASAA have all included detailed information on their Web sites about what abuses to look for and where and how to complain. The NASDR's Web site also makes e-mailing a complaint possible.

As the regulatory database of customer complaints grows, plaintiffs' attorneys who represent investors in arbitration cases and lawsuits will have

a rich and accessible record of every current run-in a broker has experienced. That means the days when lawyers had to depend on the legal discovery process to get records from firms, which often failed or refused to turn over pertinent documents, will draw to a close.

That should help investors with legitimate cases, says Bob Dyer, an Orlando, Fla.-based attorney who specializes in retail securities litigation and arbitration. "Securities sales are still a cowboy kind of game and it will stay that way as long as this is a commission-driven business, but any

changes that help wronged investors are changes for the better," Dyer says.

While the number of outright churning cases he sees are down because firms' own computer-driven radar screens are getting better at detecting that problem, suitability cases are still booming and inappropriate trading is still a common occurrence, Dyer says. "That's because a beautiful portfolio that doesn't require changing a few times a year doesn't make brokers money," he adds.

Gail Boliver, a plaintiffs' attorney with offices in Iowa and Nebraska, agrees that unsuitable investments and unauthorized trading have become the number-one sales practice abuses he sees. "Unsophisticated investors are constantly being sold the theory that they need an actively traded portfolio that is far beyond their investment needs and financial means," Boliver says. But with an accessible database of similar complaints to aid them, both investors and plaintiffs' attorneys should find it easier to make their cases, he says. As more complete disciplinary histories are available, it may also encourage firms that routinely postpone settling cases where the broker's wrongdoing is clear-cut to settle more quickly, Shellenberger says.

The good news for financial planners is that attorneys rarely see cases against those who do genuine needs-based planning and selling. "The fact that real financial planners do consider customer needs as a matter of course should be a huge marketing point for them when they compete against those I like to call full dis-service brokers," Shellenberger adds.

But that doesn't mean the worm won't turn if the market nosedives. In fact, those planners who charge fees for investment advice, especially on top of commissions, may be particularly vulnerable if clients' investments sour. "Expectations may be higher," says Nancy Lininger, president of The Consortium, a compliance consulting firm in Camarillo, Calif. After all, customers aren't just paying for a product; they're paying for someone to tell them what product will best serve their needs in any kind of market. "I'm not promoting commission- or fee-only planning, only the need to be careful because if we have a prolonged bear market, there are going to be a lot more complaints against everyone," Lininger explains. ■

Taking The Bear By The Reins

Regulators and plaintiffs' attorneys agree: Financial planners who conduct diligence and individual needs-based planning are the cause of a small percentage of the sales practice abuses they see.

Even so, with the market poised for a slowdown, now is the time to develop an approach to all customer complaints, says Nancy Lininger, president of The Consortium, a compliance consulting firm in Camarillo, Calif. A comprehensive approach to customer complaints should help you avoid problems in the first place and will aid you if one does occur. Here are some pointers for building an effective customer complaint system.

- **Manage your customer.** Where necessary, go beyond my new account form you to show you have done a comprehensive job of gathering and understanding the client's investment needs. If possible, have the client fill out or at least initial a disclosure of risk and performance expectations. While it's not a requirement, your good idea to update active clients once annually so that significant financial or lifestyle changes aren't missed.

- **Take all complaints seriously.** Don't dodge calls or hide, says Lininger. If you're responding to letters or phone calls, the customer will believe you're at fault and a small problem can turn into a dramatic and costly case against you.

- **Document everything.** Put written customer complaints in the client's file and in your firm's complaint file. If you have phone conversations with the client, document them and put them in both files, along with an account of any resolution you reach.

You should also tell a customer with a complaint to put his or her complaint in writing for all clients, whenever you speak with them. The fact that you have a written complaint you follow with everyone will aid you with regulators or if you find yourself in arbitration. A plaintiff's attorney will attempt to prove your notes were self-serving and written after the fact.

- **Report to your firm.** Both broker-dealers and investment advisers are required to have a written policy and procedure statement for dealing with customer complaints. Most firms require you to report such complaints to your compliance department. Let the compliance department take the lead by reporting a complaint early and asking the compliance department how they want you to handle it.

- **Reach an amicable resolution.** If you've made an honest mistake, make amends as soon as possible, after seeking the advice of your compliance department. Remember, all refunds and settlements, no matter how small, have to be run through your compliance department. So even if you want to refund a \$25 ticket charge for a trade, the refund must come from your compliance department, Lininger says.

- **Purge problem clients early.** Firing a client is never easy, but everyone has one or two customers who refuse to listen to reason or be educated, who want guarantees or who take up too much of your time for what they're paying. Try to fire them amiable with a "Dear John" letter that explains your practice has changed, you're no longer servicing their type of account, or you are working with higher-net-income individuals. If you can identify problem clients early, you can greatly reduce liability in both the short and long term, Lininger says.

B7C THE WALL STREET JOURNAL MONDAY, JUNE 9, 1997

'Yield-Burning' Is Discussed at Meeting Of Gore With State, Municipal Leaders

By JOHN CONNOR
Dow Jones Newswires

WASHINGTON — Vice President Al Gore told state and municipal leaders that the Treasury, Internal Revenue Service and Securities and Exchange Commission will work together to address concerns about municipal-bond "yield-burning," according to people at the meeting.

The vice president also said the Treasury and IRS are close to issuing a regulation that would clarify the position of tax authorities on yield-burning.

Yield-burning occurs when the price of Treasury securities sold to issuers of muni advance refunding bonds for the escrow accounts used in such deals is marked up excessively, giving the appearance of complying with federal tax restrictions on investment earnings while providing a windfall to bond-market middlemen.

The IRS last year issued a revenue procedure in which it invited muni issuers with potential yield-burning problems to settle voluntarily with the agency. This ignited howls of protests from state and local officials that their jurisdictions could be subject to a collective tax-enforcement bill of \$1 billion or more because of what they represent as the misdeeds of securities professionals.

"Vice President Gore said Treasury, IRS and SEC would be working together,"

said National League of Cities President Mark Schwartz, an Oklahoma City city councilman who attended the meeting. Other state and local leaders at the meeting included Chicago Mayor Richard Daley and New York Gov. George Pataki. Mr. Schwartz called the session "a major, major positive" for state and local governments.

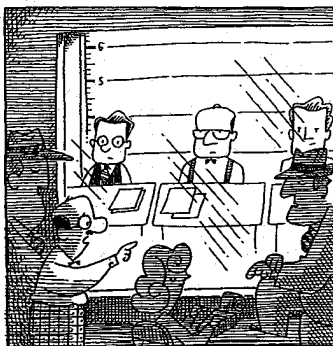
"Vice President Gore's message is a very positive signal that cities will not arbitrarily suffer the burden of responsibility for something they did not knowingly do or benefit from," Mr. Schwartz said. He said the prospect of interagency coordination sharply reduces chances that muni issuers will be double victims of yield-burning abuses. He noted that coordination suggests that funds recovered by the SEC from securities professionals in yield-burning enforcement actions could be used to settle tax liabilities of muni issuers.

Mr. Gore's press office had no immediate comment on the meeting; nor did the IRS. An SEC spokesman said the agency had no comment "at this time." A Treasury representative said "the vice president's statement speaks for itself." Treasury Secretary Robert Rubin, formerly the head of Goldman, Sachs & Co., has recused himself from the yield-burning matter.

The SEC currently has a boatload of suspected yield-burning cases under investigation. The IRS has at least seven yield-

burning cases under scrutiny, and had cast a potentially broad enforcement net with the revenue procedure inviting muni issuers with potential problems to settle.

The SEC recently said that "one consequence of yield-burning is to defraud the federal government." Separately, SEC Enforcement Director William McLucas told a senator last month that yield-burning "allegations are receiving careful consideration by the commission in accordance with our enforcement responsibilities under the federal securities laws." Mr. McLucas noted the SEC's remedies for securities-law violations include disgorgement of ill-gotten gains.



Senate Permanent Subcommittee on Investigations

EXHIBIT # 12

Getting the Goods

How to discover the past, checkered or otherwise, of your broker or dealer

BY RICHARD KARP • How do you spot a crooked broker before you give him your money?

How can you find out, in advance, if that disembodied voice on the telephone, offering you a great stock or a "conservative" options-trading deal, won't steal your money or churn your capital into oblivion? How do you know if that sober guy on the other side of the desk, with a

supposedly high-tech, fail-safe currency-futures program, isn't a commission-hungry wolf, or simply beg?

There are several ways to find out, the most efficient being to pass Go and head directly to your state regulator. Each state keeps a huge repository of information on every broker-dealer in the country, down to the last detail of the least complaint from a former investor.

Securities administrators of each state government hold the information in a huge database called the Central Registration Depository, or CRD, set up 16 years ago to maintain stockbroker registration data, but which has become a *de facto* broker-surveillance tool. Everything goes into the registry's new, and never disappears. Thanks to longstanding public records laws and more recent "open-air" or "sunshine" laws, the states must keep this information on file and make it available to the public forever — quite literally.

The federal government's chief investment watchdogs, the Securities and Exchange Commission and the Commodities Futures Trading Commission, have access to the CRD, which is

operated and maintained by the brokerage industry's self-regulating body, the National Association of Securities Dealers. The information, however, is jointly owned by the NASD and the states. But for public consumption, these regulatory bodies edit almost everything but convictions, their own public sanctions; in effect, the most obvious frauds.

In other words, whether you want to know about a stockbroker from the NASD or a commodities dealer from the CFTC, the same dynamic prevails. Thousands of angry client complaints against hundreds of brokers and pitchmen — whether because the complaints haven't been pursued or because the alleged offender awaits arbitration or has settled with his defrauded clients — aren't made available on any public investor hotline.

So, if you want to really know about Broker X, bypass the agencies and self-regulatory bodies and simply call or write to your state securities watchdog agency. In New York, for example, it's the Bureau of Investor Protection and Securities; in Texas, it's the Texas Securities Board; in California, it's the Department of Corporations, and so on.

"Just write us a letter, and we will give you the entire CRD file on any broker or firm," says Andrew Kandell, the assistant attorney general in charge of New York State's investor-protection bureau. Of course, not all the complaints are valid — sometimes it's the complainant who's at fault. But, says Kandell, "Our position is that unsubstantiated customer complaints should be available to the public via the CRD. Investors should be able themselves to weed out real disciplinary matters from unsubstantiated complaints."

The Central Registration Depository discloses the name and address of the broker, his Social Security number, his employment history, the states in which he's registered, what kind of registrations he has, which brokerage firms he's worked for, his test scores and when he took the tests.

The CRD also will disclose the broker's entire disciplinary file, including not only arbitration awards and court judgments, but also pending cases and updates of those cases. It will provide the name of a case, where and when it was filed and the name of the com-

plainant and of any co-respondents. In addition, the file briefly outlines pending claims, a description of the defense and the sum claimed as damages.

If the proposed investment represents a big enough chunk of your capital, and you can afford the fee, a lawyer will search the CRD for you — and go beyond it. Most investors' lawyers provide the service.

Although the CRD's database gets any letter of complaint that goes to any agency or exchange, as well as any action, it relies to a large extent on brokerage firms to report instances of customer complaints and arbitration filings directed at the firms, as well as their individual brokers — but the firms don't always comply. So, to learn about cases outside the depository, a lawyer may contact the Securities Arbitration Commentator, a newsletter published in Maplewood, N.J. (201-761-6880). The latter has a database fed by such arbitration forums as the NASD, the New York Stock Exchange, the American Stock Exchange and other self-regulators. A good lawyer will also run a Lexis/Nexis search, to see what comes up on the broker in newspapers and magazines and on television, as well as comments made by or about the broker.

Or, if you have a telephone and a computer hookup, you can do all of the above yourself.

To get some limited information, you

September 15, 1997

BARRON'S

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could check the SEC's World Wide Web site to learn about its disciplinary actions against firms and some individuals, as well as some state-level actions. (The information goes back only to September 1995, but a whole range of private services, such as Westlaw and Lexis/Nexis, list some enforcement actions back to the mid-Seventies.) But because the SEC prosecutes just the most egregious cases of fraud and malfeasance, unless you suspect your prospective broker or bond dealer is of the caliber of a Michael Milken or Ivan Boesky, the SEC probably won't have any information about him, even if he has a record as long as Shaquille O'Neal's arm.

For slightly more data, you could contact the National Association of Securities Dealers or the Commodities Futures Trading Commission's self-regulatory body, the National Futures Association.

The NASD makes public the disciplinary histories of any registered broker or brokerage firm (of course, if the guy isn't registered, forget about him). You can also get the same data at the NASD's Web site, by sending an E-mail request. Either way, the organization will speedily send you the information by mail, fax or E-mail.

Though the NASD hotline provides a much broader base of information than the SEC, its publicly available data is severely, and controversially, limited, just like the federal agency's. If your broker was found to be a very bad actor in the past, the NASD will regulate you with criminal felony and investment-related misdemeanor charges or convictions,

HELPFUL NUMBERS

Commodities Futures Trading Commission (CFTC)
800 675-4674
302 418-5508, Office of Proceedings
Web site: <http://www.cftc.gov>

National Association of Securities Dealers (NASD)
800 285-9999
Web site: <http://www.nasdr.com>

Securities and Exchange Commission
202 942-7040, Office of Investor Education & Assistance
Web site: <http://www.sec.gov>

SOME INDIVIDUAL STATE SECURITIES REGULATORS

California:
Securities Commissioner
Department of Corporations
1500 11 St.
Sacramento, Calif. 95814
916 653-6814

Florida:
Securities Division
Department of Banking & Finance
181 East Gaines St.
Tallahassee, Fla. 32301
904 488-9005

Illinois:
Secretary of State
520 South 2nd St.
Springfield, Ill. 62701
217 782-2201

Massachusetts:
Secretary of the Commonwealth
Securities Division
1 Ashburton Place
Boston, Mass. 02108
617 727-7190

Missouri:
Division of Securities
Secretary of the State's Office
600 West Main St.
Jefferson City, Mo. 65101
573 751-4136

New York:
Bureau of Investor Protection & Securities
120 Broadway
New York, N.Y. 10271
212 416-8222

New Jersey:
Bureau of Securities
153 Hobart St.
Newark, N.J. 07101
973 504-3600

Ohio:
Division of Securities
Department of Commerce
77 South High St.
Columbus, Ohio 43215
614 466-3440

Pennsylvania:
Securities Commission
1010 North 7th St.
Harrisburg, Pa. 17102
717 787-6628

Texas:
Securities Board
P.O. Box 13167
Austin, Texas 78711
512 305-8300

both domestic and foreign; pending or final regulatory actions by all state and federal agencies against the broker; and awards or judgments against the broker in arbitration or civil proceedings in public customer cases.

But the group won't disclose any investigations of a broker or brokerage by a regulatory agency, or the resignation or discharge of a broker "under certain allegations involving fraud, wrongful taking of property, rule violation or failure to supervise." And it won't make disclosures about bankruptcies, unsatisfied judgments or liens, or denial of bond.

Another source of information for investors is the Commodities Futures Trading Commission's consumer-protection hotline, known as DIAL, for Disciplinary Information Access Line. It gets you to a public database run by the NFA, the agency's self-regulator, which you can also reach on the CFTC's Web site.

Here you can learn whether the stranger on the phone trying to sell you pork-belly contracts is a registered commodities dealer. If not, he's probably violating federal law by selling futures without a license.

DIAL will give you background on a registered dealer, such as the kind of licenses he or his firm have, and when and

where he was registered. If the database shows any disciplinary history, including enforcement actions by the CFTC, the NFA or any of the 13 U.S. commodities exchanges, DIAL will mail or fax you the info.

The CFTC operates an in-house complaint-adjudication forum. If an investor has a gripe against a registered futures dealer, he can, for a minimum \$50 filing fee, take it directly to the agency's Customer Complaint Reparatons Program, where the case will go before an administrative-law judge, who can order restitution. Decisions can be appealed to the CFTC and, ultimately, to the U.S. Court

of Appeals.

Significantly, the CFTC/NFA hotline provides brief summaries of any reparations case — whether adjudicated or pending. Moreover, if you want complete details, such as the strategies being employed by the lawyers, you need only call the CFTC's Office of Proceedings. The records will be mailed out the next business day.

Although some investors' attorneys regard the CFTC as more forthcoming than the NASD, it also deliberately conceals far more broker information than it reveals. Among the data it doesn't make public are letters of complaint, unless

they are accepted for adjudication by the agency or in customer complaints against a commodities dealer that go to arbitration, only after an award has been entered. Disciplinary actions instituted by the commodities exchanges are made public only after a sanction has been imposed on the errant dealer. Arbitration cases that are settled before final judgment simply drop into a black hole; no information about them is readily available to investors.

In any case, change is coming, even for the CRD, which is the center of a dispute that pits the states and the North American State Securities Administra-

tors (NASSA), a group that represents state investment watchdogs, against the NASD and the Securities Industry Association, a trade organization. The NASD operates and maintains the Central Registration Depository, but jointly owns the information on it with the states.

Three years ago, all parties concerned began talking about how to redesign the depository, so it could be available on the Internet in its entirety by early 1998. The NASD and the SIA insisted that the new CRD continue to delete unsubstantiated complaints that weren't pursued, while NASSA and the states simply wanted everything in the Central Regis-

tration Depository disclosed.

They reached a compromise, whereby customer complaints would be publicly disclosed on the Internet or hotline, but if not pursued by the claimants, would be deleted after two years. Just as in the case currently, only complaints involving at least \$10,000 would be publicly disclosed.

In addition, the NASD has agreed to build and maintain for the states, as a complement to the newly designed CRD, Internet system, a separate database containing all their "deleted" complaints. This will be accessible through the North American State Securities Administrators organization. Still, investors will have to go to the states for complete information.

The deal between the NASD and the securities administrators, which would require SEC approval to take effect, hasn't been finalized in at least one very important respect. The states want a third



public database containing the full disciplinary histories of investment advisers. These are professional financial planners, not necessarily registered brokers who make their living from management fees rather than from trading commissions. This group represents a rapidly growing sector of the investment industry, according to Denise Voigt Crawford, Texas Securities Commissioner and president-elect of NASSA, who says the number of registered investment advisers in her state has jumped by 30% over the past year. The state securities administrators are now considering NASD offer to build an "Investment Adviser database," to be jointly owned by their organization and the SEC.

The problem is the state administrators don't trust the NASD, so they're considering having other information vendors do the job. "If the 'deleted cases' delivery system for the states fall short of being complete, we are going to have serious reservations about letting the NASD build an IA database," says Crawford. "We want a database to cover every IA rep and every IA firm, just like the old broker CRD — with every complaint in it."

Another reason for the mistrust: The NASD, claiming a mountain of technical difficulties, says the redesigned CRD/Internet broker disclosure system, slated to go online in early 1998, will initially contain only a fraction of the information it has promised to provide.

So, at least for now, the thing to do if you have doubts about a broker is to contact your state securities agency. And depending on what happens with some of the other sources of data that are contemplated, that may remain your best bet for years to come. ■

Type of Information Reported to Central Registration Depository (CRD)	Disclosed to Public	
	Current NASD Policy	Proposed NASD Policy
Criminal investment-related misdemeanor charge or conviction	Yes	Yes
Criminal felony charge or conviction	Yes	Yes
Pending regulatory action (pending NASD and other SRO formal complaints, as well as pending actions of state and federal agencies)	Yes	Yes
Formal investigation by regulatory agencies	No	Yes
Final regulatory action (NASD formal complaint, decisions, AWCs and settlements, as well as other SRO, state and federal actions)	Yes	Yes
Revoked/suspended authorization to act as attorney, accountant or federal contractor	No	Yes
Domestic or foreign court found a violation of any investment-related statute or regulation or issued an injunction in connection with any investment-related activity	Yes	Yes
Investment related civil actions initiated by state or foreign regulatory authority that are dismissed pursuant to a settlement agreement	N/A *	Yes
Award or judgment against respondent in arbitration/civil proceeding in public customer cases	Yes	Yes
Resignation/discharge or permitted to resign under certain allegations involving fraud, wrongful taking of property, rule violation or failure to supervise	No	Yes
Open customer sales practice complaint **	No	Yes **
Settled customer sales practice complaint **	No	Yes **
Settled arbitration/civil proceeding in public customer cases **	No	Yes **
Open customer complaint alleges theft, forgery, misappropriation or conversion	No	Yes
Pending arbitration/civil proceeding in public customer cases	No	Yes
Financial disclosure (such as bankruptcies, unsatisfied judgments or liens, denial of bond)	No	Yes

* New U-4 page 3 question.

** Subject to certain dollar limit reporting thresholds.

INVESTING

LESS THAN FULL DISCLOSURE

If you've got a suspicion about your broker, don't count on the NASD to tell you what you need to know. For that, you'll have to turn elsewhere.

Which Frederick Alan Gladle would his suburban Los Angeles clients recognize if they requested a copy of their stockbroker's disciplinary record? A call to the National Association of Securities Dealers (NASD) would yield a sketchy two-page report involving an incident that led to a brief suspension in 1991. But a call to California's state securities office would produce a nine-page tale of censure, dismissal and arbitration actions against him by former clients. And guess what: Both reports would come from the same computer data base. One version is sanitized, while the other tells all.

The vast majority of the 310,000 licensed stockbrokers are outstanding professionals. Only one in ten has a black mark in the Central Registration Depository (CRD).

By Tracey Longo

The NASD report on stockbroker GLADLE took up two pages; the state report took nine.



ILLUSTRATION BY [illegible]

July 1994

VANGUARD'S PERSONAL FINANCE MAGAZINE

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BROKER DISCLOSURE

data base kept by the NASD and used by both it and the state securities regulators.

But there is a problem. The Securities and Exchange Commission is complaining that the NASD and its member brokerages are doing little to rid the business of what SEC chairman Arthur Levitt calls "rogue brokers." These are the brokers who bounce from firm to firm, leaving a trail of unhappy customers and tangled arbitration histories. And the system is rigged against you when you want to know if your broker—or more likely, someone who *wants* to be your broker—is among them.

If you call the NASD (800-289-9999) for a broker's CRD report, you are not told about customer complaints lodged against the broker or about pending or settled arbitration cases. Nor are you informed of pending civil lawsuits or criminal convictions on appeal. What you do get is a brief employment history and a summary of NASD disciplinary actions against the broker and past criminal convictions no longer on appeal.

The lack of information about arbitration cases is particularly galling. The NASD is a self-regulating trade association of brokerages. Virtually all brokerages require that customers surrender their right to sue the firm or its brokers and submit unresolved complaints to NASD-designed arbitration. But then the NASD turns around and refuses to tell you whether a broker has a history of pending or settled arbitration complaints.

Fortunately, you don't have to settle for the highly censored disciplinary records offered by the NASD. Almost all state securities regulators provide a far more thorough version. In fact, many states let you order a disciplinary record over the telephone. (Essential facts about your state's regulators—including addresses, telephone numbers and what you will or will not be told—can be found on page 68.)

You'll need a guide to help you decipher the report you request. Both the state and NASD reports are virtually unintelligible without a legend to translate the arcane codes and

abbreviations. The National Council of Individual Investors publishes a booklet, *How to Check Out a Broker*, which explains the codes and regulatory shorthand used in the reports (\$5; 800-663-8516). You can also ask the regulatory office that mailed you a report to explain anything that is incomprehensible.

WHAT THE NASD LEFT OUT

Gladle's case demonstrates the stone wall faced by investors who request a broker's disciplinary record from the

Seven other cases, filed between 1992 and 1995, still await arbitration or settlement. They involve more than \$750,000 in claimed losses and punitive damages sought from both Gladle and Oppenheimer by former customers, whose complaints are similar to those in the cases that were settled.

Gladle blames his troubles on two attorneys, who upon learning that the price of one of his penny-stock picks had plummeted obtained a list of his customers from a member of his family.

Gladle says this family member, a buyer of penny stocks he recommended, had acquired his list of customers to sell them a vitamin supplement.

These days, Gladle is busy rebuilding his client base (he currently has 110 clients). He says that he retains his penchant for penny stocks, small-company securities, initial public offerings and shares in bridge loans that help finance companies going public.

What would he say to people who are aware of his long disciplinary history and who are troubled by it? "They don't have to work with me," he replies. "I'm a risk-taker, and my customers know it."

BIG PLANS AFOOT

Some states—Florida and Texas, for instance—may refuse to license a broker with a record like Gladle's that involves repeated arbitration of disputes. California, Massachusetts and New York, however, are among the states that will not disqualify a broker with a record of numerous arbitration cases. Neither will the NASD itself.

As things stand now, if the NASD doesn't adopt tougher standards for broker licensing, no one might. Legislation that would have given the states three years to adopt uniform standards has been replaced in Congress by a bill that requires the SEC to study the "feasibility" of uniform requirements and report back to lawmakers in one year with recommendations. The original three-year deadline was scrapped because it was unworkable, says a securities attorney who worked on the legislation. Forcing states to find common ground might have lightened licensing standards in states such as California and New York, which seldom refuse to

If the NASD doesn't toughen its standards for brokers, then no one might.

NASD. From that report, you'd learn only that in 1991 he was censured, suspended for five days and fined \$5,000 for circumventing his brokerage's internal policy "by opening securities accounts and executing securities transactions for nonresident aliens and misrepresenting the true beneficial owner of the accounts." (The incidents occurred while he was employed by Merrill Lynch, between 1985 and 1989.)

But the state of California, where the 37-year-old Gladle now works for the firm of Grant Bettingen, will provide a broker's complete disciplinary history—including what happened after Gladle's 1991 suspension. His former clients at Oppenheimer & Co. (where Gladle was employed between 1990 and 1993) initiated 16 arbitration cases against him and his brokerage. Nine cases were settled for undisclosed amounts of money between 1992 and 1994, before they could be arbitrated. The customers in those cases claimed that Gladle had misrepresented the risks of penny stocks he traded on their behalf and, in some cases had made unauthorized trades and "churned" accounts—that is, made an excessive number of trades in order to generate commissions.

BROKER DISCLOSURE

WHAT YOUR STATE WILL TELL YOU ABOUT YOUR BROKER

THESE PHONE NUMBERS and addresses to obtain an employment and disciplinary report on a stockbroker. Nearly all 50 states and the District of Columbia say they will send out-of-state investors a report on a broker. So if you live in Louisiana, which withholds all disciplinary information, or in a state that deletes some information, call another state's securities department because all have access to the Central Registration Depository data base.

There is usually a charge for a report. In most instances, the cost is nominal, but Georgia charges a minimum of \$10 and Michigan and Rhode Island charge hourly fees ranging from \$11 to \$15. The NASD's reports are free.

Here's what you'll find in the state reports:

- Unresolved investor complaints. Included by all states except Alaska, Connecticut, Illinois, Louisiana, Minnesota, Nevada, North Dakota, Rhode Island and Wisconsin and the District of Columbia.
- Pending arbitration cases. Included by all states except Georgia, Hawaii, Illinois, Louisiana, Minnesota, Nevada, New York,

Oregon, Rhode Island and Wisconsin and the District of Columbia.

► Pending civil lawsuits. Included by all states except Georgia, Hawaii, Illinois, Louisiana, Rhode Island and Wisconsin and the District of Columbia.

► Criminal charges. Included by all states except Delaware, Hawaii, Illinois, Louisiana, Rhode Island and Wisconsin.

► Criminal convictions being appealed. Included by all states except Delaware, Hawaii, Illinois, Louisiana, Oklahoma and Wisconsin.

ALABAMA
Office of Securities Commission
770 Washington Ave., Ste. 570
Montgomery, AL 36130
800-222-1253

ALASKA
Div. of Banking and Securities
P.O. Box 110807
Juneau, AK 99811
907-465-2521

ARIZONA
Securities Division
1300 W. Washington St. 3rd Fl.
Phoenix, AZ 85007
602-542-4242

ARKANSAS
Security Dept.
Heritage West Bldg.
201 E. Markham
Rock, AR 72201
(phone requests)

CALIFORNIA
Department of Corporations
3700 Wilshire Blvd., Ste. 600
Los Angeles, CA 90010
213-736-2502

COLORADO
Division of Securities
1500 Lincoln St., Ste. 420
Denver, CO 80203
303-894-2320

CONNECTICUT
Dept. of Banking/Securities
and Business Investment Div.
260 Constitution Plaza
Hartford, CT 06103
860-240-8230

DELAWARE
Department of Justice
Securities Division
820 N. French St., 8th Fl.
Wilmington, DE 17801
302-577-2515

DISTRICT OF COLUMBIA
Division of Securities
450 5th St. N.W., Ste. 821
Washington, DC 20001
202-626-5109

FLORIDA
Office of Comptroller
Dept. of Banking and Finance
Division of Securities
122 The Capitol
Tallahassee, FL 32399
904-488-9530

GEORGIA
Business Services Regulation
2 Martin Luther King Jr. Dr.
West Tower, Ste. 802
Atlanta, GA 30334
404-656-2855

HAWAII
Business Registration Division
Dept. of Commerce and
Consumer Affairs
P.O. Box 40
Honolulu, HI 96810
808-586-2740

IDaho
Department of Finance
P.O. Box 83720
Boise, ID 83720
208-332-6004

ILLINOIS
Securities Dept.
Uncola Tower, Ste. 200
520 South Second St.
Springfield, IL 62701
217-782-2256

INDIANA
Secretary of State's Office
Securities Division
302 W. Washington St., Rm. E111
Indianapolis, IN 46204
317-232-6681

IOWA
Securities Bureau
Lucas Building, 2nd Fl.
Des Moines, IA 50319
515-281-4441

KANSAS
Office of the Securities
Commissioner
618 S. Kansas Ave., 2nd Fl.
Topeka, KS 66603
(no phone requests)

KENTUCKY
Dept. of Financial Institutions
477 Versailles Rd.
Frankfort, KY 40601
(no phone requests)

LOUISIANA
Securities Commission
Energy Centre
1100 Poydras St., Ste. 2250
New Orleans, LA 70163
(no phone requests)

MAINE
Securities Division
121 State House Station
Augusta, ME 04333
207-624-8551

MARYLAND
Division of Securities
200 St. Paul Plaza, 20th Fl.
Baltimore, MD 21202
410-576-6494

MASSACHUSETTS
Securities Division
One Ashburton Pl., Rm. 1701
Boston, MA 02108
800-269-5428

MICHIGAN
Registration Section
P.O. Box 30222
Lansing, MI 48909
517-334-6215

MINNESOTA
Department of Commerce
Securities and Licensing Div.
133 East Seventh St.
St. Paul, MN 55101
800-657-3602

MISSISSIPPI
Securities Division
P.O. Box 136
Jackson, MS 39205
800-804-6364

MISSOURI
Attn: Kathy Palmero
Division of Securities
P.O. Box 1276
Jefferson City, MO 65102
800-721-7996

MONTANA
no printed report
406-444-2040

NEBRASKA
Bureau of Securities
The Atrium, Ste. 311
1200 N. St.
Lincoln, NE 68508
(no phone requests)

NEVADA
Sec. of State/Securities Div.
555 E. Washington Ave., Ste. 500
Las Vegas, NV 89101
800-758-6440

NEW HAMPSHIRE
Bureau of Securities Regulation
State House, Rm. 204
Concord, NH 03301
(no phone requests)

NEW JERSEY
Bureau of Securities
P.O. Box 47029
Newark, NJ 07101
(no phone requests)

NEW MEXICO
Securities Division
725 St. Michaels Dr.
Santa Fe, NM 87501
505-827-7140

NEW YORK
Andrew Kandel/Bureau Chief
Investor Protection & Securities
Attorney General's Office
120 Broadway
New York, NY 10271
(no phone requests)

NORTH CAROLINA
Attn: Sandra Strickland
Sec. of State/Securities Div.
300 N. Salisbury St., Ste. 100
Raleigh, NC 27603
919-333-3924

NORTH DAKOTA
Securities Commissioner's
Office
600 E. Blvd., 5th Fl.
Bismarck, ND 58505
701-328-2910

OHIO
Division of Securities
77 South High St., 22nd Fl.
Columbus, OH 43266
(no phone requests)

OKLAHOMA
Department of Securities
First National Center, Ste. 860
120 N. Robinson
Oklahoma City, OK 73102
405-280-7700

OREGON
Div. of Finance/Corp. Securities
350 Winter St., N.E., Ste. 410
Salem, OR 97310
503-378-4387

PENNSYLVANIA
Office of the Secretary
1010 N. 7th St., 2nd Fl.
Harrisburg, PA 17102
717-787-8061

RHODE ISLAND
Business Regulation/
Securities Div.
233 Richmond St., Ste. 232
Providence, RI 02903
401-277-3048

SOUTH CAROLINA
Sec. of State/Securities Div.
P.O. Box 11350
Columbia, SC 29211
(no phone requests)

SOUTH DAKOTA
Attn: Linda Todd
Division of Securities
116 W. Capitol Ave.
Pierre, SD 57501
605-773-4013

TENNESSEE
Securities Division
Broker/Dealer Section, Ste. 680
500 James Robertson Pkwy.
Nashville, TN 37243
(no phone requests)

TEXAS
State Securities Board
Broker/Dealer Registration
P.O. Box 13167
Austin, TX 78711
512-305-8327

UTAH
Securities Division
160 East 300 S., Box 146760
Salt Lake City, UT 84114
801-530-6600

VERMONT
Dept. of Banking, Insurance
and Securities
89 Main St., Drawer 20
Montpelier, VT 05620
802-828-3420

VIRGINIA
Securities Division
P.O. Box 1197
Richmond, VA 23219
804-371-9686

WASHINGTON
Dept. of Financial Institutions/
Securities Div.
P.O. Box 9033
Olympia, WA 98507
(no phone requests)

WEST VIRGINIA
Securities Division, WV 118
Capitol Building
Charleston, WV 25302
304-558-2257

WISCONSIN
Commissioner of Securities
Div. of Market Licensing
P.O. Box 1768
Madison, WI 53701
608-266-3431

WYOMING
Attn: Securities Division
Sec. of State, State Capitol
Cheyenne, WY 82002
307-777-7370

*Registration history only. **Users must include a request for public information. ***No written report by phone.

license a broker, but would have worked against consumers in states such as Florida and Texas, that already have strict standards, according to the attorney.

The NASD, sensitive to criticism being heaped upon its oversight of brokers, is moving to disclose as much about the work history of brokers as the states already do. Mary Schapiro, the NASD's new head of enforcement, says her organization's board of directors has approved publicizing past and pending arbitration cases as well as complaints that haven't been lodged as arbitrations. "There are brokers who feel that some customers lodge complaints because they lost money, not because the broker did something wrong," Schapiro says. "But I think investors have the right to know. If there are ten complaints against a broker, the customers need to know that, and I'm determined they will."

In addition, Schapiro is seeking to redesign the all-but-impenetrable CRD reports. "They're hard to read and understand," she says. "It's no one's fault because public disclosure wasn't the purpose of the depository. The redesign will make reports much more reader-friendly."

OUR COURSE OF ACTION

The new, more detailed, more understandable NASD reports probably won't appear before next year, at the earliest. (Ultimately, Schapiro would like brokers' records to be available over the Internet.) In the meantime, how can you learn if there are warning signs on the employment record of your broker or someone who seeks to be your broker?

In most instances, you'll get more information by contacting your state securities regulator rather than the NASD to obtain a background report on a broker. Only ten states delete customer complaints from the reports they send consumers, according to our survey (see the box on the opposite page). All but ten states and the District of Columbia will tell you about pending arbitration cases involving a broker, and all but six and the District inform you about pending civil lawsuits. Only six states will not reveal criminal convictions under appeal. All of this information is currently omitted in reports you get from the NASD. Most states—including Alabama, Vermont and West Virginia—and the NASD say they will keep your inquiry confidential. (Alabama says it has "no set policy.")

REPORTER: SUZANNE SULLIVAN

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Barry R. Goldsmith
Executive Vice President
Enforcement

NASD Regulation Inc.
1801 K Street, NW, 8th Floor
Washington, DC 20006-1500
202-974-2800

Senate Permanent Subcommittee
on Investigations

EXHIBIT # 15

September 24, 1997

The Honorable Susan M. Collins, Chairman
Permanent Subcommittee on Investigations
432 Hart Senate Office Building
Washington, DC 20510

Re: Emerging Securities: Fraud in the Micro-Capital Markets

Dear Chairman Collins:

We appreciated the opportunity to testify before the Senate Permanent Subcommittee on Investigations concerning our efforts to combat fraud and sales practice abuse in the microcap securities market. Your questions and comments, as well as those by all those participating, will be of great value to our further consideration of these important issues. Please accept this letter as a supplement to the record in these hearings.

During the proceeding, you suggested that we consider approaches to ensure that investors are aware of the NASD Regulation's Public Disclosure Program "hotline" number (800-289-9999). You also suggested that we consider whether the examination requirements for registered representatives should be strengthened. In this connection, we want to bring to your attention two recent initiatives that focus on these concerns.

On September 10, 1997, the SEC approved an NASD rule proposal that requires NASD member firms to provide NASD Regulation's Public Disclosure hotline number to their customers, in writing, at least once a calendar year. NASD Regulation's Public Disclosure hotline number is the 800 telephone line which investors may call to obtain the disciplinary history of a registered representative or member firm. Investors who request information on how to file a complaint are directed to the appropriate NASD Member Regulation district office for further assistance. We have enclosed a copy of the rule filing and the SEC's approval. This initiative complements our outreach to investors through the NASD Regulation Web site (www.nasdr.com) which gives investors the on-line ability to request disciplinary histories of brokers and file complaints, and our public service announcements on radio and television. (Press Release enclosed.)

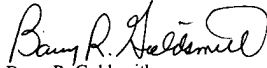
With regard to the examination requirements for registered representatives, I would like to advise the Subcommittee of a recent initiative in this area requiring continuing education for registered representatives. These new rules require the uniform periodic training of registered representatives who have been in the industry for less than ten years ("Regulatory Element") and require each member firm to maintain a continuing and current training program for all registered representatives who have contact with customers ("Firm Element"). In addition, there are

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specific provisions requiring the fulfillment of the Regulatory Element for those individuals who become the subject of a significant disciplinary action. We have enclosed copies of NASD Rule 1120 and the relevant Notices to Members that describe this program. We have also enclosed a recent settlement and press release in which Citicorp Securities was ordered to make payments of \$325,000 for failure to comply with the requirements of Rule 1120.

In addition to these initiatives and those described in my testimony, we will continue to give very serious consideration to the suggestions made by you and Senator Cleland, as well as those made by the witnesses who testified before the Subcommittee.

Respectfully submitted,



Barry R. Goldsmith
Executive Vice President
Enforcement

cc: Senator Cleland

Supplemental Questions for the Record of
Chairman Susan M. Collins and Responses of
the Staff of the Securities and Exchange Commission

1. *In footnote 2 of Chairman Levitt's written statement, the Chairman notes that "[t]he term 'micro cap' is not a term defined under the federal securities laws, [but that one definition of the micro-cap market includes] companies with market capitalizations of less than \$300 million.... In general, securities of micro cap companies are quoted on Nasdaq's OTC Bulletin Board, in the National Quotation Bureau's Pink Sheets and on the Nasdaq Small Cap Market."*

- A. *What is the Securities and Exchange Commission's ("the Commission") best estimate of the dollar value of fraud in the micro capital market as the Commission has defined it?*

The Commission does not routinely collect, as part of its examinations or investigations, the dollar value of the fraudulent activity. Efforts to gather additional data on this question would entail considerable expense and still might not yield reliable results. For example, estimating the dollar value of the fraud would involve analyzing many different aspects of the micro cap market, such as the commissions and fees collected by the brokers; and opportunity lost by investors who could have made legitimate investments. Moreover, in addition to the Commission, the self-regulatory organizations ("SROs"), states and criminal authorities also investigate fraud involving the micro cap market. Finally, there is no way to measure fraud that has yet to come to light.

- B. *What is Commission's best estimate of the dollar value of fraud in the penny stock market, i.e., the market of company stocks that trade at \$5 or less?*

See response to Question 1.A. above.

- C. *According to a recent Wall Street Journal article, the incidence of penny stock fraud is on the increase, or, to use the article's headline, "penny stock fraud is roaring back." Does the Commission agree? If not, please explain why.*

From its enforcement investigations, its interaction with other regulators, and its review of investor complaints, the Commission's staff considers incidents of fraud in low-priced, speculative securities to be on the rise since the last examination of penny stock activity in 1993 (the Joint Regulatory Penny Stock Examination Sweep conducted by the staffs of the National Association of Securities Dealers, Inc. ("NASD"), the New York Stock Exchange, Inc.

("NYSE"), and the North American Securities Administrators Association ("NASAA")). The Commission's staff believes this increase is due to many factors, including the enduring robust performance of the market; the increasing participation of retail investors; and "hype" on the Internet bulletin boards and chat rooms about high-tech and scientific companies that attract the interest of unwary investors.

However, the staff believes that the focus of the fraud has changed in the past four or five years and is now concentrated in securities with prices greater than \$5 that are quoted on the NASD's Over-The-Counter ("OTC") Bulletin Board or on Nasdaq. The shift in activities away from penny stocks was already evident when the Joint Regulatory Penny Stock Examination Sweep was conducted in 1993, the respective staffs of the various regulatory agencies involved noted that penny stock broker-dealers were then generating 75 percent of their revenues from activity in Nasdaq securities.

The Commission and the NASD are working together to combat fraud in the micro cap market, focusing on the OTC Bulletin Board and lower-tier Nasdaq securities. Not only are more examination and enforcement resources being devoted to this segment of the market, but both the Commission and the NASD are reviewing ways in which applicable rules can be strengthened or new rules implemented.

- D. *In fact, the Wall Street Journal reports that "[r]egulators now estimate annual losses to investors at more than \$6 billion, triple the 1980s peak" of around \$2 billion. Is this a fair estimate? Why/why not? Does the Commission agree that in constant dollars, more money is being lost now to penny stock fraud than in the 1980s? Why/why not?*

It is our understanding that this estimate may come from NASAA. In 1989, NASAA estimated the annual loss caused by penny stock fraud was \$2 billion. Based on market growth, NASAA apparently has estimated that the investors' annual loss in 1997 probably increased proportionately with the market, resulting in the \$6 billion figure.

As noted above, the Commission does not maintain statistics on individual investor losses and believes that estimating investor losses based solely on market growth may not correctly gauge the extent of the fraudulent activity. Thus, while the extent of fraud in the micro cap market is not determinable, the Commission is concerned about any level of investor fraud and is determined to address the problem.

E. What accounts for that increase? Why is it occurring?

See response to Question 1.C. above.

2. *Is the Commission observing a particular segment of the population that repeatedly is targeted for penny stock scams, such as the elderly? Does the Commission know how it is that scam artists obtain information on their targets?*

In general, unsophisticated investors typically are the targets of penny stock or micro cap stock scams. Scam artists may target unsophisticated investors through a variety of methods. For instance, the staff is aware that scam artists use commercially-available lists with certain information (regarding income, for example) to target a particular group of investors. They also find vulnerable investors through cold-calling.

Investor education is key to protecting unsophisticated investors, such as the elderly, from fraud. The Commission's publications program and the penny stock rules are important elements of this effort. Please see responses to Question 3 and 8.

3. *Has the Commission initiated any outreach or investor education programs aimed at the population segments that are targeted by rogue brokers?*

A. *What are those programs?*

B. *How successful have they been?*

C. *How is the Commission going to build on them?*

The Commission has aggressively pursued numerous investor education programs that are designed to reach out to all investors, especially those who are new to the market and less sophisticated about investing. The Commission believes that an educated investor provides the best defense against securities fraud. The Commission's Office of Investor Education and Assistance ("OIEA") provides information aimed at educating investors regarding how to identify securities fraud. OIEA urges investors to report suspicious activity to securities regulators. OIEA also informs investors about the importance of investing wisely. While it is not possible to measure the number of frauds prevented by the investor education programs, the Commission believes these programs are critical to its mission of protecting investors and helping investors protect themselves.

The Commission's efforts to reach out to investors include the following measures:

Publications

Since its creation in 1994, OIEA has written and distributed over a dozen pamphlets and brochures that warn investors about scams and state in plain English what every investor should know about investing. All of these publications are available, free of charge, on the Commission's Website (<http://www.sec.gov>) and through the Commission's toll-free publications and information line (1-800-SEC-0330). The Commission is committed to continuing this program.

OIEA's newest publication, entitled *Cold Calling Alert*, specifically addresses problems in the micro cap market. It tells investors what the cold-calling rules are; how to deal with cold calls; how to stop them; and how to evaluate investment opportunities that come over the telephone. In the one month since the Commission released *Cold Calling Alert*, over 1,000 investors have called the Commission's toll-free information line to request copies, and over 4,000 investors have down-loaded a copy from our Website. In addition, OIEA has sent over 4,500 copies to state securities regulators, Members of Congress, and investor education professionals. OIEA is working with NASAA to do a state-by-state release of the brochure. This will give *Cold Calling Alert* the widest possible circulation.

Investors' Town Meetings and Seminars

To further educate investors and listen to their concerns, the Commission began in 1994 to organize Investors' Town Meetings throughout the country. To date, Chairman Levitt has presided at 20 town meetings in New Jersey, Illinois, Florida, California, New Mexico, Texas, Tennessee, Ohio, Massachusetts, Washington D.C., New York, Pennsylvania, Virginia, Connecticut, and Oklahoma. The Commission plans to hold at least six more during fiscal year 1998.

The Commission's town meetings have been well received and regularly attract over 1,000 investors at each location. At each, Chairman Levitt discusses questions investors should ask before they invest. In addition, the Commission's staff and members of the securities industry hold seminars for investors on a wide variety of topics.

Earlier this year, OIEA began working closely with local and national media to maximize news coverage of the town meetings. This allows the Commission to reach investors who cannot attend the meeting. To build upon

the momentum our town meetings have generated, OIEA has prepared and is distributing a manual to advise investor organizations and state securities regulators on how to stage their own investor education events.

4. *The trade press and popular press in recent months have expressed the view that reforms are much needed in the NASD's bulletin board market, a market with no Commission reporting requirements and no public disclosure requirements. One recent Wall Street Journal article states that there are significant problems with fraud on the over-the-counter market. In fact, Barry Goldsmith, Executive Vice President of NASD-R, has gone on record stating "let me be blunt, there are significant problems in the over-the counter market and a strong regulatory response is needed."*

A. *Does the Commission agree with Mr. Goldsmith?*

The Commission's staff agrees with Mr. Goldsmith that problems exist in the OTC market and believes that regulatory action is warranted as part of a comprehensive effort to remedy the problems. Regulatory action, however, is only one element of a three-part response that includes prevention and enforcement. The staff now is reviewing the kinds of fraudulent and manipulative activities that have occurred to date to determine what regulatory actions would be most effective. Regulatory actions, however, usually impose a cost on the participants in the market; therefore, the Commission must carefully weigh these costs when considering the benefits of any rulemaking initiatives.

B. *Among the suggested reforms to the bulletin board, are:*

1. *Holding market makers responsible for verifying company financial information and requiring annual updates to that data.*
2. *Making publicly available the company information market makers file with the National Association of Securities Dealers.*
3. *Requiring all bulletin board companies to file financial reports with the Commission.*
4. *Updating the penny stock rule[s], possibly raising the definition of a "penny stock" to \$10 or \$15 per share.*
5. *Giving the NASD unilateral authority to halt trading in stocks where fraud is suspected.*
6. *Revising the Commission's registration-exemption rules to close loopholes.*

- C. *To what extent, if at all, does the Commission agree with the merits of each of these? Which reforms should be accorded the highest priority? Why?*
- D. *In what ways will each one of these reforms help stem the tide of penny stock scams?*
- E. *Can the Commission give us an approximate timetable that the Commission expects each one of these proposals to go into effect? Have they been submitted by the NASD to the [C]ommission for its approval? If not, when does the Commission expect them to be submitted?*

Questions 4.C., 4.D., and 4.E. relate to a series of regulatory initiatives that you enumerate in Question 4.B. We have restated your questions and then set forth responses to Questions 4.C., 4.D., and 4.E. with respect to each of the items listed in Question 4.B. above.

1. *Holding market makers responsible for verifying company financial information and requiring annual updates to that data.*

Market makers in OTC Bulletin Board stocks should be familiar with information about the issuers of securities that they quote. Rule 15c2-11 under the Securities Exchange Act of 1934 (the "Exchange Act") requires the first market makers that publish a quote for a security to have financial and other information about the issuer of that security. As Chairman Levitt testified before your Subcommittee, the staff is preparing amendments to strengthen the rule's requirements. These proposed amendments would provide market makers and other market participants with greater information about issuers that do not file reports with the Commission. The staff anticipates submitting proposed amendments to the Commission for its consideration by the end of the year.

2. *Making publicly available the company information market makers file with the National Association of Securities Dealers.*

The proposals outlined in the response to Question 4.B.1., above, also would require a market maker, at the request of a customer, to provide information about the issuer that it has obtained to satisfy Rule 15c2-11's requirements. The proposals also will discuss whether to facilitate development of a central repository to maintain Rule 15c2-11 information about issuers.

3. *Requiring all bulletin board companies to file financial reports with the Commission.*

Many issuers with securities traded on the OTC Bulletin Board or in the Pink Sheets are not subject to the periodic reporting requirements of the federal securities laws. Requiring OTC Bulletin Board issuers to participate in the Commission's public disclosure system would make information about these companies more widely available. Another possibility would be to limit eligibility to the OTC Bulletin Board to those issuers that are reporting companies under the Exchange Act. One drawback to this proposal is that it could force the securities of a number of issuers into other quotation media that do not have the transparency of the OTC Bulletin Board and are not operated by an SRO.

The NASD has not yet formally recommended limiting OTC Bulletin Board eligibility to only reporting companies under the Exchange Act. Any proposal of this nature would be filed with the Commission and would be subject to a public comment period before the Commission could approve or disapprove it. When evaluating any proposal in this area, the Commission will consider its costs and benefits, such as whether it would force smaller companies' securities to trade in markets that are easier to manipulate and more difficult to monitor.

4. *Updating the penny stock rules, possibly raising the definition of a "penny stock" to \$10 or \$15 per share.*

Currently, the definition of "penny stock" excludes securities that, among other things, are priced at \$5 or more per share. The Commission's staff believes that the penny stock rules are very effective; however, some broker-dealers have circumvented their application by pricing securities above the current \$5 threshold. The staff is considering recommending to the Commission that it raise the price threshold in conjunction with other possible changes to the penny stock rules to cover more of the types of securities that are used in micro cap frauds. The staff will be working on the penny stock rules during the coming months.

5. *Giving the NASD unilateral authority to halt trading in stocks where fraud is suspected.*

The authority of the NASD to halt trading in a particular OTC Bulletin Board security when it suspects that fraud or manipulation is associated with that security would appear to be consistent with its authority over

other OTC securities. As with possible changes to the OTC Bulletin Board discussed above, the NASD would have to file a proposed rule change with the Commission, which would be subject to public comment before the Commission could approve or disapprove it. The NASD has not yet presented a proposed rule change to the Commission.

6. *Revising the Commission's registration-exemption rules to close loopholes.*

The Commission's staff is considering whether it should recommend to the Commission rescission of its exemptions from registration. These exemptions, however, relate to the initial offering of the securities and not to transactions in the secondary markets. (For a more complete discussion of the Rule 504 exemption, see our response to Supplemental Question 17 from Senator Glenn).

It is not clear that further limiting the resale status of securities sold in exempt offerings would limit secondary market fraud or manipulation. Regardless of the limitations in the exemption from registration for the initial offering, all securities are, eventually, eligible for resale. Therefore, it is not clear how revisions to the exemptive structure would impact micro cap fraud. The Commission's internal Working Group on Micro Cap Fraud currently is considering whether action should be taken regarding the exemptive structure.

5. *It has been reported that the electronic Bulletin Board's "link to Nasdaq gives its listings credibility to unwary investors. At the same time, on-line technology simplifies the marketing of these stocks."*

- A. *Does the Commission agree that the Bulletin Board's link with Nasdaq gives it credibility with unwary investors which unscrupulous market makers exploit? What if anything should be done to correct this, assuming a correction is in order?*
- B. *Does the Commission favor regulations that would forbid market makers from representing directly or indirectly that the [B]ulletin [B]oard is affiliated with the Nasdaq market?*
- C. *How would such a rule be structured? How would it be enforced?*

Questions 5.A., 5.B., 5.C., and 5.D. are answered in Question 5.D.

- D. *If not, does the Commission propose dispelling the public's mind of the fact that the [B]ulletin [B]oard does not meet the listing and disclosure requirements of the other NASD markets?*

The OTC Bulletin Board disseminates quotations in electronic form for securities that, for many years, had quotations published only through paper reports known as the "pink sheets." The OTC Bulletin Board was initiated to allow the market makers in non-Nasdaq securities to enter and update quotation information on a real-time basis and provide the NASD with transaction data to enable the NASD to better surveil this market. The Commission believes that the OTC Bulletin Board is beneficial because it strengthens our ability to detect fraud and it provides investors with updated quotes.

At the same time, the OTC Bulletin Board is not equivalent to Nasdaq and should not be portrayed as such. The staff believes it would be misleading for a broker-dealer to claim that an OTC Bulletin Board stock was somehow the equivalent of a security quoted on Nasdaq. Because the NASD has the ability to address market makers' misleading statements, the staff does not currently believe that a new Commission regulation specifically to prevent market makers from representing that the OTC Bulletin Board is equivalent to Nasdaq is necessary.

There are, however, other ways to address potential investor confusion. For example, the NASD may propose changing the OTC Bulletin Board to allow only the securities of reporting companies to be quoted on the OTC Bulletin Board. Moreover, the NASD may consider requiring that a disclosure statement be given to potential investors indicating the differences between the OTC Bulletin Board and Nasdaq, including the fact that OTC Bulletin Board securities do not have to meet listing standards that are required for securities quoted on Nasdaq. We will evaluate these and any other proposals when they are filed.

6. *The House of Representatives Report that accompanied the Penny Stock Reform Act of 1990 states that "[t]he fact that the penny stock market is so susceptible to manipulation makes it very attractive to unscrupulous securities professionals who are looking to deceive the public. Recent evidence demonstrates that the penny stock industry is now fraught with repeat offenders of state and federal securities laws and other felons . . . [f]or example, [a] NASAA report noted that 83 percent of the major penny stock enforcement cases examined in preparation of the report contained names of one or more individuals with a background of securities law violations." Recent reports appearing in *The New York Times* and *The Wall Street Journal* note that the problem of repeat offenders or "rogue brokers" participating in micro-cap scams remains a real one.*

A. *Does the Commission agree?*

The staff believes that there is a problem of repeat offenders or "rogue brokers" participating in micro cap scams. The Commission's examiners and enforcement staff frequently identify new sales practice abuses by brokers whose disciplinary records already include Commission, SRO, and state actions as well as numerous arbitration cases. This was the focus of an examination sweep of 179 branch offices of 101 broker-dealers that was conducted in 1995 by the staffs of the Commission, NASD, NYSE, and state regulators. The March 1996 report on that sweep, entitled "Joint Regulatory Sales Practice Sweep: A Review of the Sales Practice Activities of Selected Registered Representatives and the Hiring, Retention, and Supervisory Practices of the Brokerage Firms Employing Them" ("Sales Practice Sweep Report"), found that broker-dealer firms are willing to employ registered representatives with a history of disciplinary actions or customer complaints.

A number of recommendations were made to combat this problem, including requiring more stringent hiring procedures and special supervision of registered representatives with a disciplinary history. In addition, the Commission and the SROs agreed to focus more attention on supervision and cold-calling during examinations. The Commission and other securities regulators are dedicated in their efforts to stop not only the problem registered representatives, but also the brokerage firms that employ them. Significant examination resources are committed to reviewing the activities of problem brokers and broker-dealers with high numbers of problem sales personnel. In addition, the Commission's staff is coordinating its examinations with the SROs to try to cover more ground and stretch each of our resources a little farther.

B. *If "recidivist" brokers are still in the system, where did the 1990 Act fall short? In other words, what additional steps should be taken to reduce the problem of repeat offenders?*

The Commission's staff and SROs are considering the ways to discourage broker-dealers from employing individuals with a history of disciplinary actions and customer complaints. Following up on the recent Joint Regulatory Sales Practice Sweep, Commission examiners are focusing on the activities of problem registered representatives who continue to receive customer complaints or are employed by firms suspected of exercising inadequate supervision. It is also important that the penalties against individuals who engage in securities scams be sufficient to effectively deter future violative conduct. The Commission is doing this through, among other things, more aggressive enforcement of the securities laws and increased penalties for serious deficiencies in supervision, strengthening rules relating to sales practices in micro cap securities, and targeting

examinations of broker-dealers that appear to engage in micro cap fraud and sales practice abuses.

7. *Another aspect of the same problem is what the 1990 House Report terms the "cloning" of penny stock firms whereby "[l]arge penny stock brokerage firms become training grounds for a new generation of promoters who then set up hundreds of identical operations." The report asserts, "[u]nder current law, it is not difficult for a firm, once shut down, to emerge once again or even to multiply."*

- A. *Is the Securities and Exchange Commission still grappling with the problem of cloning? What new tools -- new rules or regulations -- if any, does the Commission need to prevent "cloning"?*

The Commission's staff continues to be concerned about the problem of "cloning." Shutting down a brokerage firm for its fraudulent practices does not guarantee that individuals associated with that firm would not commit fraud under a different corporate name or entity. Therefore, we have aggressively pursued enforcement actions against not only the brokerage firms but also those individuals associated with the firms who are responsible for or participate in unlawful activities. In this regard, the Commission has relied on its broad sanction authority - most recently expanded by the Penny Stock Reform Act of 1990 - to bar individuals from being associated with a brokerage firm or otherwise from participating in penny stock offerings. In addition to bars, the Commission has imposed on individuals monetary penalties and orders requiring disgorgement to deter and prevent future misdeeds. At this time, the staff does not believe that additional tools to combat the problem of cloning are necessary.

- B. *Does the Commission have an opinion as to the merits of extending the Commission's reach to promoters of micro-cap stocks that fall outside the \$5 penny stock definition? Would the Commission support such an extension?*

The staff is reviewing the possibility of modifying the current exclusion from the penny stock rules for securities priced at \$5 or more pursuant to our existing statutory authority.

8. *Pursuant to the 1990 Penny Stock Reform Act, the Commission adopted rules requiring brokers to give customers specific information before the sale about the market for penny stocks and the broker's compensation.*

- A. *Please describe the kind of information that must be disclosed in the penny stock context.*

The penny stock rules require broker-dealers to determine the customer's suitability to invest in penny stocks, based on the customer's financial situation,

experience, and investment objectives before the transaction is executed, except in the case of established customers. After making this determination, the broker-dealer must send a written statement to the customer disclosing the basis for the suitability determination. The broker-dealer may not execute the penny stock transaction until the customer returns a signed copy of the suitability determination. Broker-dealers must also provide customers with specific information prior to effecting a transaction in penny stocks. This disclosure includes a standardized document (Schedule 15G) that advises investors of the risks of investing in penny stocks, the broker-dealer's duties, the customer's rights and remedies in cases of fraud, and phone numbers that investors may call for information on the disciplinary history of broker-dealers and their associated persons.

In addition, before executing a penny stock transaction, a broker-dealer must provide the customer with information regarding current quotations for the security and the compensation paid to the broker-dealer and its salespersons in connection with the transaction. This information must be given to the customer twice, first before the trade, then by written confirmation after the trade. A broker-dealer that has effected a penny stock transaction with a customer must send monthly account statements to the customer that state either the market value of the customer's penny stocks or that there is insufficient information to determine the securities' market value.

B. How does the Commission monitor compliance with this rule to gauge its efficacy?

The Commission's Office of Compliance Inspections and Examinations ("OCIE") regularly reviews broker-dealers' practices involving the sales of low-priced securities, including penny stocks, in connection with its broker-dealer examination program. Serious violations of federal securities laws are referred to Commission enforcement staff or SROs for further investigation. Less serious offenses are handled through deficiency letters requiring the broker-dealer to remedy identified deficiencies or problems. If a trend in compliance problems is found, OCIE brings the matter to the attention of examiners around the country for a more concerted review throughout the examination program. In addition, OCIE oversees the examination and enforcement programs of the SROs to evaluate their effectiveness at finding and resolving compliance problems.

C. Arguments against rules such as these are either that the broker conveys the information after the sale, so the investor never really considers it prior to committing, or, if the broker gives it out prior to the sale, the broker down plays its significance with a line like "hey, it's a fast changing marketplace, what's in a piece of paper is only so useful," thereby pressuring a transaction. And, moreover, the broker has created a record for herself because she can point to

the fact that she buried the customer with paper. Do these arguments have any merit? What percentage of the Commission's micro-cap prosecutions are predicated on failures to disclose the kind of information the rule[s] require[]?

The penny stock rules were adopted specifically to impede the use of high pressure sales tactics and to provide investors with disclosures about the risks of investing in penny stocks, as well as the compensation the broker would receive in connection with the proposed penny stock transaction. As discussed above, the rules require written disclosures about the risks of investing in penny stocks that must be made prior to any transaction in penny stocks. In addition, the rules require that the customer receive further disclosures after the transaction has been effected, on the transaction confirmation. Moreover, the broker may not effect the transaction until the customer has returned a signed copy of Schedule 15G to the broker. The possibility that a broker may minimize the risks of investing in penny stocks in his or her oral disclosures to the customer is intended to be counteracted by the written disclosures made to the customer by Schedule 15G. The customer will have the opportunity to read and scrutinize the disclosures made in the Schedule 15G after any sales pressure has subsided. The obligation that the customer return a signed copy of Schedule 15G before the transaction can be executed, combined with the risk disclosures contained in the Schedule, should clearly convey to the customer the importance of the disclosures and the degree of risk involved in penny stock transactions. Of course, rules cannot require customers to read the mandated disclosures, even when it is in their best interest to do so.

Most of the micro cap fraud enforcement actions brought by the Commission are not predicated on a failure to disclose the type of information that the penny stock rules require, but instead are based upon violations of the general anti-fraud provisions. Many of the micro cap fraud securities trade at a price greater than \$5 per share and, thus, are not covered by the penny stock rules.

- D. *Chairman Levitt's statement notes that "[t]he Commission today sees more fraud in mostly lower-priced Nasdaq-listed securities and in securities valued at \$5 or more." Why is that? Should the penny stock rules be ratcheted upwards?*

The penny stock rules are some of the most effective tools the Commission has to combat fraud and manipulation for securities covered by these rules. The penny stock rules, however, were drafted to apply only to securities that meet certain criteria - most notably, securities that are priced below \$5 per share and that do not trade on a national securities exchange or through Nasdaq. The limitations were designed to avoid imposing burdens on legitimate small businesses. In addition, the \$5 threshold was intended to cover low-priced stocks for which a small absolute increase in price produces a high percentage gain and hence are particularly attractive to investors. Some broker-dealers,

however, have avoided the penny stock rules by limiting their activities to securities priced at above the \$5 threshold or qualifying for other exceptions from the rules. The result is that certain fraudulent and manipulative schemes, once prevalent in very low-priced securities, have migrated to securities outside of the scope of the penny stock rules.

The Commission's staff presently is reviewing the scope of the penny stock rules to find ways to more effectively combat the abusive schemes that have occurred since the rules' adoption. One possibility is to raise the \$5 threshold for securities excepted from the penny stock definition. In evaluating this and several other options, we must be certain that any changes that the Commission makes will be effective in curbing abuses, but will not interfere with the ability of legitimate smaller issuers to raise capital and compete with more established companies.

9. *What is the surveillance strategy developed by the Commission to prevent fraud on the Internet? How does it work?*

The Commission's strategy to prevent fraud on the Internet is two-pronged: first, staff from the Division of Enforcement actively polices the Internet; and second, users of the Internet assist the Commission by self-policing and reporting questionable activity to the Division of Enforcement.

The Division of Enforcement maintains a "Cyberforce" comprised of 60 or so staff members, each of whom "surfs the Web" for several hours each week. The staff monitors the Internet, especially the World Wide Web and message areas such as newsgroups and bulletin boards. The staff uses commercial on-line access accounts, the latest browsing software for viewing the Internet, and Pentium processors to conduct surveillance.

Second, the Commission has established an SEC Enforcement Complaint Center on its Website which receives 50-75 messages daily from users of the Internet. Internet fraudsters face a double-edged sword: they want the investor to find their materials and be able to contact them with ease, but they also want to stay hidden from federal authorities. Thus, the combined efforts of the Enforcement staff and of Internet users work to root out fraudulent securities activities being conducted on-line.

10. *Has this surveillance strategy been effective?*

Yes. This surveillance strategy has resulted in the commencement of numerous investigations and a number of significant cases. The Commission has been bringing an increasing number of enforcement actions that involve fraudulent offerings on the Internet. These enforcement actions are not unlike those employing more conventional means of communication and include: prime bank investments offering staggering

returns; investment opportunities in eel farms; gold mine schemes; and opportunities in "coconut chip" enterprises.

11. *To what extent is the Internet used for legitimate securities transactions by honest market participants?*

There are hundreds of broker-dealers that have home pages on the World Wide Web. Most of these are just informational: they provide information about the broker-dealer, market information, and other general investing information. Over two dozen broker-dealers have set up interactive systems that permit the broker-dealers' customers to access their account information and transmit orders to buy or sell securities via the Internet. These systems are popular with investors because they are generally much less expensive than traditional brokerage accounts, and account information and the ability to enter orders is available 24 hours a day. Investors also report that they feel more in control of their investments when they use these systems. Internet trading typically involves a broker-dealer receiving e-mail from a customer containing the name of a security, whether it is to be bought or sold, the quantity, and whether the order is a market or limit order. The e-mail is checked electronically against the customer's account and, barring a discrepancy, is routed from the broker-dealer to the appropriate exchange or market maker for execution. After the order is executed, the customer receives an e-mail message confirming the order, and the customer's account is often updated on-line.

At this point, Internet trading facilities are simply order-routing systems, rather than alternative trading systems with immediate execution. The Commission is aware of plans for broker-dealers to create alternative trading systems for retail customers, and the Commission supports the development of more trading opportunities for retail investors. However, we are keeping a watchful eye on these developments to make sure that these systems have adequate investor protection safeguards.

The anti-fraud provisions of the federal securities laws apply to securities transactions, whether they occur through the Internet, on an exchange floor, or over the telephone. The Commission is mindful of a number of issues relating to trading through the Internet. For example, investors' private financial data must be secure. In addition, any computer system designed to trade securities must have the capacity to handle demand.

12. *There has been considerable press about the demise of A.R. Baron -- a firm that was indicted in May 1997 by a New York State grand jury for defrauding investors of \$75 million -- and the fact that Bear Stearns processed trades for A.R. Baron, as a clearing firm. The Subcommittee understands that the New York Stock Exchange has adopted rules requiring clearing firms to notify introducing brokers about available supervisory and compliance reports compiled by the clearing firms that could show irregularities on the part of introducing brokers -- such as excessive commissions or churning.*

- A. Does the Commission support these reforms?
- B. If so, when does the Commission expect them to go into effect?
- C. Does the Commission encourage all SROs -- like the NASD -- to adopt similar rules?

The Commission's staff is encouraged by the SROs' prompt response after Chairman Levitt wrote to the NYSE and the NASD expressing his concerns about the abusive activities of some introducing brokers. The NYSE proposal has been published in the Federal Register, and the NASD proposal is expected to be ready for publication shortly. It is worth noting that, in addition to requiring clearing firms to make available compliance and supervisory reports to introducing brokers, each of the rule proposals also will require that customer complaints regarding an introducing firm that are received by a clearing firm be forwarded by the clearing firm to both the introducing firm and the introducing firm's SRO. In accordance with the Commission's SRO rulemaking procedures, once the Division of Market Regulation completes its initial review, an SRO proposed rule change is published in the Federal Register, where interested persons are invited to comment on them. After the comment period has closed and the Division staff has had a full opportunity to review the SRO proposals in light of any public comments received, the Commission is then in a position to approve or disapprove the proposed rule change.

In addition, the Commission's staff is working with the industry to determine ways that clearing brokers can help minimize harm to investors without imposing an undue burden on clearing brokers.

- 13. In March 1996, a working group of the NASD, the New York Stock Exchange, the North American Securities Administrators Association and the SEC issued a joint report entitled "Joint Regulatory Sales Practice Sweep: A [R]eview of the Sales Practice Activities of Selected Registered Representatives and the Hiring, Retention, and Supervisory Practices of the Brokerage Firms Employing Them". As its title suggests, the report recorded the results of the hiring and recruiting practices of over 100 small and medium size brokerage firms, by making "specific recommendations aimed at improving brokerage firms" thereby creating "improvements in the prevention and detection of sales practice abuses." Among the recommendations of the report are tying branch manager compensation to the manager's effective supervision of registered representatives, more stringent hiring procedures with greater scrutiny into the kinds of securities sold by the applicant while with a previous firm.

- A. *What is the current status of these recommendations? Is there a formal process by which they are being implemented? What kind of follow-up is being done?*

Shortly after the Sales Practice Sweep Report was issued, the NASD and the NYSE issued a joint memorandum (dated April 15, 1997) to their respective members discussing the importance of the report's findings and recommendations. The memorandum also provided guidance to their members in enhancing their supervisory systems. As such, it sent a clear message to the industry of the SROs' position with respect to broker-dealers' supervisory obligations. In addition, the Commission's staff and SROs continue to urge firms to adopt the recommendations and have increased their examination focus on the problem areas cited in the Sales Practice Sweep Report.

- B. *In the year and a half since this report was issued, can the Commission offer an opinion as to whether the report's "specific recommendations" have, in fact, "result[ed] in improvements in the prevention and detection of sales practice abuses"? What more needs to be done?*

It would be difficult to quantify or directly relate implementation of the recommendations to reduced sales practice abuses. However, the staff continues to review firms' hiring and supervision procedures in cases where sales practice violations are suspected. The Commission's staff also has asked SROs and encouraged state regulators to include this review in their examinations.

The Sales Practice Sweep Report was successful in raising the industry's awareness of firms' obligation to supervise brokers with problematic backgrounds more closely. Reinforcing the principle that firms have an obligation to heighten their supervision over brokers whose backgrounds give "red flags" of the likelihood of continuing problems, the NYSE recently levied a \$250,000 fine against one of its member firms for, among other deficiencies, failing to monitor and subject registered representatives with customer complaints and/or disciplinary histories to a program of enhanced supervision.

14. *Chairman Levitt's statement indicates that the Commission's staff is studying how to amend rule 15c2-11 -- the rule designed to prevent the publication of stock quotations on the OTC [B]ulletin [B]oard and pink sheets that may be used in fraudulent schemes. As the statement notes, that rule requires a broker -- before publishing the initial quotation for a particular stock or after a trading halt -- to review the issuer's most recent balance sheet, profit and loss statements and to examine whether there is any relationship between the broker-dealer and company insiders.*

A. *How is this rule enforced?*

Both the Commission and the NASD have programs and procedures to ascertain market makers' compliance with Rule 15c2-11. Under both Rule 15c2-11 and NASD Marketplace Rule 6740, market makers must submit the information specified in Rule 15c2-11 to the NASD at least three business days prior to initiating or resuming a quotation for a security on either the OTC Bulletin Board or the Pink Sheets. Market makers must also submit Form 211 to the NASD in which they must specify the basis and factors considered by the market maker in establishing its initial entry before such entry may be published. The NASD conducts a review of the Rule 15c2-11 information submitted prior to permitting the quotation to be published. In addition to the NASD's oversight prior to the initiation or resumption of a quotation, the Commission and NASD review the market maker's Rule 15c2-11 files in the course of their examinations to verify compliance with the rule. The Commission and NASD have brought enforcement and disciplinary cases against market makers for violations of this rule.

B. *What possible amendment does the Commission envision?*

The Commission's staff is working on amendments to Rule 15c2-11 that would increase the information that market makers must review before initiating quotes for non-Nasdaq OTC securities. Generally, the amendments we are considering would expand the rule to cover all market makers that initiate quotes in non-Nasdaq OTC securities and would require the market makers publishing priced quotations to review the information annually.

15. *In conducting investigations of suspected rogue brokers and firms where the NASD-R and States are conducting parallel investigations, what are the specific mechanisms by which the three enforcement interests coordinate their fact-finding?*

The Commission's staff, including the regional office staff, coordinates on an informal basis with the NASD and the states. Representatives of the various regulators meet on a regular basis to discuss the division of investigative responsibility. To date, this practice of informal coordination and cooperation has served the various enforcement interests well.

A. *Do any or all of the three entities currently have the authority/ability to share discovery, including documents and deposition transcripts? If not, would the Commission favor legislation allowing disclosure? What would be the parameters of this kind of legislation?*

There are adequate mechanisms through which the Commission, SROs and state regulators may obtain information from one another. Specifically, the

Commission's Rules Relating to Investigations permit members of the Commission's staff to engage in discussions with various entities, including other governmental entities and SROs about nonpublic investigations. Requests for access to the Commission's files also can be made. The states typically have similar mechanisms which provide access by the Commission and SROs to information. The SROs are required by law to keep records and provide such records to the Commission upon request. The Commission's staff meets regularly with state regulators and SROs. Good working relationships have developed as a result of these meetings so that the sharing of information is easily and routinely facilitated. Thus, legislation is not required.

**Supplemental Questions for the Record of
Ranking Minority Member John Glenn and
Responses of the Staff of the Securities
and Exchange Commission**

- I. *With respect to micro cap fraud, please provide figures for each year of the past five years on the number of actions, disciplinary proceedings and investigations initiated by the SEC against:*

A. *Individuals; and*

B. *Firms.*

The table below sets forth the total number of enforcement actions instituted in each of the last five years, and the number of those cases that related primarily to broker-dealer fraud against customers and broker-dealer failures to supervise (the number of defendants or respondents is in parentheses). While the Commission does not keep statistics on broker-dealer micro cap fraud, many of the enforcement actions included in these numbers involved fraudulent activity in the micro cap market.

<u>YEAR</u>	<u>Broker-Dealer Enf. Actions</u>	<u>Fraud against Customers</u>	<u>Failure to Supervise</u>
FY 1996	453 (981)	61 (120)	17 (22)
FY 1995	486 (1072)	67 (110)	9 (9)
FY 1994	497 (1127)	57 (80)	8 (15)
FY 1993	416 (887)	48 (60)	5 (8)
FY 1992	394 (859)	41 (53)	6 (9)

The data should include, but not be limited to:

- i. *Matters Under Investigation (MUIs) that were opened by the Division of Enforcement (also indicate how many of those MUIs were closed with no action);*

The table below sets forth the total number of MUIs opened over the past five years. The Commission does not keep statistics on the number of MUIs closed without any action. As a matter of Commission policy, all MUIs should be closed once the investigation becomes formal or once the staff devotes a certain number of hours to the investigation.

<u>YEAR</u>	<u>MUIS OPENED</u>
FY 1997	1301
FY 1996	1409
FY 1995	1337
FY 1994	1501
FY 1993	1388

ii. *Fraud investigations;*

The table below sets forth the percentage of investigations pending at the end of each fiscal year that were classified as indicated. Note that each investigation may have multiple classifications.

<u>YEAR</u>	<u>FRAUD OFFER/SALE/PURCHASE</u>
FY 1997	72%
FY 1996	75%
FY 1995	74%
FY 1994	70%
FY 1993	67%

iii. *Trading suspensions issued by the SEC (also indicate how many cases have involved staff recommendations for trading suspensions that management (Assistant Director and higher) have not forwarded to the Commission, and identify those cases;*

The table below sets forth the number of trading suspensions issued in each of the last five fiscal years. The Division of Enforcement does not keep statistics on recommendations not forwarded to the Commission. Note, however, that trading suspensions typically are warranted and submitted to the Commission for approval when there is inadequate or inaccurate public information available upon which an investor could make an investment decision or, in a few instances, where the trading activity makes no economic sense.

<u>YEAR</u>	<u>ISSUED</u>
FY 1997	13
FY 1996	8
FY 1995	5
FY 1994	1
FY 1993	8

- iv. *Fines (please identify how many of the fines were the only disciplinary action and how many were combined with other disciplinary actions);*

The amount of disgorgement and penalties ordered in each fiscal year is listed below. In most instances, disgorgement and/or penalties were ordered in addition to injunctive relief or administrative censure, suspension, or bar. In some instances, the payment of disgorgement pursuant to a court order was waived based upon the defendant's demonstrated inability to pay. Courts also have noted, in some cases, that civil penalties were appropriate but were not imposed because of a demonstrated inability to pay.

<u>YEAR</u>	<u>Disgorgement</u>	<u>Penalties</u>
FY 1996	\$325 million*	\$67 million
FY 1995	\$994 million*	\$34 million
FY 1994	\$730 million*	\$34 million
FY 1993	\$225 million	\$29 million
FY 1992	\$558 million	\$221 million

- * Disgorgement figures for fiscal years 1994 - 1996 include disgorgement paid by Prudential Securities for its fraudulent practices in connection with the sales of limited partnerships. Specifically, Prudential paid \$330 million in disgorgement in 1994, \$561 million in 1995 and \$46 million 1996.

- v. *The number of contempt actions brought by the SEC to enforce its own injunctions;*

The table below sets forth the number of civil contempt actions filed. The number of defendants in these actions is noted in parentheses.

<u>YEAR</u>	<u>Civil Contempt Actions Filed</u>
FY 1996	32 (47)
FY 1995	23 (55)
FY 1994	33 (89)
FY 1993	15 (27)
FY 1992	11 (35)

- vi. *The number of cases referred to the Department of Justice, state or local authorities for criminal action (please detail how many criminal prosecutions there have been specifically for manipulation of micro-cap stocks, fraud involving a micro-cap stock, broker bribes and money laundering involving securities fraud); and*

- vii. *the number of cases referred to the Department of Justice, state or local authorities for civil action.*

In lieu of making formal referrals recommending that other agencies commence civil or criminal prosecution, the Commission has developed a practice of providing other agencies, on an informal, working basis, with information concerning cases, and granting access to case files to agencies upon their request. This ongoing process of access grants has virtually come to replace formal referrals.

The table below sets forth statistics relating to the number of grants of access to our files that were made to criminal authorities over the past five years. While the Commission does not maintain statistics on the precise number of civil access grants made over the past five years, the staff estimates that the Commission granted access to its files to authorities pursuing civil investigations and prosecutions approximately 300 times each year over the past five years.

<u>YEAR</u>	<u>Criminal Access Grants</u>
FY 1996	229
FY 1995	285
FY 1994	451
FY 1993	205
FY 1992	280

2. *With respect to the Enforcement Division's Market Surveillance Unit, for each year of the past five years:*

- A. *How many cases has the unit generated on its own?*

Although the Division of Enforcement's Office of Market Surveillance ("OMS") frequently detects trading situations which it refers for investigation and which ultimately result in enforcement actions, the OMS does not keep statistical data on these trading situations. Members of the staff of the OMS monitor all announced merger and acquisition activity and material changes in price movements in equity securities and are in daily contact with the various marketplaces to discuss such situations and, where warranted, to ensure that market data pertaining to a particular matter is directed to the appropriate Commission office on a timely basis for investigation. Responsibility for real-time, on-line surveillance of domestic markets rests with the SROs that supervise each market. The OMS is the primary liaison for the market surveillance units of the various domestic marketplaces with respect to potential violative trading situations.

- B. *How many cases that came out of the Market Surveillance Unit were cases that were referrals from the NASD, the Exchanges or the states?*

The following table sets forth the number of referrals to the Commission from the SROs that were made over each of the last five years.

	<u>FY 93</u>	<u>FY 94</u>	<u>FY 95</u>	<u>FY 96</u>	<u>FY 97</u>
NYSE	52	44	41	47	83
AMEX	23	15	35	32	24
NASD	66	85	120	117	136
CBOE	24	31	34	48	31
PACX	5	11	11	24	29
PHLX	6	3	4	6	3
BSEX	1	2	0	1	2
TOTAL	177	191	245	275	308

3. *Should Congress extend the Department of Justice's authority to give it concurrent jurisdiction with the SEC over civil enforcement, so that it, too, can bring civil actions in this area?*

If not, why not?

The most effective response to recidivist micro cap brokers is jail time. Thus, the Department of Justice plays a critical role in establishing a strong criminal enforcement deterrent to micro cap fraud. The Commission has redoubled its efforts to cooperate with and assist the Department of Justice in bringing more criminal actions against hardened securities law violators.

Given the importance of a strong criminal enforcement program, the Commission believes it is preferable for the Department of Justice and the U.S. Attorneys to focus on criminal enforcement of the federal securities laws rather than extending the Department's jurisdiction to civil enforcement cases. Moreover, there are certain advantages to maintaining the Commission's role in overseeing all civil enforcement actions. The staff's expertise permits the Commission to more efficiently handle complex securities cases and to shape the development of law in this area. In addition, the Commission is currently authorized to bring administrative proceedings

as well as civil actions in federal district court. In deciding the proper forum to bring a case, the Commission considers several factors -- the severity of the conduct, the expertise of the decision-maker, the estimated length of time to reach a hearing, and the involvement of unregulated persons or entities in the conduct. The Department of Justice cannot appear in Commission administrative proceedings; thus, it would not have the same flexibility as the Commission in choosing the appropriate forum and remedies in civil enforcement actions.

4. *Should the national regulatory agencies work more closely with the Department of Justice and state and local authorities to refer more of its cases for criminal action?*

If not, why?

If so, what is being done to achieve that and what is the timetable for implementing those efforts?

Criminal sanctions are more likely to deter illegal conduct than are civil sanctions. Thus, it is always useful for an agency to refer criminal activity to criminal authorities. Currently, the SROs and state and local authorities work closely with the criminal authorities where appropriate to do so. For example, in October 1996, the U.S. Attorney for the Southern District of New York, the Commission and the NASD announced charges that resulted from a year-long coordinated undercover operation that focused on undisclosed kickbacks paid to brokers to induce them to sell stock to customers. The Commission's staff believes the informal coordination that regularly occurs between the various regulators and criminal authorities has been, and will continue to be, effective in addressing criminal activity in the securities markets, including criminal activity in the micro cap market.

5. *How does the SEC's Division of Enforcement select its cases for investigation and prosecution?*

Commission investigations derive from a number of sources, including: examinations of filings made with the Commission; broker-dealer, investment company, and investment adviser inspections conducted by the Commission's staff and SROs; market surveillance conducted by the Commission's staff and SROs; complaints from members of the public; the news media; referrals from other governmental agencies; and from other investigations.

6. *How long does the SEC maintain data concerning MUIs in its computer system?*

When the Commission commenced computerized tracking of data concerning MUIs, the information was maintained in the system for two years. Since 1988, however, the Commission has maintained computerized data concerning MUIs on an indefinite

basis in the same manner that it maintains such information concerning its investigations.

7. *What impediments are there to the use of trading suspensions by the SEC?*

The Commission has the authority to suspend trading in a security. Section 12(k) of the Securities and Exchange Act (the "Exchange Act") provides that a trading suspension order may be entered if, in the Commission's opinion, "the public interest and the protection of investors so require." The Commission has imposed a trading suspension based on, for example, suspicious trading activities suggesting stock manipulation or a significant concern that there is inadequate or inaccurate public information about the issuer. The Commission's exercise of its trading suspension authority has not been challenged, with the exception of one case. Under SEC v. Sloan, the Commission cannot impose consecutive trading suspensions for the same security unless there are new developments giving independent grounds for the suspension.¹

The Commission has effectively utilized its trading suspension powers to protect investors and to maintain the integrity of the trading markets. At the same time, it fully appreciates the emergency nature of the suspension order and has attempted to utilize its authority judiciously, taking into consideration any significant collateral impacts of such an order. One such consideration is the effect of a trading suspension on existing shareholders.

8. *With respect to micro cap fraud, are there matters under investigation by the SEC that either do not reach the level of formal investigation or do reach that level, but do not result in SEC action because the Commission does not have the resources to deal with them?*

- A. *If so, does the SEC have a practice of referring the matters to either the NASD or to a state so that they can consider taking action?*
- B. *If the SEC has no such practice, should it have one?*
- C. *If so, should the SEC have a policy of following up with the NASD and the states on a regular basis to inquire as to the status of those referrals?*

Like other law enforcement agencies, the Commission's resources are finite, and the staff is constantly evaluating and reevaluating the best use of its resources. Cases are developed, and staff is assigned, based on management's views of the constantly changing enforcement needs and priorities. For

¹ 436 U.S. 103 (1978).

example, in recent years a large number of staff members in the Los Angeles Regional Office were assigned to investigations relating to the Orange County matter, and a large number of Home Office staff were assigned to the investigation which led to the Commission's report on the NASD.

The Commission coordinates enforcement efforts with the SROs and criminal and state authorities to maximize enforcement efforts. The Commission provides these other regulatory entities with information concerning possible violative activities when appropriate and receives leads and information from these other entities in the same way. Leads we receive or develop would be passed along on an informal basis; information on investigations we have opened would be shared through the Commission's access program, discussed above. The information provided is, of course, of varied value and quality, and Commission and other agencies do not seek status reports on results.

9. *Is investigative testimony taken by the Division of Enforcement sworn testimony?*

Yes. Testimony given in connection with a formal investigation is sworn testimony.

10. *For each of the past five years, how many cases has the SEC referred to the Department of Justice for perjury?*

Although the Commission does not maintain statistics on how many perjury cases have been referred each year for the past five years, at least twenty such cases were referred to the Department of Justice in fiscal year 1997.

11. *How much duplication of investigative effort is there between the SEC and the NASD?*

From time to time, there is some duplication of investigative effort because the jurisdiction of the Commission and NASD overlaps. As a matter of practice, the Commission coordinates investigative efforts with the NASD to divide responsibilities, maximize enforcement efforts, and avoid duplication.

12. *Should the national regulatory agencies put more emphasis on disciplining individual brokers and not limit disciplinary actions to firms and principals?*

If not, why? If so, what is being done and what is the timetable for implementing those efforts?

It is important for the regulatory agencies to strike a balance when disciplining individual brokers and firms and principals. For example, the Commission has an aggressive enforcement program that seeks to get and keep "bad" brokers out of the securities industry. Enforcement actions brought by the Commission against broker-dealers have nearly doubled since 1990. Similarly, the Commission and the SROs

have been putting pressure on brokerage firms and supervisors to closely monitor the activities of brokers, particularly those with a disciplinary history. The number of enforcement actions brought by the Commission against supervisors and firms has more than doubled since 1990.

13. *Right now, it appears as if a lot of bad actors - individuals and firms - are let off with essentially nothing more than a slap on the wrist - suspensions that allow them to resurface with another firm, or fines that may be less than what they bilked from the victims.*

Should the regulatory agencies invoke stronger sanctions against wrongdoing by brokers and firms?

If not, why?

If so, what is being done to develop stronger sanctions and what is the timetable for implementing those sanctions?

As stated in the response to Question 12 above, the Commission has been aggressive in bringing enforcement actions against wrongdoers and has sought appropriate sanctions against them. For example, the Commission has barred individuals from the securities industry altogether - and not just from associating with broker-dealers. The Commission has sought, in addition to civil penalties, disgorgement from the wrongdoers, which is generally returned to defrauded investors. In a number of recent cases, the Commission also has worked with the criminal authorities to ensure that "bad" brokers are criminally prosecuted as well.

In the area of failure to supervise, the Commission has recently toughened the sanctions against individuals. The Commission now disfavors settlement offers in failure to supervise cases that do not include "time out" from the securities industry for at least some period of time.

14. *What specific steps does the SEC plan to take in furtherance of a "zero tolerance" policy for micro-cap fraud, and what is the timetable for implementing those actions?*

The Commission has a three-part strategy to address fraud in the micro cap markets. The three parts of the strategy are prevention, enforcement, and regulatory initiatives. Obviously, preventing securities fraud is far more effective than seeking to punish wrong-doers after the fact. The Commission seeks to prevent securities fraud through inspections of broker-dealers, market and Internet surveillance, the review of forms filed with the NASD by brokers who trade in penny stocks to identify offerings that may be fraudulent, and investor education. The Commission's Division of Enforcement works with the criminal authorities to lock up recidivist brokers and deter wrongdoers. The Division also coordinates enforcement efforts with state

authorities and other securities regulators to maximize resources. Over the last several months, the Commission's staff has worked with the NYSE and the NASD to develop rules that address the vulnerabilities in the lower-end segment of the market. (For a more complete discussion of the regulatory initiatives, see our response to Supplemental Questions 4 and 8.D. from Chairman Collins and Question 17 below).

15. *In many instances, states take action to bar a firm and/or an individual and then those actors simply move to another state and continue to bilk investors. Often, the national regulatory agencies are much slower to take action.*
- A. *Should there be some mechanism put in place to ensure that once a bad actor is sanctioned by a state, investors across the nation can be protected? Do you support the suggestion made by Mr. Borg, representing NASAA, that the SEC should interpret Section 3(a)(39) of the Exchange Act, imposing statutory disqualifications, to apply to state actions?*
 - B. *If you believe that the SEC has the discretion to interpret the statute in that manner, will you initiate an SEC action to apply such an interpretation? If so, when?*
 - C. *If you believe that the SEC does not have the discretion to interpret the statute in such a manner, will you support a change in the Act to codify such an interpretation?*

Under the current statutory scheme, the Commission does not have the authority to interpret Section 3(a)(39), which defines the scope of the term "statutory disqualification," in the way Mr. Borg has suggested. In particular, Mr. Borg recommended that the Commission interpret the term "appropriate regulatory authority," as used in Section 3(a)(39), to include state securities regulators. However, the term "appropriate regulatory authority" is defined in Section 3(a)(34) of the Exchange Act and refers generally to the Commission and federal banking regulators. The legislative history of this section indicates that this term was included in the Exchange Act to recognize the overlapping responsibilities of the Commission and the federal banking regulators in certain areas of the federal securities laws.

The Commission's staff acknowledges the need to recognize certain state actions as disqualifying events for purposes of the federal securities laws, especially given the enhanced regulatory role allocated to the states under the National Securities Markets Improvement Act of 1996 ("NSMIA").²

² Among other things, NSMIA shifts to the states the responsibility for regulating
(continued...)

Accordingly, it would be useful to begin discussions between the Commission and appropriate Members of Congress regarding amendment to the definition of "statutory disqualification" that would include bars imposed by state securities regulators.

16. *A lot of attention has been given to the shortcomings of the CRD. You mention it in your testimony. NASD is expected to institute a new system in 1998. However, as some states have pointed out, the revisions have been underway for many years.*

The SEC is the only body that has the authority to put the NASD on a firm timetable. Is the SEC prepared to issue such a timetable if the changes aren't in place in 1998?

The Commission's staff does not think that it will be necessary for the Commission to establish a timetable for the NASD. First and foremost, the NASD is better suited to establish a timetable regarding the CRD because they are responsible for its day-to-day operations, as well as the development of its redesign. Nevertheless, Commission staff continues to work closely with the NASD and with NASAA regarding technical, program, and policy issues of the CRD system; and the staff will continue to monitor the timetable that has been set.

The staff would like to clarify what the NASD expects to institute over the next year for the CRD. Among other things, key initiatives proposed for 1998 and 1999 include the Internet, Web-based form filing, and the implementation and processing of new uniform forms.

17. *In your testimony, you note some of the regulatory changes that have been made to facilitate the formation of capital. One such change has been Rule 504 of Reg. D, which allows companies to raise up to \$1 million per year in seed capital without complying with the registration requirements of the securities laws.*

How much has that contributed to the micro-cap fraud we are seeing today, and might it be necessary to scale back the \$1 million threshold?

Rule 504 was revised in 1992. Prior to its revision, if the offering was state registered, there were no resale restrictions. Rule 504 was revised to eliminate resale restrictions, regardless of state registration.

²(...continued)

investment advisers with assets under management of \$25 million or less (excluding those who are acting as advisers to a registered investment company). As a result, states will now be the sole regulators of a large number of investment advisers.

The structures that the Commission has put in place to combat secondary market fraud apply to the resales of securities offered under Rule 504. For example, the penny stock rules and Rule 15c2-11, which requires broker-dealers to have a reasonable basis for believing the accuracy of certain required information, apply to these resales.

The Commission's staff is revisiting Rule 504 to determine whether changes need to be made. In this regard, we will consider: (1) whether there should be a federal information requirement for these offerings; (2) whether the exemption should be conditioned on state registration of the offering; and (3) the resale status of securities sold in exempt offerings.

In reviewing this issue, the staff will be careful to: (1) balance the need of legitimate small businesses to raise capital efficiently with the continuing presence of fraud in the secondary markets; and (2) not impose federal regulations that unnecessarily overlap state regulation of offerings.

18. *In 1992, Congress asked the General Accounting Office to evaluate the regulatory actions necessary to reduce penny stock fraud in the wake of enactment of the Penny Stock Reform Act of 1990.*

In 1993, the GAO reported the conclusions of both regulators and law enforcement officials that penny stock fraud is frequently committed by branch offices of securities dealers, rather than merely in main offices. It cited past experience that examinations of those branch offices uncover fraud and abuse -- fraudulent misrepresentations, misuse of customer fund, excessive mark-ups, unregistered broker-dealers selling securities, and other abuses.

Apparently, internal NASD documents indicated as far back as February, 1989 that greater emphasis needed to be placed on examining branch offices. Then, four years later, in 1993, the GAO reported that the NASD does not regularly conduct such examinations, and specifically recommended that the SEC require the NASD to do so.

- A. *Has the SEC followed this recommendation and required the NASD to conduct examinations of branch offices? If not, why not?*
- B. *If so, has the SEC informed the NASD of this requirement, and when did it do so? What kinds of examinations does the SEC require, and how regularly are they required?*

- C. *What follow-up does the SEC do to ensure that the NASD is in fact conducting these branch office examinations, that they are meaningful, and that they are conducted regularly?*

Branch office examinations are an integral part of an SRO's examination program and are important to uncovering fraud and abuse. To this end, the staff has continually stressed to the NASD the importance of conducting branch office examinations. The adequacy of the NASD's branch office examination program has been a significant focus of several meetings with the NASD in the past few years.

The NASD currently conducts broker-dealer branch office examinations as part of its examination program in its district offices. In addition, the NASD has conducted branch office examinations as a part of the recent joint SRO regulatory examination sweeps and the NASD's own national regulatory program. The staff has continually recommended to the NASD that it increase the number of branch examinations conducted.

To target branch office examinations for review, the NASD district offices generally rely on customer complaints, terminations of registered representatives for cause, and micro cap activity by particular branches. We have emphasized to the NASD that it should expand the criteria it uses to select branch office examinations to include additional sales practice-related criteria. In this regard, the staff has been working with the SROs to refine and develop the criteria that can best be used to select particular branch examinations for review. The NASD also is currently developing an automated risk-based examination system that will enable the NASD as part of its examination program to identify firms and branches with the greatest regulatory risks. The staff is closely monitoring the NASD's efforts and progress in implementing this system.

Finally, to ensure that the NASD is conducting meaningful branch office examinations, the Commission conducts both oversight examinations of NASD examinations and regular inspections of each of the NASD district offices. A review of each NASD district office's branch examination program is an integral part of such inspections.

19. *What does Congress need to do, that it has not already done, to ensure that the problem of micro-cap fraud is effectively controlled? Specifically, a) is there certain specific additional authority that needs to be given to the SEC and the SROs and the states? b) do we need to extend the jurisdiction of the Department of Justice? and c) are there any changes in the securities laws that would [be] valuable in this effort?*

In general, the Commission believes it has broad authority in its own rulemaking and oversight of the SROs to address the major areas of concern raised by fraud in the micro cap market. Nevertheless, the Commission's staff welcomes the opportunity to work with the Subcommittee (and other appropriate committees) to consider whether appropriate legislative changes could be proposed to the Commission and Congress. In particular, several judicial decisions concerning whether certain Commission remedies are "punitive" have affected the scope of relief available to the Commission in some enforcement cases. This might be one area to explore.

20. *As a result of the abuses of the 1980s that led to the enactment of the Penny Stock Reform Act of 1990, the SEC set up a penny stock "task force" to focus specifically on penny stock fraud. However, that task force was disbanded and apparently there is no longer a group within the SEC that focuses on penny stock fraud.*

Please describe how the task force was organized, when it existed, and what it achieved?

The Commission's Penny Stock Task Force was established in 1988 by then Commission Chairman David Ruder to coordinate the Commission's response to the particular problems at that time. The Task Force sought to increase coordination of enforcement efforts with SROs and criminal and state authorities, consider regulatory initiatives, where warranted, and educate investors. As a result, at least in part, of the Task Force's efforts, over 300 broker-dealers engaged in fraudulent activities were closed and the Commission, the SROs, and state and criminal authorities brought a significant number of enforcement actions to address fraud in the penny stock market. In addition, the Task Force provided assistance to the Senate and House staffs in crafting the Penny Stock Reform Act of 1990, and the Commission adopted a series of new regulatory initiatives designed to help prevent misuse of blank check offerings and to address certain broker sales practice abuses. Having completed its mission, the Task Force was disbanded in 1995.

21. *Given that the losses attributable to penny stock fraud have tripled since the abuses which led the SEC to set up the task force in the first place, does the SEC plan to reinstitute such a task force? If not, why not?*

As Chairman Levitt indicated before the Subcommittee, a special Commission-wide Working Group on Micro Cap Fraud was created to bring together top officials from the Divisions of Corporation Finance, Enforcement, and Market Regulation and the

Offices of Compliance Inspections and Examinations, General Counsel, and Investor Education and Assistance. The Working Group has been meeting -- and will continue to meet -- regularly to exchange ideas and identify better ways to attack the current problems in the micro cap market.

To date, the Working Group has focused on possible changes to the rules governing market makers and clearing brokers and has begun to examine the costs and benefits of current capital formation rules. The Working Group has also been exploring how best to devise an early warning system for detecting fraud and how to use our enforcement resources most effectively to fight fraudulent practices in the micro cap market.

22. *About ten years ago, the Department of Justice, at the direction of Congress, mandated the creation of asset forfeiture divisions of the United States Attorneys' offices to pursue the assets of narcotics dealers and thus advance the war against drugs. The creation of the asset forfeiture divisions seemed to bring about tangible results. Would it be useful in the campaign against micro-cap fraud to direct the Department of Justice to set up either securities fraud task forces on a regional basis - the way organized crime task forces are set, for example -- or securities fraud divisions within the individual United States Attorneys' offices, the way asset forfeiture divisions are set up?*

The Commission has worked hard to foster good working relationships with the criminal authorities. The Commission staff, including its regional office staff, meet regularly and routinely with criminal authorities throughout the country to address securities fraud. As a result, the Commission often works in concert with criminal authorities in investigating and stopping securities fraud. For example, as mentioned above, in October 1996, the Commission worked with the U.S. Attorney for the Southern District of New York and the NASD on a year-long coordinated operation that focused on undisclosed kickbacks paid to brokers to induce them to sell stock to customers. Similarly, in February 1997, the Nevada U.S. Attorney announced that 12 defendants plead guilty to racketeering, securities fraud, money laundering, illegal structuring of monetary transactions and conspiracy to commit securities fraud and wire fraud charges in connection with the sales of the stock of three small cap issuers. Three of these defendants previously were named as respondents in an administrative proceeding brought by the Commission, and the Commission and the U.S. Attorney had worked together to ensure that the wrongdoers were brought to justice. These are but two examples of the types of cases where the Commission has coordinated efforts with the criminal authorities to address securities fraud in the micro cap market. The Commission's routine, regular, but informal, coordination with the criminal authorities has worked so well that we do not believe that a more formal program is needed.

**ALABAMA SECURITIES DIRECTOR JOSEPH BORG'S RESPONSE TO
SUPPLEMENTAL QUESTIONS BY SENATOR JOHN GLENN AS A FOLLOW-UP
TO THE SEPTEMBER 22, 1997 HEARING ON FRAUD IN THE MICRO-CAP
MARKET**

1. Should the national regulatory agencies be working more closely with the Department of Justice and state and local authorities to refer more cases for criminal action?

A. If not, why?

It is imperative that national regulatory agencies align closely with the Department of Justice and state and local authorities to refer more cases for criminal action. It has been the experience of state regulators in dealing with micro-cap fraud and firms such as Stratton Oakmont (as well as its progeny and predecessors) that civil sanctions have little or no effect. These firms, knowing they are manipulating the market to line their pockets with innocent investors' money, will not cease their activities on the threat of civil action. Knowing a civil action may be imminent will cause these principals and firms to speed up their activities to generate as much ill-gotten investor funds as possible. It is clear that these firms consider civil actions as "a cost of doing business."

During my testimony, I conveyed a story where a principal of one firm allegedly got up on a table and announced to his employees he had just been fined by one of the national regulatory agencies. After the requisite boos and hisses, this principal allegedly announced he had made ten times that amount of money in the same period of time, to which there were cheers. This is a clear illustration that civil penalties, when dealing with crooks and scam artists of this nature, are ineffective. Likewise, putting them out of business does nothing more than allow them to keep fraudulent profits from innocent investors and does not deter the second tier of fraudsters who have now witnessed the art of market manipulation from their elders and who re-enter the market with their own newly formed firms. The interconnections, detailed by the charts at the hearing, I believe are conclusive that this networking among micro-cap broker dealer manipulators exists.

Notwithstanding the need for criminal referral in these cases, there are some obvious barriers to inter-agency referrals. There are multiple causes for these barriers.

The first barrier has to do with properly crediting an agency for its work. Currently, regulatory agencies tend to confine their tasks to those matters which start-to-finish are within their statutory mandate. Consequently, agencies, having authority to bring administrative and civil action, tend to angle their objectives more towards these

remedies -- even when a criminal remedy accomplished by referral to another agency, might be the more effective means of addressing the violation.

Additionally, current constitutional case law creates barriers as well. The case of U.S. v. Halper, 490 U.S. 435 1989, established the principal that administrative fines or civil penalties in excess of the reasonable costs incurred by the agency in bringing the action, are deemed to be sufficient to cause jeopardy to attach for constitutional purposes. Consequently, the double jeopardy clause will prevent the subsequent criminal prosecution of an individual who has previously suffered "penal" fine, regardless of the fact that the fine was applied in a civil or administrative case. This means that if there is a criminal case referred, the administrative agency must, in a sense, forgo an important remedy or "stand down" in order to allow the criminal prosecution to go forward. Such regulatory selflessness is not expected unless the regulatory agency making the referral, and more importantly, the staff of that agency, is given considerable credit for the work done prior to the referral.

And finally, sometimes a lack of expertise with the subject matter violations sometimes causes prosecutorial agencies to forgo criminal prosecution of securities cases when they compete for attention with the more easily understood violent crimes or drug cases.

Despite these challenges, the SEC, the states and the NASD have made progress in the area of criminal referrals. I understand, for example, that the SEC now accounts statistically for criminal referrals. Additionally, several district offices of the SEC have lawyers cross-designated as Special Assistant U.S. Attorneys to work criminal securities cases. Moreover the NASD has supplied key information and other assistance in task force investigations involving the Justice Department. Finally, the states frequently arrange for the local prosecution of cases referred by state, federal and self-regulatory agencies. Particularly, in some jurisdictions, the state securities agencies have referred for local prosecution cases that have come first to the attention of the SEC, but because of their size, do not attract the interest of a federal prosecutor.

B. If so, how do you suggest this be done?

Despite the progress noted above, more needs to be done.

I would suggest consideration of the following ideas:

1. Promote joint investigations, whereby a team of investigators locates and pursues a target for investigation. The team, in some combination, should be made up of the Securities and Exchange Commission (SEC), NASD Regulation, Inc. (NASDR), State securities, and Department of Justice (DOJ) personnel, with each having an equal stake in seeing the case through to prosecution.

2. Maintain and disseminate to all regulatory agencies, as well as the Department of Justice, a contacts list on a state-by-state basis of those persons or departments having prosecutorial authority and responsibility for securities related cases. Not all states have equal authority with respect to the prosecution of cases and such a list will allow proper contacts to be made. Some agencies, such as Alabama, have the authority to prosecute cases directly from its Securities Commission and others are required to forward cases to state or federal prosecutors.

3. Continue and expand the practice of cross-designation of special assistant prosecutors to provide expertise in the prosecution of criminal securities cases.

4. In addition to contact lists and joint training efforts, a better dialogue and the sharing of information needs to be promoted between local and federal offices. As investigations develop at either the state or federal level, the corresponding authority should be notified of the ongoing investigation so the local jurisdiction and the federal agency involved may coordinate their investigative activities without duplicating efforts. If this is done in conjunction with the Department of Justice through its US Attorney's office, FBI and other affiliated agencies, such as National White Collar Crime Center (NWCCC), Regional Organized Crime Institute Center (ROCIC), or other Regional Information Sharing Systems (RISS) projects, greater efficiency can be achieved and the local level cases may come to trial quicker.

2. Should more efforts be made by the national regulatory agencies to discipline more of the rogue brokers, rather than limiting disciplinary proceedings to firms and principals?

It is imperative national regulatory agencies expand their disciplinary activities to lower echelon agents and cold-callers. Once firms and principals of fraudulent firms are put out of business, the agents of the defunct firms, who have now learned the trade, become the "big dogs" of new firms and move into the equivalent positions that prior principals formerly held. Unless rogue brokers are disciplined and forced out of the industry, they become principals with new firms and the lying, cheating, and stealing continue.

3. Do the national regulatory agencies have adequate sanctions? If not, what types of changes does NASAA feel are needed?

National regulatory agencies' sanctions may need to be strengthened. There appears to be little interest in state enforcement actions by the local Department of Justice agencies unless the matter is of national significance (although this varies by region). The states recognize, however, that the national agencies generally look at national and global matters and defer action on local cases to state regulators. However, better communication and coordination between state and national regulatory actions could facilitate the effectiveness of Cease and Desist ("C&D") orders and license suspensions. Consideration should be given to establishing a protocol for national regulatory agencies

to better monitor and rely upon state orders, and be available to partner with state agencies in closing down rogue brokers, firms, and agents before further damage is sustained.

4. You suggest extending the statutory disqualification provisions of the Exchange Act to cover disciplinary bars by state agencies. Please elaborate on why this is needed.

The Exchange Act of 1934 does not specifically reference state securities actions as a statutory disqualification. However, the SEC may have the existing statutory authority to authorize the disqualification of persons based on state orders by interpreting the language in Section 3(a)(39), [(i) an order to the Commission, other appropriate regulatory agency], to mean state securities agency. Perhaps due to this vagueness, actions taken by state regulatory agencies are not recognized by the national regulatory agencies which results in redundant actions being taken at the state and federal level. This is a waste of precious regulatory resources. The national regulators could rely upon state disciplinary actions such as C&D orders, and Orders of Suspensions/permanent bars to put the broker/agent out of business before the situation spreads and gets worse.

5. How important is it to improve the quality and quantity of CRD information that is available to investors?

In order for investors to be better equipped to make an informed decision when selecting a broker, both the quality and type of CRD information is very important and needs to be improved. The current disclosures provided by the CRD system are very confusing due to the redundancy of their presentation and the way such information is coded. Under the redesigned CRD, the presentation of such information should be much improved. In addition, currently only certain information is released to the public by the NASDR from the disclosures that are made and inputted into CRD, although the states generally provide investors access to most of the disclosures that are available from the CRD. Under the NASDR's new Public Disclosure Program, the NASDR is proposing to provide investors with disclosures of all reportable events filed with the CRD. This broader disclosure policy will provide investors with better access to this important information.

A. What specific improvements are needed?

One of the most critical improvements needed for the CRD is the modification to its architecture to permit a real time review of disciplinary filings by states. The system lacks a "flagging" medium to notify state regulators of the types of new disciplinary filings on the system. Without such a "flagging" medium, the number of new filings are far too overwhelming to sort and review on a real time basis. This is expected to be addressed in the redesigned CRD.

6. From the state regulators' perspective, what are the most effective actions that the national regulatory agencies could take to prevent and combat micro-cap fraud?

a) The national regulatory agencies review registration filings for new broker/dealer firms. A more critical review of the principals of the firms might red flag those who use promoters or aliases and have histories of disciplinary actions that warrant additional scrutiny and might prevent the movement of rogue brokers from firm to firm. Therefore, a greater emphasis on naming individual principals and brokers as part of enforcement actions would have a positive long-term impact.

b) The companies who list on the OTC Bulletin Board get the benefit of the perceived linkage to the electronic NASDAQ marketplace. Presently, no background checks or financial statements are required of the principals, directors, or CEOs of these firms. Limited information on these individuals might be made available as well as some form of regular limited reporting of the financial statements of the company. Our entire public marketplace is based on disclosure of material information and this omission is a serious flaw.

The NASD is actively studying this segment of the market to determine how investors can obtain accurate and current information about the companies whose shares trade on the Bulletin Board. NASAA supports this effort and the educational effort to emphasize the distinct differences between the OTC Bulletin Board and The Nasdaq Stock Market.

c) Organized, coordinated federal and state criminal prosecutions for securities fraud would also assist to deter and combat fraud.

7. The Penny Stock Reform Act of 1990 required that brokers provide both oral and written disclosure to all prospective purchasers, and obtain signatures on such disclosure forms. Since one of the great concerns is that pressure tactics that cause misleading representations to be made to investors unfortunately are working, and thousands of Americans are in fact misled:

A. Is the problem as significant as it had been reported as being:

The problem is significant but the rules are not being adhered to and therefore it is difficult to access what the magnitude of the problem would be if compliance with the rules were more vigorously policed. An example that the problem appears not be abating can be seen in New York State. The New York Attorney General Office's Bureau of Investor Protection and Securities received a record number of complaints and inquiries from the investing public, approximately 3100 in 1996, up 40% from 1995. This year the office is expected to top that number by another 35%.

B. Since enforcement frequently is left to the states, how many states have stringent disclosure requirements?

For small public offerings of securities that may be considered micro-cap stocks because they are not listed on a national exchange, states have developed a uniform set of requirements that include additional uniform disclosure requirements used to identify conflict of interest situations and other risks unique to smaller deals.

In the area of broker licensing, every state except California has more stringent disclosure requirements and entry level thresholds for the licensing of individual brokers.

In the area of local inspection and examination of broker/dealer offices located in a particular state, state officials are limited to the federal standards established for books and records. NASAA has been working with the SEC to improve upon the existing standard. We hope a new rule will be adopted soon by the SEC.

C. Are these disclosure requirements anything more than the most meaningless of paper protections: For example, if only the federal government has disclosure requirements, and the SEC devotes precious little resources to enforce them in a micro-cap fraud context, what difference do these requirements make in terms of setting effective standards?

It is not effective to have only after-the-fact enforcement. In many instances, investors can not get their money back if they have been defrauded. It is just as important to point to the risks of the deals to investors more clearly before they invest so they may evaluate their potential exposure. In addition, one ongoing issue is whether "disclosure" of material facts is presented in a usable manner. The SEC's "Plain English" project should assist in this area.

D. If the goal is to dilute the coercive and misleading effects of telephone calls at the outset, before the customer is "in the stream," isn't it important to actually ensure that the full set of oral disclosures and warnings be made in each and every phone call between broker and customer?

It would be difficult to monitor directly all oral disclosures. NASAA supports the action taken recently by the NASD Board that approved a rule to require brokerage firms to tape all customer sales calls for two years if a certain percentage of the firm's brokers worked for firms that have been expelled for telemarketing fraud or sales practice abuse. This approach keeps a check on the problem brokers but does not burden that segment of the industry employing honest, scrupulous brokers. Many in the system, however, rely on the integrity of the firms themselves. As large, international firms seek to strip away regulations here in the US in order to create a level playing field, they unwittingly create loopholes for the fraudulent practices outlined in the hearing.

There is also the problem of unregulated cold-calling and a need for registering those "introducing" callers who are effectively unregulated and many times making sales. NASAA supports the NASDR's recent proposed interpretive release that would require all agents who communicate with the public relating to the offer or sale of securities to be registered. In addition, consideration should be given to setting minimum standards for training programs.

E. Should it not be a federal requirement that all such phone calls be taped and that the tapes be kept for some period of time so that if investors file a complaint, regulatory authorities can review the tapes and ascertain whether the disclosures were made, and take disciplinary action if they were not?

Many of the nation's firms routinely tape incoming calls. An analysis should be undertaken to assess the cost and practicability of taping all cold calls. The ultimate approach would be to tape all calls, but we suspect that substantial objection would be raised by the securities industry. For now, NASAA is supportive of the NASDR rule. The rule should be closely monitored to assure it is achieving the intended goals and to determine if further modifications will be necessary.

The adoption by the SEC of a federal Books and Records rule that will allow state regulators to conduct meaningful examinations of branch offices and follow-up with enforcement proceedings if necessary. Exams of firms are only as good as the records they are required to maintain, today's standard is a structural weakness.

8. What does Congress need to do, that it has not already done, to ensure that the problem of micro-cap fraud is effectively controlled? Specifically:

A. Is there certain specific additional authority that needs to be given the SEC, the SROs and the states?

a) As mentioned in my response to question #4, there should be a clarification that the SEC has the statutory authority to authorize the disqualification of persons based on state enforcement orders by interpreting the language in Section 3(a)(39), of the Securities Exchange Act of 1934 to include a state securities agency as an "other appropriate regulatory agency."

b) There should be licensing of unregistered cold-callers and a special licensing classification for stock promoters. Greater authority is necessary to regulate the action of stock promoters (individuals whose income is derived from putting together syndicates). As to the unregistered/unregulated cold-calling NASAA is committed to working closely with the SEC, NASDR, and NYSE to develop an effective regulatory response.

B. Do we need to extend the jurisdiction of the Department of Justice?

a) State and federal officials may wish to establish a direct mechanism to refer cases to the Internal Revenue Service (i.e. money laundering cases). The resources and the expertise of this federal agency could have an enormous positive impact.

C. Are there any changes in the securities laws that would be valuable in this effort?

Adoption by the SEC of a disqualification provision for SEC Rule 506 offerings similar to the disqualification provision currently existing for SEC Rule 506 offerings would have a salutary effect on investor protection. A disqualification provision means that an issuer or a person associated with an issuer that has obtained a disciplinary record in connection with securities activities may not rely on an exemption from registration for a specific time period to make a securities offering. The regulatory principle embodied in the disqualification provision is that a person who has demonstrated a propensity to violate the securities laws should not benefit from a registration exemption which, per force, provides less regulatory scrutiny.

Prior to NSMIA, state disqualification provision similar to SEC Rule 505(a)(2)(iii) applied to both SEC Rule 505 and 506 offerings. State level notice filings generally caught persons with a disqualification who sought to evade this prohibition. NSMIA preempted application of these provisions to SEC Rule 506 offerings and there have been instances of persons with significant disciplinary history, such as permanent SEC injunctions, offering and selling securities without disclosing their disciplinary past. The states believe that investor protection is better served by precluding persons with significant disciplinary history from being able to rely on the exemption in SEC Rule 506 for the same time period as applicable in SEC Rule 505.

It is prudent for the Permanent Subcommittee on Investigations to continue its series of valuable oversight hearings on the subject of micro-cap fraud. As a supplement to those changes we have cited, NASAA members pledge to work with you to evaluate what additional legislative initiatives may be necessary to combat this problem.

9. Regarding the consent decree entered into by NASD in connection with the SEC investigations, the SEC found that for a four-year period from 1990 to 1994, the NASD failed to take appropriate action to thoroughly investigate these problems, and that as part of the agreement with the SEC, the NASD undertook a series of remedial steps to prevent wrongdoing in the future.

What kind of remedial steps are not included in that agreement which you would like the NASD to undertake, or which you think might be valuable in combating the sort of micro-cap stock fraud this hearing has been called to address?

State regulators were not parties to the SEC/Justice investigation and therefore are not in a position to comment substantively. There already exists, however, regulations and guidelines that could be more rigorously enforced. It appears to me that our strong economy and unprecedented bull market have covered up a lot of problems in the micro-cap area. Regulators of all branches of government simply must come together to aggressively combat and prosecute those responsible for the problems.

Senate Permanent Subcommittee
on Investigations

EXHIBIT # 18

SUPPLEMENTAL QUESTIONS FOR THE RECORD
OF CHAIRMAN SUSAN M. COLLINS
Hearing Before The
U.S. SENATE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
September 22, 1997
Fraud In The Micro-Capital Markets,
Including Penny Stock Fraud

BARRY R. GOLDSMITH
Executive Vice President
NASD Regulation, Inc.

1. In footnote 2 of Chairman Levitt's written statement, the Chairman notes that "[t]he term 'micro cap' is not a term defined under the federal securities laws, [but that one definition of the micro-cap market includes] companies with market capitalizations of less than \$300 million.... In general, securities of micro cap companies are quoted on Nasdaq's OTC Bulletin Board, in the National Quotation Bureau's Pink Sheets and on the Nasdaq Small Cap Market."
- A. What is the NASD-R's best estimate of the dollar value of fraud in the micro-capital market as the NASD-R has defined it?
- B. What is NASD-R's best estimate of the dollar value of fraud in the penny stock market, i.e., the market of company stocks that trade at \$5 or less?
- C. According to a recent *Wall Street Journal* article, the incidence of penny stock fraud is on the increase, or, to use the article's headline, "penny stock fraud is roaring back." Does the NASD-R agree? If not, please explain why.
- D. In fact, the *Wall Street Journal* reports that "[r]egulators now estimate annual losses to investors at more than \$6 billion, triple the 1980s peak" of around \$2 billion. Is this a fair estimate? Why/why not? Does the NASD-R agree that in constant dollars, more money is being lost now to penny stock fraud than in the 1980s? Why/why not?
- E. What accounts for that increase? Why is it occurring?

ANSWER:

A and B. NASDR has not made dollar value estimates of fraud in any particular market. We believe that reliable estimates of this type would be difficult to make with any degree

of statistical rigor. Nor do we believe that they would add significantly to more precisely targeting our antifraud resources. We would refer you to the Bureau of Justice Statistics to obtain information on the methods, cost, and reliability involved in compiling such statistics.

C. We are not aware of increases in penny stock fraud as defined by the Penny Stock Reform Act of 1990 and the rules under it. We believe that such fraud has probably decreased as a result of pre-transaction requirements of that Act and the subsequent decrease in the number of firms that transact business in penny stocks. Findings of our 1993 examination sweep with the SEC and the state regulators bore this out. That sweep found widespread compliance with the penny stock rules and decreased activity in stocks covered by those rules.

D and E. As stated in A and B above, estimates of total fraud in securities markets are difficult to perform with sufficient rigor to result in reliable findings. As pointed out by SEC Chairman Levitt at the Subcommittee's hearings, the \$6 billion number was arrived at by multiplying an earlier estimate of \$2 billion in fraud, which was made by neither the SEC nor the NASD, by the growth in the markets since that first estimate was made. We are unable to vouch for the accuracy of the results of either the estimate, or the methodology used to update them.

2. Is the NASD-R observing a particular segment of the population that repeatedly is targeted for penny stock scams, such as the elderly? Does the NASD-R know how it is that scam artists obtain information on their targets?

ANSWER:

NASDR does not specifically monitor the segments of the public who purchase OTC securities. Our investigations indicate that elderly and unsophisticated investors, as well as more sophisticated investors may be the subject of abusive sales practices or fraud. Scam artists often obtain information on public customers through a number of sources including: Dun & Bradstreet lists, advertising in industry newspapers and trade journals, commercially available mailing lists based on demographic parameters, postcard mailings from individuals claiming to be an issuer's "public relations" officer seeking investors, and information obtained from various sources on the Internet.

3. Has the NASD-R initiated any outreach or investor education programs aimed at the population segments that are targeted by rogue brokers?
 - A. What are those programs?
 - B. How successful have they been?
 - C. How is the NASD-R going to build on them?

ANSWER:

A, B, and C. NASDR investor outreach and education programs are coordinated through the NASD Office of Individual Investor Services (OIIS), which manages joint investor programs for the NASD and both subsidiaries, NASDR and Nasdaq. The OIIS addresses groups that have been targeted by rogue brokers, but primarily focuses on educating and protecting *all* individual investors.

NASDR and OIIS target various groups to improve investor education and protection through a broad array of activities, from printed materials, interactive media, and speaker and conference participation. Through these activities we fulfill the NASDR philosophy of protecting investors and strengthen market integrity through vigorous and even-handed self-regulation. Targeted groups include general investors, elderly, mainly through the American Association of Retired Persons (AARP), students, and women's organizations and associations. The printed materials and programs available include:

Printed Materials

- *NASDR Investor Protection - Market Integrity; There Are Rules To Protect You; What To Do If A Stockbroker Calls To Pitch An IPO* (attached). These booklets have been widely distributed in the investor package and at investor fairs. Distribution will be increased through adding mailings and distribution at additional investor forums or conferences held by our targeted groups. Additionally, several new brochures are being considered: The Basics of Investing, How to Read A Prospectus, How To Use the Arbitration and Mediation Process, How To Select A Broker, and Frequently Asked Questions. In addition, the NASD is currently working with the SEC to revise and update the *Invest Wisely* brochure.
- *Investor Insight* newsletter (attached) - All issues have been well-received, and the first issue went into a third printing due to its popularity at investor fairs. The newsletter

distribution will be increased through an expanded mailing list. Updates on NASDR activities will be continued in the newsletter.

- *PennySavers* (attached) - Three PennySaver articles have been published in 1997. The NASD will print at least nine more PennySaver articles over 1997-98.
- <http://www.invest.carefully> (attached) - This brochure describes the possibilities and pitfalls of using the Internet as an investment tool, advises on how investors can protect themselves in on-line investing, and points out safe web sites for help.
- *Limit Order Rules - New Opportunities For Better Prices* (attached) - This brochure went into a second printing. Brochures will be updated or created as rule changes affecting investors occur.
- Other Brochures - *Invest Wisely/Invest Carefully/Dispute Resolution* (attached) - These brochures have been distributed with the investing package, and at conferences. These brochures will continue to be printed and distributed. *Invest Wisely* is being revised and updated as a joint project with the SEC.

Programs

- Toll-Free Hotline for Investing Information Package (800) 334-0668 - Since the phone number was first promoted in March 1997, the NASD has received almost 5000 calls for investor information. This number will remain available to all investors to call for a free package of investing materials.
- Dispute Resolution Process - NASDR operates the largest forum of dispute resolution for the securities industry in the U.S., to resolve matters between an investor and broker. The arbitration and mediation processes are continually being reviewed and improved in order to best serve investors' needs. We have briefed investor groups on an ongoing basis about the NASDR's progress in this area, and have solicited their views and input. NASDR will continue to review and improve the dispute resolution process. In addition, staff from Dispute Resolution will be attending investor fairs in 1998 to explain the process and answer investor questions.
- AARP - The NASD is working with AARP to communicate investor protection issues to its membership. The AARP program is still in development. The AARP program will be enhanced and continued throughout 1998.
- *The Basics of Investing: A Guide for Educators* (attached)-- This six-unit *Guide* was created with the National Institute for Consumer Education for teaching personal finance and investing. Feedback from teachers is requested both in training workshops as well as

on the web site. Oral and written feedback to date has been positive. Schools, school districts, and government agencies have requested the *Guide*. The Guide will continue to be available on the web site, and teacher training on using the Guide will be ongoing throughout next year.

- Public Service Announcements (PSAs) -- The NASD is now running three PSAs on television and radio, in both English and Spanish, one of which specifically promotes the securities industry public disclosure hotline that makes the disciplinary histories of all brokers available to the public. In the campaign's first four months, the PSAs aired more than 40,000 times for a cumulative airtime value of approximately \$1.4 million. PSAs will continue to run into 1998.
- Web sites -- Investors may visit four corporate web sites: nasdr.com, nasd.com, nasdaq.com, and investor.nasd.com. The nasdr.com site receives 8,000 hits a day, up from 3,500 earlier in the year. The nasdaq.com site now receives 6,000,000 hits per day. The nasdr.com web site is being expanded to not only receive CRD and public disclosure requests via email, but to provide the CRD information on the site. Additionally, a list of frequently asked questions will also be made available for investors. Both sites will be maintained and updated on an ongoing basis.
- Public Disclosure Hotline (800) 289-9999 - This hotline is heavily promoted through the PSAs, literature, speeches and media appearances, and provides investors with a means for checking the disciplinary history of a broker. The hotline has received over 110,000 calls so far in 1997. This hotline will continue to give investors the information they request on a broker in a timely and accurate manner.
- Women's program - The NASD, NASDR, and Nasdaq are currently in the process of developing a comprehensive program to address the investing myths, questions, and needs of women. The women's program is currently in the planning stage and will be measured as it is implemented through written surveys, customer comments and feedback, and distribution of printed materials. Investing education and protection information for women will be provided on an ongoing basis through personal contact, conferences, exhibits, speeches, printed articles, web site information, and materials. The NASD plans to increase the number of groups that will be contacted over 1998.
- Media events - The NASD is investigating the possibility of teaming with print media outlets in targeted markets to conduct a half day Investor Forum. The joint venture efforts with media outlets are part of an initiative under the "Promoting Financial Sense" campaign. NASD will also have NASDR and Nasdaq staff on hand to conduct seminars and answer investor questions.

- ¹ **Speakers, Conferences, Investors Fairs** - In 1997, the NASD and NASDR have attended approximately 70 investor fairs and forums around the United States. In 1997 alone, the NASD and NASDR attended approximately 70 investor fairs and forums around the United States, reaching over 500,000 investors. We are expanding our participation to include sponsoring events, setting up exhibit booths and sending speakers to conferences being held by targeted groups, such as women's associations, teachers' associations, or the AARP.
- **Advising Elgin Project** - Nasdaq has participated in a yearlong project, Advising Elgin, as a co-sponsor with *Money* magazine. Joining with Microsoft and Fidelity Investments, the project is designed to raise the financial IQ in the typical American community of Elgin, Illinois. The project features a long list of educational offerings, including seminars and workshops free to Elgin residents, personalized financial planning sessions, and a dedicated Elgin Internet web site.
- **Alliance For Investor Education** - The NASD plays an active role in the Alliance, which is a consortium of organizations advancing investor education. The group has begun production of a web site.
- **Investor Input** - The NASD actively solicits input from investors and consumer groups to requests for comments on regulatory proposals published in our *Notices To Members*, which are also published on our web site. To ensure awareness of these proposals, they are sent in hard copy to the leading investor and consumer groups with a letter expressing our interest in their comments.

4. The trade press and popular press in recent months have expressed the view that reforms are much needed in the NASD's bulletin board market, a market with no Securities & Exchange Commission ("the Commission") reporting requirements and no public disclosure requirements. One recent *Wall Street Journal* article states that there are significant problems with fraud on the over-the-counter market. In fact, Barry Goldsmith, Executive Vice President of NASD-R, has gone on record stating "[l]et me be blunt, there are significant problems in the over-the-counter market and a strong regulatory response is needed."
 - A. Does the NASD-R adhere to that statement?
 - B. Among the suggested reforms to the bulletin board, are:
 1. Holding market makers responsible for *verifying* company financial information and requiring annual updates to that data.
 2. Making publicly available the company information market makers file with the National Association of Securities dealers.
 3. Requiring all bulletin board companies to file financial reports with the Commission.
 4. Updating the penny stock rule, possibly raising the definition of a "penny stock" to \$10 or \$15 per share.
 5. Giving the NASD unilateral authority to halt trading in stocks where fraud is suspected.
 6. Revising the Commission's registration-exemption rules to close loopholes.
 - C. To what extent, if at all, does the NASD-R agree with the merits of each of these? Which reforms should be accorded the highest priority? Why?
 - D. In what ways will each one of these reforms help stem the tide of penny stock scams?
 - E. Can the NASD-R give us an approximate timetable that the NASD-R expects each one of these proposals to go into effect? Have they been submitted by the NASD to the Commission for its approval? If not, when does the NASD-R expect them to be submitted?

ANSWER:

A. While NASD Regulation is of the view that the overwhelming majority of individuals in the securities industry are honest professionals who comply with the law, it also believes that there are significant problems in the recommendation, sale and trading of securities in the over-the-counter market and that a strong regulatory response is appropriate. The abuses in this market, in our view, generally involve the securities of thinly capitalized micro-cap companies. As answer B and C below indicate, we have and continue to respond to these abuses.

B and C. With regard to B.1 and B.4, we are actively studying the issues relating to the quoting of securities in the over-the-counter market and the operations of the Over-the-Counter Bulletin Board. In addition to focusing on NASD rules in this area, we are also studying Rule 15c2-11 and the Penny Stock Rules. Rule 15c2-11, subject to certain exemptions, requires a market maker that initiates a quotation in any quotation medium to review certain financial information about the issuer. We are studying this rule with the SEC, and reviewing the type of information that is required to be reviewed and whether such information should be updated on a more regular basis. We will also raise with the SEC whether the information filed by market makers under Rule 15c2-11 should be more widely available. The SEC Penny Stock Rules require that certain disclosure be given to an investor prior to purchasing a penny stock. This includes disclosure of the compensation to the individual registered representative and the firm, the current quotations for the security and, with certain exceptions, a written suitability determination. The current rules include certain exemptions, and for example, do not apply if a security is traded at a price greater than \$5.00 per share. We are studying these exemptions with the SEC in an effort to address instances where trading is effected over that price to avoid the requirements of the rules. While the SEC must determine the appropriate regulatory structure for its rules, we have continuing discussions with SEC staff and are studying these issues to meet the concerns we see in the microcap market.

With regard to B. 2, B.3, and B.5, a major focus of our concerns in the trading of microcap securities is the lack of current financial information available to the public about the issuers of securities that trade on the OTCBB. To ensure that there is information available to the public, we are studying a proposal that would limit quoting on that system to the securities of issuers that file periodic reports with the SEC, or with banking or insurance regulators. We are also studying a proposal to expand NASDR's authority to include quote halts on the OTCBB, in certain limited circumstances. We are continuing to study the regulatory issues relating to both of these proposals.

With regard to B.6, we are not studying the SEC's regulatory structure for registered and exempt offerings and would refer you to the SEC.

D. The major impact of the proposals discussed above will be to provide more information to the public investor. The proposal to limit the OTCBB to the securities of issuers that provide periodic reports to the SEC will ensure that timely financial information is available to the public and to the marketplace for all issuers whose securities are quoted on that system. Other proposals we are studying would seek to ensure that market makers have current information about the issuers whose securities they quote, and that the investing public receives adequate risk disclosure about investing in the OTC markets.

E. NASDR is considering these various initiatives and has not yet submitted any of these proposals to the SEC for approval. While we have not set a date for submission of proposals to the SEC, we are moving forward in a prompt manner. We have discussed many of these proposals with our SRO committees and have obtained their input. They will be considered by the NASDR Board of Governors in the near future. Prior to their submission to the SEC, they will likely be issued for comment by our members and the public. Those initiatives that involve consideration of changes to the SEC rules are being discussed with SEC staff, and we refer you to the SEC for a timetable on those proposals.

5. Mr. Goldsmith's prepared statement indicates that "[c]ompanies trading either on Nasdaq's SmallCap Market or the Nasdaq National Market -- the two respective tiers of The Nasdaq Stock Market --- are required to make extensive financial disclosure and meet well-established listing standards [and that] these standards are being strengthened, particularly in the Nasdaq SmallCap market."
- A. How are the listing standards being strengthened?
- B. Why are the SmallCap listing standards being strengthened? What kind of study went into the decision to strengthen those standards?
- C. Those standards as we understand it, were approved by the SEC in August. Are they therefore in effect now? When will they go into effect?

ANSWER:

A. Earlier this year Nasdaq proposed, and the SEC approved, significant changes to strengthen the qualitative and quantitative standards for issuers listing on Nasdaq. These changes were most significant in the Nasdaq SmallCap Market, where, in addition to a substantial increase to numeric standards, corporate governance requirements were imposed for the first time. The Nasdaq Stock Market, like other national securities markets, has formal company listing requirements, electronic surveillance of trading, real-time dissemination of quotations and trade reports, order-routing and execution systems, and limit-order display capabilities. The recently approved changes materially enhance the threshold criteria necessary to qualify for listing, establish a \$1 minimum bid price and, for the first time, extend the corporate governance requirements applicable to National Market companies to SmallCap Market companies. The minimum bid price requirement provides a safeguard against certain market activity associated with low-priced securities, and enhances the credibility of the market. Nasdaq is the only market that has a stated minimum bid price requirement. In addition, the changes add a requirement that auditors of all Nasdaq-listed companies be subject to practice monitoring under a program such as the AICPA SEC Practice Section peer review program. Such a program must provide that an accounting firm's quality control system be peer reviewed every three years. Today the quantitative listing standards for the Nasdaq Small Cap Market generally equal or exceed those of the Boston, Chicago, Pacific, Philadelphia and American Stock Exchanges. The tables after part C of this answer provide a comparison of the old and new standards. A summary of the corporate governance requirements now required for companies listed on The Nasdaq SmallCap Market include:

- Distribution of annual and interim reports
- A minimum of two independent directors

- An audit committee, a majority of which are independent directors
- An annual shareholder meeting
- Quorum requirement
- Solicitation of proxies
- Review of conflicts of interest
- Shareholder approval for certain corporate actions
- Voting rights

B. Nasdaq qualification requirements for listing of securities on the National Market and SmallCap Market were last revised in 1989 and 1991, respectively. Since that time, The Nasdaq Stock Market witnessed significant growth in the size and number of listings and volume of transactions. Accompanying this growth has been an increase in participation of individual investors, and heightened public awareness and expectations for Nasdaq listed companies. Nasdaq recognized that along with this growth and the changes in the market, a commensurate level of quality and investor protection is needed. Nasdaq believes it is important to emphasize not only ensuring that all Nasdaq companies warrant listing by virtue of the compliance with the applicable qualification requirements, but also that the qualification requirements themselves are in fact appropriate and designed to foster the protection of investors and enhance the credibility of the market.

C. The standards were approved on August 22, 1997. The initial listing standards are retroactive to March 3, 1997, the date that they were filed with the SEC. Companies listed under the new initial listing standards are immediately subject to the new maintenance standards. For companies that were listed under the old initial listing standards, the maintenance standards are effective February 23, 1998, six months after the SEC approved them. The delayed effective date for the maintenance standard allows currently listed companies the opportunity to come into compliance with the new requirements.

Comparison of Previous and New Listing Criteria for The Nasdaq SmallCap MarketSM

	SmallCap Market Entry Standards		SmallCap Market Maintenance Standards	
	Previous	New	Previous	New
Net Tangible Assets ¹	N/A	\$2,000,000	N/A	\$2,000,000
Market Capitalization	N/A	\$500,000	N/A	\$500,000
Net Income (2 of last 3 years)	N/A	\$250,000	N/A	\$250,000
Total Assets	\$4,000,000	N/A	\$2,000,000	N/A
Total Equity	\$2,000,000	N/A	\$1,000,000	N/A
Public Float (Shares)	100,000	N/A	100,000	N/A
Market Value of Public Float	\$1 Million	N/A	\$200,000	N/A
Bid Price	\$3.00	N/A	\$1.00	N/A
Market Makers	2	N/A	2	N/A
Shareholders	300	N/A	300	N/A
Operating History (years)	N/A	N/A	N/A	N/A
Market Capitalization	N/A	N/A	N/A	N/A
Corporate Governance	N/A	N/A	N/A	N/A

¹ Net Tangible Assets equals Total Assets less Total Liabilities & Goodwill.

² New entry standards require: \$4 million in Net Tangible Assets or \$750,000 in Net Income in 2 of the last 3 years or Market Capitalization of at least \$50 million.

³ Under the new standards, for continued inclusion an issuer must maintain Net Tangible Assets of \$2 million or Net Income of \$200,000 in 2 of last 3 years or a Market Capitalization of at least \$35 million.

⁴ Market Capitalization must be at least \$30 million in Operating History is less than 1 year.

Comparison of Previous and New Listing Criteria for the Nasdaq National Market[®]

	Alternative 1: Entry Standards		Alternative 2: Entry Standards		Alternative 3: Entry Standards		Nasdaq National Market Maintenance Standards	
	Previous	New	Previous	New	Previous	New	Previous	New
Net Tangible Assets ¹	\$4,000,000	\$12,000,000	\$12,000,000	\$12,000,000	\$12,000,000	\$12,000,000	\$1,000,000	\$1,000,000
Market Capitalization	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Total Assets	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Total Revenue	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Net Income (2 of last 3 years)	\$400,000	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Pre-Tax Earnings (2 of last 3 years)	\$750,000	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Public Float (Shares)	300,000	N/A	1,000,000	N/A	N/A	N/A	100,000	N/A
Market Value of Public Float	\$3,000,000	N/A	\$15,000,000	N/A	N/A	N/A	\$1,000,000	N/A
Bid Price	\$5.00	N/A	\$3.00	N/A	N/A	N/A	\$1.00	N/A
Market Makers	2	N/A	2	N/A	N/A	N/A	2	N/A
Shareholders	400	N/A	400	N/A	N/A	N/A	400	N/A
Operating History (years)	N/A	N/A	3	N/A	N/A	N/A	N/A	N/A

¹ Net Tangible Assets equals Total Assets less Total Liabilities & Goodwill.

² Issuers are required to maintain \$1 million in Net Tangible Assets or \$2 million if the issuer has had losses in 2 of the most recent 3 years or \$4 million if losses in 3 of the most recent 4 years.

³ An issuer qualifying for initial inclusion under Alternative 3 must have Market Capitalization of \$75 million *or* \$75 million in both Total Assets *and* Total Revenue.

⁴ An issuer qualifying for continued inclusion under Alternative 3 must have Market Capitalization of \$50 million *or* \$50 million in both Total Assets *and* Total Revenue.

6. Mr. Goldsmith's statement also indicates that, in terms of strengthening investor protection, "we need to explore rule changes that would place tougher new requirements -- *beyond the existing suitability requirements* -- on brokers to confirm with their customers, *based on objective criteria*, that purchases of these types of securities are suitable investments."
- A. What are the specific "changes *beyond existing suitability requirements*" that Mr. Goldsmith is alluding to here? How would they work?
- B. Are these "changes" Mr. Goldsmith referenced actual formal proposals, pending deliberations, or are they merely ideas floating around? If the latter, please tell us when they will take the form of formal recommendations?

ANSWER:

A. We are considering specific proposals to make the broker's existing duty of due diligence higher in the recommendation of OTC securities. One such approach would require a broker, prior to recommending a transaction in the over-the-counter market, to review the issuer's current financial information. This would be in addition to the broker's obligation to ensure that the recommendation is suitable for his customer under the NASD's suitability rule. That rule (NASD Rule 2310) requires a broker, when making a recommendation to an investor, to have reasonable grounds for believing that the recommendation is suitable for the customer based on the customer's financial and tax status, investment objectives and other information used by the broker in making a recommendation to the customer. Courts have also found that by making a recommendation, a securities dealer implicitly represents to a buyer that he has an adequate basis for the recommendation. See e.g., *SEC v. Hasho*, 784 F. Supp 1059 (S.D. NY 1992); citing *Hanley v. SEC*, 415 F.2d 589 (2d Cir. 1969). Rule proposals in this area would focus on the recommendation of OTC securities, and would be in addition to these regulatory requirements.

B. We are actively considering proposals in this area. Please refer to our answer to Question 4.E above. However we are unable at this time to announce our timetable publicly to make formal recommendations to our boards, and to the SEC. Our micro cap initiatives are a major priority in NASDR's regulatory program, and we are proceeding in a prompt manner.

7. It has been reported that the electronic Bulletin Board's "link to Nasdaq gives its listings credibility with unwary investors. At the same time, on-line technology simplifies the marketing of these stocks."
- A. Does the NASD-R agree that the Bulletin board's link with Nasdaq gives it credibility with unwary investors which unscrupulous market makers exploit? What if anything should be done to correct this, assuming a correction is in order?
 - B. Does the NASD-R favor of regulations that would forbid market makers from representing directly or indirectly that the bulletin board is affiliated with the Nasdaq market?
 - C. How would such a rule be structured? How would it be enforced?
 - D. If not, how would the NASD-R propose dispelling the public's mind of the fact that the bulletin board does not meet the listing and disclosure requirements of the other NASD markets?

ANSWER:

A. As Barry Goldsmith pointed out in the NASD's testimony to the Subcommittee on September 22, 1997:

A misperception that is frequently fostered by scam artists is that trading on the OTC Bulletin Board is akin to trading in a highly regulated market such as Nasdaq. They will often refer to an OTC stock as listing on "Nasdaq's OTC Bulletin Board" or on "the Nasdaq OTC" or some other deliberately confusing variation that improperly links the two.

B, C, and D. NASDR is considering many reforms to combat microcap fraud, and we refer you to the answer to Question 4 above for a discussion of them. We are especially concerned about the problems stemming from deliberately created confusion between Nasdaq and the OTC Bulletin Board. We are exploring ways to reduce the confusion, such as requiring a broker to disclose to his customers information about over the counter securities and their differences from those traded on a highly regulated market such as Nasdaq. We would require that investors acknowledge receipt of such a disclosure statement and would enforce such a rule by bringing disciplinary actions against our members and associated persons who violate it. We are also focusing on increasing

investor awareness of the differences between securities traded in the OTC market and those listed on Nasdaq.

8. The House of Representatives Report that accompanied the Penny Stock Reform Act of 1990 states that "[t]he fact that the penny stock market is so susceptible to manipulation makes it very attractive to unscrupulous securities professionals who are looking to deceive the public. *Recent evidence demonstrates that the penny stock industry is now fraught with repeat offenders of state and federal securities laws and other felons . . .* [f]or example, [a] NASAA report noted that 83 percent of the major penny stock enforcement cases examined in preparation of the report contained names of one or more individuals with a background of securities law violations." Recent reports appearing in *The New York Times* and *The Wall Street Journal* note that the problem of repeat offenders or "rogue brokers" participating in micro-cap scams remains a real one.
- A. Does the NASD-R agree?
- B. If "recidivist" brokers are still in the system, where did the 1990 Act fall short? In other words, what additional steps should be taken to reduce the problem of repeat offenders?

ANSWER:

A. While we have seen instances of repeat offenders, there is no statistical data that would accurately reflect the scope of fraudulent activity on the part of repeat offenders as a percentage of all individuals disciplined for sales practices.

B. NASDR's Enforcement program includes a specific review of prior disciplinary history of an individual in assessing the sanctions appropriate for unlawful activity. In addition, we believe that it is important to ensure that investors have information available to them regarding past violators. NASD Regulation plays a vital role in ensuring that this information is available. The disciplinary history of each violator is recorded in our Central Registration Depository and is available to all regulators and member firms. Investors may obtain such information through use of the NASD's toll free hotline. On September 10, 1997, the SEC approved our new Conduct Rule 2280, effective January 1, 1998. This rule requires NASD members that carry customer accounts to provide customers with the following information in writing at least every year: 1) The NASDR Hotline number, 2) the NASDR web site address, and 3) a statement regarding the availability to the customer of an investor brochure that describes the NASDR Public Disclosure Program. We also have a broad investor outreach campaign to ensure that investors are fully informed about the availability of this information, which is described more fully in the answer to Question 3, above. Our efforts to focus on recidivist brokers include other major regulatory proposals. For

example, on September 11, 1997 we filed with the SEC a new rule that would require brokerage firms to tape record all of their brokers phone calls with investors if a certain percentage of their brokers were employed by a firm that has been expelled or had its broker dealer registration revoked for sales practice violations. This proposal complements our other efforts in this area, which include providing better regulator and investor access to information on past violations, punishing repeat violators more heavily, and more closely monitoring firms that hire past violators. Coupled with these efforts, the NASD has a rigorous process in place that makes it difficult for expelled members or barred brokers to re-enter the industry. Where barred brokers reappear as promoters and officers of companies that are suspected of wrongdoing and are beyond our jurisdiction, we will refer those cases to the SEC and other enforcement agencies.

9. Another aspect of the same problem is what the 1990 House Report terms the "cloning" of penny stock firms whereby "[l]arge penny stock brokerage firms become training grounds for a new generation of promoters who then set up hundreds of identical operations." The report asserts, "[u]nder current law, it is not difficult for a firm, once shut down, to emerge once again or even to multiply."
- A. Is the NASD-R still grappling with the problem of cloning? What new tools -- new rules or regulations -- if any, does the NASD-R need to prevent "cloning"?
 - B. Does the NASD-R have an opinion as to the merits of extending the NASD-R's reach to promoters of micro-cap stocks that fall outside the \$5 penny stock definition? Would the NASD-R support such an extension?

ANSWER:

A. The difficulty in this area is that brokers who work at firm that is subject to a major disciplinary action may then become employed at another broker dealer, sometimes set up by those who owned the firm subject to sanctions. On September 11, 1997 NASD Regulation filed with the SEC a significant proposal in this area. Our new rule, if approved by the SEC, will require a brokerage firm to tape record all customer sale calls if a certain percentage of brokers were employed by an expelled brokerage within the last two years. The taping rule defines an expelled firm as one that has been expelled from a securities industry self-regulatory organization, or has had its registration revoked by the SEC, for sales practice violations or telemarketing abuses. The threshold percentage of brokers from a disciplined firm that would require recording will vary from 40% for a small firm to 20% for a large firm. Under the proposal, every firm will be required to conduct a quarterly review to determine whether there must be taping. A press release on the taping rule is attached.

NASDR also brings disciplinary actions against specific individual registered representatives to attack the problem of cloning. It is through this enforcement tool that individual registered representatives acquire disciplinary histories. Brokers with prior disciplinary histories are subject to heightened supervision requirements. See *Notice to Members 97-19*, attached. For example, NASDR recently filed a detailed complaint against 33 former principals and brokers of Stratton Oakmont. In A.R. Baron & Co. Inc. 20 individuals were charged primarily with sales practice abuses, complaints have been brought against approximately 25 former Hibbard Brown salesmen relating to sales practice violations, 15 principals and salesmen were charged in Sterling Foster & Co., Inc, 37 registered individuals were charged in H. J. Meyers & Co., Inc relating to

overcharging customers and 29 individuals from GKN Securities were charged with similar violations. Press material on issued decisions is attached.

B. NASD Regulation's primary responsibility is to review the activities of member firms and registered representatives. We have an effective referral process with the SEC, and other regulators, including the criminal authorities when we see unlawful activity by those not within our jurisdiction, such as promoters of microcap issuers. With regard to the limits of the current SEC rules regarding the sale of penny stocks, we refer you to the answer to Question 4.C regarding our continuing discussions with the SEC on this issue.

10. Mr. Borg testified about the difficulties of rooting out those responsible for the Stratton Oakmont scam -- a very troubling case study.

- A. Briefly tell us what role the NASD-R played in expelling Stratton Oakmont and whether NASD-R's action preceded or followed that of the states; and whether the NASD-R coordinated its proceedings with those of the SEC and the 19 states?
- B. In what ways, if at all, can the NASD improve its enforcement efforts with the states and the Commission? Can you share discovery with each other? Would it be to your advantage to do so? Why/why not?
- C. More generally on the issue of NASD-R enforcement, please tell us whether the NASD-R focuses its enforcement efforts against *individuals or firms*? Do you think individual actions bear more fruit than actions directed at firms rooting out the underlying cause of penny stock scams, that is, unscrupulous brokers? Do you see a greater enforcement effort in the future directed at individuals?

ANSWER:

A. NASDR was responsible for expelling Stratton Oakmont, Inc. from membership, which it did in December of 1996, the first regulator to expel them from doing a securities business everywhere in the US. That action was a result of a disciplinary action taken by the Association against the firm, Daniel Porush, its president and Steven Sanders, its head trader charging customers fraudulent markups and for deficient supervision to prevent the violations from occurring. In addition to the expulsion, Porush and Sanders were both barred from the securities industry. The NBCC also ordered the firm to pay over \$400,000 in restitution to customers, fined the firm \$500,000, Porush \$250,000 and Sanders \$25,000. Porush and Sanders have appealed the decision to the SEC. The SEC, at the NASDR's urging, denied a stay of the National Business Conduct Committee's expulsion and bar orders.

At the time of this action, many states, the SEC, and NASDR had taken prior actions against the firm. The decision noted the prior actions and expelled the firm - in part - because of

"the number and gravity of the firm's relevant prior disciplinary incidents. We find that this history establishes a coherent pattern of willful disregard for regulatory requirements and regulatory authority, as well as a failure of lesser steps to remediate the firm's conduct."

NASDR regularly coordinates its activities with the SEC and the states. Stratton had been the subject of many meetings and conversations among the various regulators. Press material on this case is attached

B. As noted above, we have an active referral process with the SEC, the states, and the criminal authorities. In addition, we exchange information and regulatory intelligence on a continuing basis, and are permitted to share information on particular matters through a grant of access. We believe the coordination and sharing of information provides for fair regulation and efficient enforcement by the various regulators. We are active participants at NASAA and SEC conferences, during which we share regulatory methods and intelligence.

C. NASDR focuses its enforcement activities on both individuals and firms. We are keenly aware of the fact that an investor deals with the individual broker, and the broker must comply with our rules to effectively protect the investor. We also scrutinize carefully the supervisory activities of those individuals in the brokerage firm who are responsible for overseeing the activities of the individual registered representative. Finally, we impose significant sanctions against firms that violate our rules, or fail to adequately supervise its sales force. NASDR is committed to pursuing cases against individual brokers who have abused the public trust by engaging in serious sales practice violations. As stated earlier, NASDR recently filed a detailed complaint (more than 100 pages in length) against 33 former principals and brokers of Stratton Oakmont. The complaint identifies at least 70 specific customers who were victimized by these brokers. In addition, there are pending settlements against several additional brokers for similar violations. While these cases take considerable time to develop, NASDR believes it is critical to not only rid the securities industry of miscreant firms and their principals but to specifically target the individual registered representatives who directly committed these violations. This is not the first case in which we have named a large number of registered representatives for sales practice violations. In A.R. Baron & Co. Inc. 20 individuals were charged primarily with sales practice abuses. Complaints have been brought against 25 former Hibbard Brown salesmen relating to sales practice violations, 15 principals and salesmen were charged in Sterling Foster & Co., Inc. 37 registered individuals were charged in H. J. Meyers & Co., Inc. and 29 individuals from GKN Securities were charged. Press material on issued decisions is attached to the answer to Question 9.A.

11. Pursuant to the 1990 Penny Stock Reform Act, the Commission adopted rules requiring brokers to give customers specific information before the sale about the market for penny stocks and the broker's compensation.
- A. Please describe the kind of information that must be disclosed in the penny stock context?
 - B. How does the NASD-R monitor compliance with this rule to gauge its efficacy?
 - C. Arguments against rules such as these are either that the broker conveys the information *after* the sale, so the investor never really considers it prior to committing, or, if the broker gives it out prior to the sale, the broker down plays its significance with a line like "hey, its a fast changing market place, what's in a piece of paper is only so useful", thereby pressuring a transaction. And, moreover, the broker has created a record for herself because she can point to the fact that she buried the customer with paper. Do these arguments have any merit?
 - D. What percentage of the NASD-R's micro-cap prosecutions is predicated on failures to disclose the kind of information the rule requires?
 - E. Chairman Levitt's statement notes that "[t]he Commission today sees more fraud in mostly lower-priced Nasdaq-listed securities and in securities valued at \$5 or more." Why is that? Should the penny stock rules be ratcheted upwards?

ANSWER:

A. In transactions subject to the SEC Penny Stock rules, the brokerage firm must inform the investor of the bid and offer for the security and the number of shares to which the quoted prices apply; the brokerage firm's compensation for the trade; and the compensation received by the individual registered representative for the trade. In addition, the brokerage firm is required to give the investor a risk disclosure statement and, with certain exceptions, a suitability statement and obtain the investor's signature on each of these documents prior to the first trade in a penny stock. Finally, the brokerage firm is required to send the customer a monthly statement that gives an estimate of the value of each penny stock in the account.

B. NASDR reviews for compliance with the 1990 Penny Stock Reform Act in routine examinations through the use of Examination Module IX, the Sales Practice Module. Among other things, prior to conducting an on-site inspection of a broker-dealer the examiner reviews reports filed by the firm. During the review, the examiner identifies all securities reported at a price below \$5.00 that appear to be penny stocks. The examiner

also reviews the monthly Rule 15c2-11 reports for Bulletin Board and pink sheet issues that the firm recently initiated or resumed quotations for, in order to identify a potential sample of penny stocks.

While in the firm the examiner generally gives a Penny Stock Questionnaire to a principal for completion. The examiner determines what procedures the firm uses to comply with the Rules, and obtains copies of the risk disclosure document, suitability form, purchase agreement and supervisory procedures used by the firm.

Other areas generally addressed during the examination include: (1) the name of the individual responsible for supervising both sales and trading of penny stocks; (2) the minimum standards the firm has, if any, for approving a customer as suitable for transactions in penny stocks; (3) whether the firm underwrote any new issues of penny stocks in the past two months; (4) whether the firm is a market maker in any penny stock; (5) how the firm obtains suitability information concerning the customer's financial situation, investment experience and investment objectives; (6) how the suitability statement is delivered to the customer; (7) who monitors receipt of the signed suitability statement; (8) where the signed suitability statements are maintained; (9) how the written purchase agreements are delivered to customers; (10) who monitors receipt of signed written agreement; and (11) where the signed written agreements are maintained.

Using specially prepared worksheets, examiners determine whether Rule 15g-3, relating to disclosure of quotations, is complied with. Generally, the examiner completes a separate worksheet with respect to customers who were identified during the examination process for each of several penny stocks also identified during the examination. Using customer and security specific information the examiner determines whether the broker dealer disclosed to each customer, either orally or in writing prior to effecting the penny stock transactions, and in writing either prior to or at the time of confirming the transaction with respect to the penny stock, the bid and ask prices for the penny stock and the number of shares to which such bid and ask prices apply.

SEC Rule 15g-4 requires disclosure of aggregate broker dealer compensation to any customer both prior to effecting any transaction in and at the time of confirming any transaction with respect to any penny stock. Specific examination steps are followed to ensure compliance with this rule, where it is applicable. For example, (1) the examiner verifies that prior to executing the transaction the firm disclosed to the customer the total remuneration the firm would receive; (2) the examiner verifies that compensation information was also disclosed in writing prior to or at the time the confirmation was sent to the customer; and (3) the examiner identifies any deficiencies on the part of the firm to maintain a record of all written or oral disclosures made to the customer under SEC Rule 17a-4.

SEC Rule 15g-5 requires disclosure either orally or in writing prior to effecting, and in writing either prior to or at the time of confirming, the transaction, the aggregate amount of cash compensation that certain associated persons of the broker dealer will receive to the extent that compensation is determined at or prior to the time the transaction is effected. Additionally, information concerning any compensation that is paid to the associated person by someone other than the broker dealer must be separately disclosed. Under this rule, the written disclosure must disclose the existence of any contingent payments that are not determined at the time of the trade.

In reviewing for compliance with this rule, examiners use specially designed worksheets to gather relevant information and to determine whether prior to executing the transaction, the firm disclosed to the customer the aggregate amount of any cash compensation the associated person had or would receive in connection with the transaction. The examiner also verifies that this information was disclosed in writing prior to or at the time the confirmation was sent to the customer.

If any amount of the cash compensation would be paid to the associated person based on some future contingency such as sales volume, examiners determine whether the written disclosure made in connection with the confirmation states this fact and describes the basis upon which such compensation is determined.

Finally, the examiner identifies any deficiencies on the part of the firm to maintain a record of all written and oral disclosures made to the customer under SEC Rule 17a-4.

C. As noted above, specific information must be disclosed before the sale. While a broker could attempt, in certain circumstances, to argue that such disclosure has created a record for him, this possibility is far outweighed by the benefits an investor obtains through the receipt of this required disclosure. We have attached Schedule 15G, which sets out the required disclosure under Exchange Act Rule 15g-2. With regard to the broker failing to provide the customer with adequate disclosure, and attempting to circumvent the Penny Stock rule requirements, we have observed that conduct and recently issued a decision in La Jolla Capital Company imposing significant sanctions for such conduct, attached for your review. Please note that this decision is not final, and is subject to appeal to the NASD's National Business Conduct Committee.

D. *The Report by the Staff of the Securities and Exchange Commission on the Rule 15c2-6* (February 8, 1991) covers an examination sweep by the SEC, NASD, and the State of Florida. That sweep was conducted on the SEC's Rule 15c2-6, which has since been superseded by the 15g Rules. It carried out 188 examinations involving 144 different broker-dealers and found that 43 of the 188 examinations (23%) revealed

sufficiently serious violations of the Rule to result in possible enforcement investigation. Subsequently, the Penny Stock Reform Act was passed and the new 15g rules were promulgated and enforced. As stated in the answer to question 1, the SEC, NASD and state regulators conducted an extensive examination sweep to check compliance with those new rules. The *Joint Regulatory Penny Stock Examination Sweep* (June 1994) report found widespread compliance with the Penny Stock Rules and generally diminished activity in stocks covered by them. Our data continue to verify the 1994 study's findings, with less than 1% of our cases involving violations of the Penny Stock rules.

E. Nasdaq has taken significant steps to enhance the quality of its SmallCap Market. Specifically, as described in the answers to Question 5 above, Nasdaq proposed, and the SEC approved, changes to the qualitative and quantitative standards for issuers listing on Nasdaq in order to strengthen the Nasdaq Stock Market. These changes were particularly focused on the Nasdaq SmallCap Market. The rule changes materially enhance the threshold criteria necessary to qualify for listing, establish a \$1 minimum bid price, extend the corporate governance requirements applicable to National Market companies to SmallCap Market companies, and add a requirement that auditors of all Nasdaq-listed companies be subject to peer review. We believe these changes will significantly enhance the quality of the SmallCap Market.

With respect to whether the Penny Stock Rules should be "ratcheted upwards," any such consideration should maintain the exemptions afforded to exchange and Nasdaq listed securities. As noted earlier, NASDR is working with the SEC to determine whether it would be appropriate to modify the Penny Stock Rules in order to address abuses in the microcap market.

12. We also understand that the NASD-R utilizes a system called "stockwatch on-line price and volume alerts".
- A. Can you tell us more precisely what that system does and whether it applies to the Bulletin Board?
 - B. If it doesn't apply to the bulletin board, would something like it be useful?
 - C. If it *does* apply to the bulletin board, how effective is the system in prompting *early intervention* by the NASD-R to halt trading and identify fraud on the bulletin board? Without giving a roadmap to future fraudsters, what are the weaknesses in the system? How can it be improved?

ANSWER:

A. The Nasdaq Stock Market is monitored intraday by the computerized StockWatch Automated Tracking ("SWAT") surveillance system, which identifies real-time surveillance alerts of unusual price or volume activity and related information for immediate follow-up by Nasdaq MarketWatch staff. Situations requiring further regulatory review are referred to NASD Regulation, Inc. SWAT compares real-time market activity against a 100-day statistics metric that is stored and continuously updated on each security in order to determine abnormal movement. The system also stores information as to how market activity in each security relates to the Nasdaq composite index and considers this relationship to determine relative abnormal behavior. The SWAT model also receives a feed of five major news wires (Dow Jones, Reuters, Business Wire, PR Newswire, and PIR), the news headlines are coded with the security symbol and the absence or presence of news is taken into account when determining abnormal market activity. The SWAT system does not monitor securities that are traded on the OTC Bulletin Board.

B. An on-line system with regard to securities that are traded on the OTC Bulletin Board would be useful in detecting unusual intraday market activity in these securities. From a practical standpoint, the current off-line "OTC Surveillance System" utilized by NASD Regulation, Inc. provides a significant number of regulatory breaks that identify potential fraudulent trading. This system produces weekly surveillance alerts for securities exhibiting unusual activity during 5, 20, and 40-day intervals. The NASD is currently studying options that would enable us to halt quotes and trading in OTC Bulletin Board securities under specific circumstances. If implemented, a trading or quote halt authority

would likely need to be supported by an intraday surveillance system for the OTC Bulletin Board.

C. As indicated above, the current On-Line Surveillance System does not apply to OTC securities, nor does the NASD currently have the authority to halt trading in non-Nasdaq securities.

13. What is the surveillance strategy developed by the NASD-R to prevent fraud on the Internet? How does it work?

ANSWER:

The Market Regulation Department's fraud surveillance protocol requires all regulatory alerts to be processed using basic Internet search technology. Every surveillance alert is the subject of a manual Internet search to identify issuer homepages and electronic conversation traffic, which are then analyzed for potential fraud issues.

An advanced automated Internet surveillance prototype is currently being developed for identifying securities with increased Internet traffic. This prototype, named "The Internet Surveillance System" (also known as "NetWatch") will monitor the Internet in search of individuals disseminating potentially false or misleading information about Nasdaq and OTC issues through this medium. The system will scan a list of web sites and Usenet newsgroups on a daily basis. Using advanced natural language processing tools, the system will identify references to companies and issues within the retrieved text and perform a numerical analysis on the frequency of citations to determine if an issue has an unusually high level of discussion. These will be presented to the fraud surveillance analysts as "Notifications." The staff will analyze the data that generated the notification and search through hyperlinked texts to determine if potential regulatory issues requiring further review are present. The system will also archive Internet data so that if an issuer deletes information from its homepage, the analyst will be able to retrieve historical data.

14. Has this surveillance strategy been effective?

ANSWER:

The current fraud surveillance protocol utilized by the Market Regulation Department has been effective in identifying potential regulatory issues. The staff has investigated a number of issuers whose Internet home pages contained false and misleading information, which, because of our jurisdictional limitations, were immediately referred to the SEC. During 1997, the fraud surveillance staff referred a number of matters involving potential fraudulent conduct to the SEC. These include suspicious issuer homepages, Internet web sites that disseminated suspicious stock recommendations, Internet traffic that contained price projections, and potentially false and misleading information.

The NetWatch system is anticipated to begin a testing phase of production in January 1998. This system will provide a more effective and standardized approach when searching the Internet and will be proactive in detecting potential fraud on the Internet.

15. To what extent is the Internet used for legitimate securities transactions by honest market participants?

ANSWER:

The Internet has helped democratize the investment process by providing widespread access to even the most specialized information, thus leveling the playing field for many individual investors. There are a growing number of very reputable firms who utilize the Internet to provide their clients with easier access to brokerage services. However, given the speed of the evolution of the Internet, and the breadth of the population that has access to it, and the many ways in which it now being used, we have no way of accurately measuring the extent of legitimate securities transactions that are related to the Internet.

16. There has been considerable press about the demise of A.R. Baron -- a firm that was indicted in May 1997 by a New York State grand jury for defrauding investors of \$75 million -- and the fact that Bear Sterns processed trades for A.R. Baron, as a clearing firm. The Subcommittee understands that the New York Stock Exchange has adopted a rule requiring clearing firms to notify introducing brokers about available supervisory and compliance reports compiled by the clearing firms that could show irregularities on the part of introducing brokers -- such as excessive commissions or churning.
- A. Does the NASD-R support these reforms?
 - B. Does the NASD-R expect them to go into effect?
 - C. Does the NASD-R encourage all SROs -- like the NASD -- to adopt similar rules?
 - D. Is the NASD considering adopting similar reforms? If so, when?

ANSWER:

- A. The NASD has been working with the SEC and the NYSE on rule proposals concerning the relationship between clearing firms and their client introducing firms. These proposals would require clearing firms to provide information that will allow self-regulators to better monitor the activities of the firms on whose behalf they clear trades -- "introducing firms." Under our proposal, clearing firms will be required to report to the NASD or other Designated Examining Authority certain written complaints that they receive on activities of the introducing firm, and forward all complaints received to the introducing firm. The clearing firm will also be required to make available to its introducing firms reports and analyses of the introducing firm's own activities.
- B. It is our understanding that the NYSE's proposed amendment to its Rule 382 was approved by their Board on September 4, 1997, and that the NYSE's amendment is now pending approval at the SEC. As explained in D. below, the NASDR Board has approved our proposed rule change and it has been filed with the SEC.
- C. If rules are adopted by the NYSE and the NASD, virtually all securities firms in the US will be covered by those rules.
- D. The NASDR Board proposed amending our Rule 3230 at its meeting on September 22, 1997 to require the reforms described above for our members. That proposal has been filed for approval with the SEC and, at the same time, published for comment in NASD

Notice to Members 97-79, which is attached. We expect that the SEC will shortly publish the proposal for public comment in the Federal Register.

17. In March 1996, a working group of the NASD, the New York Stock Exchange, the North American Securities Administrators Association and the SEC issued a joint report entitled "Joint Regulatory Sales Practice Sweep: A review of the Sales Practice Activities of Selected Registered Representatives and the Hiring, Retention, and Supervisory Practices of the Brokerage Firms Employing Them". As its title suggests, the report recorded the results of the hiring and recruiting practices of over 100 small and medium size brokerage firms, by making "specific recommendations aimed at improving brokerage firms" thereby creating "improvements in the prevention and detection of sales practice abuses." Among the recommendations of the report are tying branch manager compensation to the manager's effective supervision of registered representatives, more stringent hiring procedures with greater scrutiny into the kinds of securities sold by the applicant while with a previous firm.
- A. What is the current status of these recommendations? Is there a formal process by which they are being implemented? What kind of follow-up is being done?
- B. In the year and a half since this report was issued, can you offer an opinion as to whether the report's "specific recommendations" has, in fact, "result[ed] in improvements in the prevention and detection of sales practice abuses"? What more needs to be done?

ANSWER:

A. The *NASD Notice to Members 97-19* (attached to the answer to Question 9.A) in April of this year provided a joint memorandum with the New York Stock Exchange that addresses the recommendations of the Joint Regulatory Sales Practices Sweep Report. One major recommendation of that report was that the firms "must be reminded about their obligations to properly supervise the activities of registered persons and that the Commission, the SROs, and the state securities regulators will continue to closely monitor during examinations firms' supervision whenever sales practice weaknesses, deficiencies, or apparent violations are detected." *Notice to Members 97-19* provided that reminder and an in depth discussion of how firms can provide the heightened supervisory procedures covered in the sweep report in the areas of disciplinary history, development and implementation of special supervision, developing and implementing heightened supervisory procedures, and suggestions for standard supervisory procedures. Our examination program monitors broker dealers to ensure compliance with the guidance contained in the *Notice to Members*.

B. We believe that the report and the subsequent guidance provided in the *Notice to Members* has had a positive effect on the prevention and detection of sales practice abuses, but cannot quantify that effect.

18. Chairman Levitt's statement indicates that the Commission's staff is studying how to amend rule 15c2-11 -- the rule designed to prevent the publication of stock quotations on the OTC bulletin board and pink sheets that may be used in fraudulent schemes. As the statement notes, that rule requires a broker -- before publishing the initial quotation for a particular stock or after a trading halt -- to review the issuer's most recent balance sheet, profit and loss and statements and to examine whether there is any relationship between the broker-dealer and company insiders.

A. How is this rule enforced?

B. What possible amendment does the NASD-R envision?

ANSWER:

A. SEC Rule 15c2-11 is enforced through the examination and enforcement efforts of both the SEC and the NASD. Please see the answer to Question 11B for a description of how the rule is enforced.

B. We are studying this rule with the SEC, and reviewing the type of information that is required to be reviewed, and whether such information should be updated on a more regular basis. Rule 15c2-11 is an SEC rule and all amendments to it must be proposed by the SEC.

SUPPLEMENTAL QUESTIONS FOR THE RECORD
OF RANKING MINORITY MEMBER JOHN GLENN
Hearing Before The
U.S. SENATE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
September 22, 1997
Fraud In The Micro-Capital Markets,
Including Penny Stock Fraud

BARRY R. GOLDSMITH
Executive Vice President
NASD Regulation, Inc.

* * *

1. With respect to micro-cap fraud, please provide figures for each of the past five years on the number of actions, disciplinary proceedings and investigations initiated by the NASD against:

A. Individuals; and

B. Firms.

The data should include, but not be limited to: (1) De minimis letters; (2) Letters of caution; (3) Letters of future observance and compliance; (4) Staff interviews; (5) Letters of acceptance; (6) Censures; (7) Suspensions; (8) Bars, revocations, expulsions; and (9) Fines (please identify how many of the fines were the only disciplinary action and how many were combined with other disciplinary action).

ANSWER:

Because the term "microcap fraud" is not a statutorily defined term and does not enjoy a standard definition, our systems do not track disciplinary actions that involve microcap fraud. We have submitted below the data requested based on individual and firm categories on the requested break out of all of our disciplinary actions.

**NASD Disciplinary Statistics
1993 to September 1997**

Complaints & AWCs Authorized*	741	1,200	917	517	545	3920
Decisions Rendered	239	329	313	354	323	1558
Offers of Settlement Accepted	169	203	183	197	220	972
AWC Accepted	520	517	412	351	327	2127
Firms Expelled	5	7	8	16	14	50
Firms Suspended	4	7	9	11	18	49
Individuals Barred	334	394	412	364	404	1908
Individuals Suspended	188	204	196	221	228	1037
De Minimis Letters**	0	27	75	238	363	703
Letters of Caution	1356	2141	1627	1811	1768	8703
LOFOC** ***	0	0	0	0	4	4
Staff Interviews/Compliance Conferences	16	51	56	53	152	328

* AWC - Admission, Waiver and Consent

** The practice of issuing these informal actions has been discontinued and is now part of the staff's Letter of Caution process.

*** LOFOC - Letter of Future Observance and Compliance

Censures and fines are not categorized separately because our formal disciplinary actions (complaints, AWCs, decisions, offers, expulsions, suspensions, and bars) will in almost all cases include censures, as well as fines where appropriate.

2. Should the NASD be working more closely with the Department of Justice and state and local authorities to refer more of its cases for criminal actions?
 - A. If not, why?
 - B. If so, what is being done to achieve that and what is the timetable for implementing those efforts?

ANSWER:

A & B. The NASD works very closely with the Department of Justice and state and local criminal authorities. Not only do we refer cases for criminal prosecution where necessary, we have provided staffing and expertise to the criminal authorities in their prosecution of their cases that result from our referrals. There are a number of ways in which we work with Justice and other law enforcement authorities, and our work with the FBI in New York is illustrative of how this work is carried out.

Late last year, federal prosecutors in New York indicted 45 stock promoters, executives and brokers for making or accepting bribes to promote the stock of certain issuers. Some of these bribes exceeded \$100,000 and represented as much as 40% of the value of the transaction. NASDR lawyers and examiners in our New York and Washington offices contributed hundreds of hours to this cooperative effort. In addition to this substantial personnel commitment, we provided market information, technical expertise, and other assistance that contributed to the success of this undercover sting operation. In addition to these criminal prosecutions, NASDR also brought its own disciplinary proceedings against ten registered brokers implicated in the operation.

In just four months earlier this year, NASDR's work with the FBI, U.S. Attorneys, Justice Department, and state law enforcement agencies has resulted in criminal charges against more than 120 individuals. In November 1996, the U.S. Attorney in Las Vegas announced that a federal grand jury there returned securities fraud and RICO indictments against thirty defendants for the alleged bribery of stockbrokers and fraudulent issuance of Teletek stock, a Nasdaq SmallCap security. In February, six guilty pleas were unsealed in this case, bringing to twelve the number of people who have acknowledged their role in the scheme. Since February at least 12 others have plead guilty. For more than a year, NASDR examiners spent hundreds of hours working with prosecutors and federal agents, developing this important case. The U.S. Attorney explicitly

acknowledged our assistance in several News Releases publicizing these actions, which are attached.

For the past several years, NASD Regulation has had a full-time examining staff assigned to the FBI in Newark, New Jersey. These examiners have been instrumental in helping the United States Attorney in New Jersey obtain criminal convictions of many individuals associated with low-priced stocks, including stock manipulator Richard Bertoli (100 months in prison) and notorious stock promoter Eric Wynn. Wynn, along with four others, were charged in a 13-count indictment alleging criminal conspiracy, securities fraud and wire fraud in connection with a stock manipulation scheme. In July of 1995, following a six-month jury trial, Wynn was convicted on all counts and sentenced to 52 months in prison and a \$50,000 fine. Eight of his co-conspirators were convicted or pled guilty, most being incarcerated. Commenting on our role in this case, FBI Director Louis Freeh commended NASD Regulation for the "vital role" it played "during several substantial investigations involving the securities markets." Freeh called the work of NASD Regulation staff "tireless" over the last several years, and added that they "contributed immensely to the convictions of more than 30 persons." In December, five NASD Regulation staff were awarded formal commendations by the FBI in connection with this matter.

As recently as this week, the U.S. Attorney in Newark announced indictments against eight brokers at L.C. Wegard for alleged roles in a boiler room operation, where investors were induced to buy high risk over the counter stocks through deceptive sales practices. All of the defendants were previously worked at Hibbard Brown & Company. The U.S. Attorney's announcement, which is attached, explicitly acknowledged NASDR's work in the bringing of the case.

Also this week, the U.S. Attorney for the Eastern District of New York announced the unsealing of a complaint charging 13 people with securities fraud and money laundering in connection with Hampton Capital Management. NASDR's extensive assistance to the case is described in the U.S. Attorney's Press Release, which is attached.

NASDR has taken a leadership role in training and meeting with federal, state, and local prosecutors to interest them in our cases and educate them about potential criminal abuses in our markets. We have strong institutional relationships with these agencies and regulatory intelligence flows frequently between us. For example, beginning in 1996, our New York District office began a series of meetings with the FBI's New York Regional Office. Our District staff have provided these FBI representatives with securities firm examination reports, as well as making our most knowledgeable personnel available to the Bureau for interviews. We provided, and will continue to provide, the FBI with training and information about firms that we suspect are involved in criminal activity.

In December of last year, NASD Regulation organized a meeting with law enforcement agencies and securities regulators in the New York area to address the problem of criminal activity in the securities industry. Attending were representatives from thirteen different law enforcement and regulatory agencies, including three U.S. Attorneys offices and the FBI.

3. Everyone seems to agree that more must be done to combat recidivism and cloning. Yet, except for the states, we don't hear much about trying to toughen sanctions against brokers and putting more efforts into disciplining individual brokers, rather than limiting disciplinary proceedings to the firms and principals.

Stratton-Oakmont is a notorious example. Eventually, the NASD barred the firm, the CEO and the chief trader. Yet, all of the other traders were ignored and some have moved on to bilk investors at other firms. At the same time, the state of Georgia enacted proceedings against nearly 60 Stratton agents.

Why is there such a discrepancy? Shouldn't the national regulatory bodies put more emphasis on disciplining individual brokers?

A. If not, why not?

B. If so, what is being done, and what is the timetable for implementing those efforts?

ANSWER:

A and B. NASD Regulation is committed to pursuing cases against individual brokers who have abused the public trust by engaging in serious sales practice violations. In this regard, NASD Regulation recently filed a detailed complaint (more than 100 pages in length) against 33 former principals and brokers of Stratton Oakmont. The complaint identifies at least 70 specific customers who were victimized by these brokers. In addition, there are pending settlements against several additional brokers for similar violations. While these cases take considerable time to develop, NASDR believes it is critical to not only rid the securities industry of miscreant firms and their principals but to drill down to the individual registered representatives who directly committed these violations. This is not the first case in which we have named a large number of registered representatives for sales practice violations. In A.R. Baron & Co. Inc. 20 individuals were charged primarily with sales practice abuses. Complaints have been brought against 25 former Hibbard Brown salesmen relating to sales practice violations, 15 principals and salesmen were charged in Sterling Foster & Co., Inc., 37 registered individuals were charged in H. J. Meyers & Co., Inc and 29 individuals from GKN Securities were charged.

4. In your testimony, you note that the firm of D.H. Blair overcharged its customers and engaged in fraudulent pricing activities. Yet it appears that the only sanctions that were leveled were financial. The firm was allowed to stay in business and so were all of the brokers, including the CEO and the lead trader -- who only had to pay fines.

Yet, the company committed some very egregious and willful acts. As your testimony indicates:

The firm charged excessive markups in 16 Nasdaq Small Cap securities whose Initial Public Offerings (IPOs) were underwritten by D.H. Blair Investment Banking Corp. NASD Regulation found mark-ups greater than 10 percent (a level considered fraudulent) in 14 of the 16 securities that D.H. Blair Investment Banking Corporation had underwritten. D.H. Blair placed virtually all of the offerings with its own customers and controlled the after-market trading in all 16 securities, in some cases for up to four and a half months after the IPO effective date.

- A. Why shouldn't people like this be barred?
- B. Should the regulatory agencies invoke stronger sanctions against rogue brokers and firms?
- C. If not, why?
- D. If so, what is being done to develop stronger sanctions and what is the timetable for implementing the sanctions?

ANSWER:

A. The DH Blair case involved excessive markups charges and the control of certain aftermarket trading, rather than sales practice abuses by individual registered representatives. Through a settlement, in which the firm and the individuals neither admitted nor denied the allegations, NASD Regulation made findings that the Chief Executive Officer and the head trader were responsible for the pricing of these securities. The CEO and the head trader were each suspended in all capacities for periods of 60 and 90 days, respectively, as well as fined a total Of \$525,000. A suspension in all capacities effectively 'bars' the person from association with any member firm for that period of

time. While these individuals were not barred from the industry for life, the sanctions imposed are significant. As a general matter, a bar from the securities industry for life would result when an individual has an extensive disciplinary history, or has engaged in intentional fraudulent and egregious conduct directly with customers. None of the individuals named in the case have prior disciplinary histories. In addition to the sanctions, all of the individuals named were required to re-take the requisite qualifications examinations before returning to the industry.

B, C, and D. The current enforcement program at NASD Regulation provides for significant sanctions against brokers who intentionally violate the NASD rules and the federal securities laws. We periodically review our sanction guidelines to determine if any particular guidelines should be adjusted, and are in the process of concluding such a review currently. We continue to impose significant sanctions in appropriate cases.

5. What specific steps does the NASD plan to take in furtherance of a “zero tolerance” policy for micro-cap fraud, and what is the timetable for implementing those actions?

ANSWER:

NASDR is actively considering several regulatory initiatives to address the abuses we see in the microcap market. The effort to address these concerns and to quickly develop meaningful regulatory proposals is a high priority for NASDR, and we are moving forward on these proposals in a prompt manner.

Proposals we are considering include those that relate to the operation of OTC Bulletin Board, and those that relate to the quoting and sales of all OTC securities. With regard to the operation of the OTC Bulletin Board, our effort in this area is to ensure that investors have adequate information about the issuers that are quoted on this system. Thus, one proposal we are studying would limit quotation on the OTCBB to the securities of issuers that file periodic financial reports with the SEC or bank or insurance regulatory authorities.

We are also considering several initiatives that relate to the sales and quoting of all OTC securities. One proposal would require that a broker review the current issuer financial information, prior to making a recommendation in an OTC security. We are also reviewing ways to ensure that an investor in the OTC market is provided with information about that market and how it differs from the Nasdaq listed market. In addition, we are also reviewing ways to strengthen the rules that relate to the review of issuer information prior to the initiation of a quotation, and the provisions that apply to the sale of penny stocks. We have discussed many of these proposals with our SRO committees and have obtained their input. They will be considered by the NASDR Board of Governors in the near future. Prior to their submission to the SEC, they will likely be issued for comment by our members and the public.

6. In many instances, states take action to bar a firm and/or an individual and then those actors simply move to another state and continue to bilk investors. Often, the national regulatory agencies are slower to take action.

Should there be some mechanism put in place to ensure that once a bad actor is sanctioned by a state, investors across the nation can be protected? Do you support the suggestion made by Mr. Borg, representing NASAA, that the SEC should interpret section (3)(a)(39) of the Exchange Act, imposing statutory disqualifications, to apply to state actions?

If not, why?

ANSWER:

The NASD does not believe that a sanction by one state should automatically be applied nationally. The state securities regulators themselves do not automatically bar individuals for other state violations, and extending a violation nationally is even more significant. We note similar treatment of state criminal and civil judgments by other state and federal jurisdictions.

Revocation of an individual's ability to earn a living is a very serious matter that we believe deserves careful attention to the balance that must be struck between the speed of prosecution and the procedural safeguards afforded to those accused of abusive conduct. States differ in the amount of procedural protection that must be afforded those accused of violating their securities laws and regulations and in the level of sanctions that they impose. National regulators such as the SEC and NASD operate under different legal procedures. The SEC operates under procedures established under federal law, and the NASD's rules are reviewed and approved by the SEC under standards set out in federal law.

7. Everyone recognizes that there are shortcomings associated with the quality and quantity of information that investors can get from the CRD. We know that the NASD has been slowly making progress on improving the quality and quantity of information available to consumers. Please provide a detailed description of the changes that will be made to the data collection and reporting activities associated with the CRD and a timetable for when the changes will be in place.

ANSWER:

NASD Regulation's Public Disclosure Program (PDP) provides investors with information on brokers and brokerage firms-all of which is culled from the CRD.

Key Dates:

May 1988 — PDP begins by providing investors, who request in writing:

- Final Disciplinary action(s) related to securities or commodities transactions taken by federal, state, or SROs.
- Criminal convictions

October 1991 — NASD establishes a toll free number (800-289-9999) for investors.

January 1993 — Public Disclosure Program expands to also disclose:

- Civil Judgments involving securities matters.
- NASD arbitration decisions involving securities matters.
- Pending formal disciplinary proceedings initiated by the SEC, state securities administrators, NASD, and other self regulators.
- Criminal indictments and information.

December 1996 — Investors can submit requests for information via NASDR's web-site (www.nasdr.com)

April 1997 — NASD launches a series of Public Service Announcements, in English and Spanish, to alert investors to the Public Disclosure Program and advise them how to find the information they need.

May 1997 — Option provided investors to receive Public Disclosure report via E-mail.

January 1, 1998 — NASD members with customer accounts must inform their customers in writing, at least annually, of the Hotline number, the NASDR web site address, and the availability of a brochure on the Public Disclosure Program.

First Quarter 1998 — CRD plans to provide the public on-line query capability, via the NASDR web-site, of broker and firm employment-related information.

Second Quarter 1998 — NASD Regulation will put the entire Public Disclosure database on-line, using Web-based technology, to provide more information, in an easy-to-use format, to the public.

Separately, the NASD has asked the SEC to approve rules that would provide investors with even more information. In this vein, NASDR has worked with other regulators to expand and enhance the Uniform Forms through which brokers and firms disclose information to the CRD. Once the SEC approves, the Public Disclosure Program will also make available to the public:

- Pending written complaints alleging sales practice violations and compensatory damages of \$5,000 or more that have been filed within the past 24 months.
- Pending arbitrations and civil proceedings involving securities and commodities transactions.
- Open examinations that are deemed as formal investigations involving regulatory or criminal matters.
- Settlements of \$10,000 or more among the parties to arbitrations, civil suits, and customer complaints involving securities and commodities transactions.
- Employment terminations after allegations were made involving violations of investment-related statutes or rules, fraud, theft, or failure to supervise investment-related activities.
- Bankruptcies that have become final within the last 10 years and outstanding judgments and liens.
- Bonding company denials of coverage, payout, or revocation.
- Any suspension or revocation to act as an attorney, accountant, or federal contractor.

8. What, if anything, has the NASD undertaken to conduct the branch office visits which the GAO has identified as an important part in improving the fight against micro-cap stock fraud?

ANSWER:

The NASD, through its subsidiary NASD Regulation, has examination responsibilities for all of its more than 5,500 members. It conducts two distinct types of examinations. Cause examinations address particular problems or identified events that are brought to the attention of our staff through a variety of sources. Cycle examinations follow a periodic schedule, with frequency based on the type and scope of business conducted by the member, the extent of customer exposure, and past regulatory history. All cycle examinations are conducted on-site at the members place of business.

NASDR's on-site examinations cover a broad scope of NASD rules and regulations, as well as those of the SEC and the Municipal Securities Rulemaking Board. For example, NASDR examiners inspect a member's sales and trading practices, including reviews for suitability, unauthorized trading, churning, best execution, fair pricing, supervision, and fair dealing with customers. The cycle examination approach combines the major areas and regulatory risks of each member with global issues applicable to virtually all members and is executed through standard modules and instructions. Nearly 2400 cycle examinations will be conducted in 1997.

The cycle examination program includes on-site examinations of branch offices. Branch Office examinations are selected based on specific circumstances. In 1997, for example, NASD Regulation considers a firm's branch office structure in focusing on the adequacy of such members overall supervisory systems. Where an inspection of a main office indicates potential regulatory problems that raise concerns over the member's supervisory systems or structures, on site examinations are conducted if appropriate of a select number of branch offices. In determining whether to conduct branch office examinations, the following areas are considered:

- The adequacy of supervision over branch offices;
- The adequacy of the member's daily and periodic review of transactions;
- Whether supervisory procedures are reasonably designed to prevent and detect violations of SEC and NASD Rules;
- Whether managers who produce in small or single person OSJ offices are adequately supervised by other designated supervisory personnel;
- An assessment of the effectiveness of the member's continuing education program as

- applied to the personnel of such offices, and
- Customer complaints, terminations for cause, employment history, or a pattern of misconduct.

9. The Penny Stock Reform Act of 1990 required that brokers provide both oral and written disclosures to all prospective purchasers, and obtain signatures on such disclosure forms. Since one of the great concerns is that pressure tactics that cause misleading representations to be made to investors unfortunately are working, and thousands of Americans are in fact misled:
- A. Is the problem as significant as it been reported as being?
 - B. Since enforcement frequently is left to the states, how many states have stringent disclosure requirements?
 - C. Are these disclosure requirements anything more than the most meaningless of paper protections? For example, if only the federal government has disclosure requirements, and the SEC devotes precious little resources to enforce them in the micro-cap stock fraud context, what difference do these requirements make in terms of setting effective standards?
 - D. If the goal is to dilute the coercive or misleading effects of telephone calls at the outset, before the customer is "in the stream," isn't it important to actually ensure that the full set of oral disclosures and warnings be made in each and every phone call between broker and customer?
 - E. Should it be a federal requirement that all such phone calls be taped and the tapes be kept for some period so that if investors file a complaint, the regulatory authorities can review the tapes and ascertain whether the disclosures were made and take disciplinary action if they were not ?

ANSWER:

- A. Please refer to the answer to Senator Collins' Question 1 for the significance of this problem.
- B. The enforcement of the Penny Stock Reform Act is primarily the job of the SEC and the self-regulatory organizations. We refer you to the North American Securities Administrators Association for a description of the stringency of the various states disclosure requirements.
- C. The disclosure requirements under the Penny Stock Reform Act have had a salutary impact, and are not "the most meaningless of paper protections." Please refer to the answer to Senator Collins' Question 1.C, 4.B, and 11B for the impact of the Act and its disclosure requirements.

D. We believe that the current SEC rules are effective. NASD rules require that a registered representative operate under a rigorous system of supervision, with more stringent requirements for representatives who have presented problems in the past.

E. On September 11, 1997 NASD Regulation filed with the SEC a significant proposal on the taping of broker's conversations with their customers. Our new rule, if approved by the SEC, will require a brokerage firm to tape record all customer sale calls if a certain percentage of brokers were employed by a disciplined brokerage within the last two years. The taping rule defines a disciplined firm as one that has been expelled from a securities industry self-regulatory organization, or has had its registration revoked by the SEC, for sales practice violations or telemarketing abuses. The threshold percentage of brokers from a disciplined firm that would require recording will vary from 40% for a small firm to 20% for a large firm. Under the proposal, every firm will be required to conduct a quarterly review to determine whether there must be taping. We believe that taping customer calls is a relatively burdensome and expensive requirement and should not be invoked absent a previous showing of problem conduct by the firm or a significant number of its registered representatives.

10. What does Congress need to do, that it has not already done, to ensure that the problem of micro-cap fraud is effectively controlled? Specifically:

- A. Is there certain specific additional authority that needs to be given to the SEC, the SROs and the states?
- B. Do we need to extend the jurisdiction of the Department of Justice?
- C. Are there any changes in the securities laws that would be valuable in this effort?

ANSWER:

A. We believe that wide authority granted to the SEC, the SROs and the states to make rules now provides sufficient authority among them to address the problems presented by microcap fraud.

B. The SEC and the SROs refer cases to the Department of Justice whenever criminal prosecution is warranted, or the special tools of criminal investigation are called for. We are not aware of any cases that are not successfully prosecuted because of a lack of jurisdiction by the Department of Justice.

C. While we are reviewing several regulatory rule and enforcement initiatives to increase our efforts to combat microcap fraud, we do not at this time have any changes to the securities laws that we have identified as necessary in this ongoing effort. If any such changes are identified, we will communicate them to you and the Senate Securities Subcommittee for your consideration.

11. One year ago, a two-year investigation into the Nasdaq market and the NASD's policing role ended in a settlement agreement between the NASD and the SEC. The SEC criticized the NASD for not having taken steps to correct a number of problems, despite knowing about misconduct in the Nasdaq market since 1990.

The SEC concluded that between 1990 and 1994, the NASD, "without reasonable justification or excuse failed to enforce compliance with Exchange Act, the rules and regulations thereunder and its own rules." As part of that settlement, the NASD agreed to spend \$100 million over a five year period to correct certain abuses outlined by the SEC. Also, it agreed to take remedial steps to prevent wrongdoing in the future.

- A. What steps did the NASD agree to undertake?
- B. What has the NASD done thus far to comply?
- C. What remains to be done?
- D. Has \$100 million been provided for, and how?
- E. Has the NASD begun spending that money?
- F. If so, how has it been spending the money, and does it provide the Department of Justice, the SEC or anyone else with an accounting that demonstrates compliance with that agreement?

Answer:

A. Pursuant to the settlement agreement between the SEC and the NASD, the NASD agreed to implement a series of fourteen undertakings that are specifically described in the SEC Order and Section 21(a) report. These undertakings generally require the NASD to do the following: balance its boards and certain of its committees between public and non-industry membership; provide NASDR with free access to Nasdaq records; institute professional hearing officers in the disciplinary process; provide for the autonomy and independence of the NASD regulatory staff; promulgate and apply on a consistent basis regulatory and other access issues; ensure the existence of a substantial, independent internal audit staff; design and implement an equity order audit trail; improve substantially the surveillance, examination and enforcement of order handling, trade reporting and firm quote compliance; propose a rule interpretation expressly making

unlawful anti-competitive conduct; enhancing market maker competitiveness through enforcement of NASD Conduct Rule 2110; repealing the excess spread rule; and, retaining an independent consultant to review and report to the NASD and the SEC on the implementation of these undertakings.

B. On August 8, 1997, one year after the SEC action was filed, the independent consultant presented his first annual report to the SEC. The independent consultant concluded that the NASD had completed those undertakings that were capable of being completed in one year, that three other undertakings would be completed as soon as the SEC approved the NASD's new Code of Procedure (the new Code of Procedure was approved on August 8, 1997), and that the NASD made substantial improvements on those undertakings which are on-going.

C. As reflected in the Report of the Independent Consultant, the NASD is continuing to implement the undertakings imposed in the SEC settlement. The NASD is continuing to make substantial improvements in these areas and is on schedule to implement the order audit trail in a timeframe agreed to by the SEC.

D -F. In the order, the NASD agreed to expend \$100 million on its regulatory programs (specifically examinations, surveillance, enforcement and internal audit). In the order, the SEC acknowledged that \$25 million annualized (or \$11.8 million) had been authorized for 1996, and that the remainder of that amount would be committed over the next five years. In an exchange of correspondence, the NASD and SEC agreed to what expenses would be considered eligible to be counted toward the \$100 million figure, and how those figures should be calculated using the 1995 budget as a baseline. For 1997, the NASD has spent \$20.4 million through September, and has spent \$31.2 million since the inception in 1996. The independent consultant, responding to a request by the SEC, will undertake to monitor the calculation of the \$100 million, at least for the remainder of his engagement.

12. The problem of penny stock fraud is not a new one, and the recognition that it is a serious problem is not new. In September, 1989, the North American Securities Administrators Association concluded, based on a 50-state survey, "Penny stock swindlers are the No. 1 threat of fraud and abuse facing small investors in the United States." At that time the losses attributed to penny stock fraud in the United States were \$2 billion a year. In response, Congress passed the Penny Stock Fraud Act of 1990, which enhanced the regulatory tools available to fight penny stock fraud.

It is estimated that penny stock fraud abuses result in six billion dollars worth of losses per year, three times what the losses were before Congress passed the Penny Stock Fraud Act of 1990. You testified recently at a hearing on penny stock fraud: "Let me be blunt. There are significant problems in the over-the-counter market and a strong regulatory response is needed."

However, the NASD-R is a regulatory body. There are those who are skeptical of the ability of the NASD to regulate itself, that is to regulate its own members. That skepticism is reinforced somewhat by the perception that when the NASD does take disciplinary steps, its proceedings take a very long time, and any disciplinary action taken is less than effective, because violators are free to operate under another name, or as "consultants."

How do you respond to critics who say that the NASD lacks the will, or the ability, or both, to tackle securities fraud in general and penny stock fraud in particular?

ANSWER:

The NASD, with its 1649 regulatory staff and regulatory budget of \$211 million, is the largest securities self-regulatory organization in the US, and has both the will and the ability to tackle securities fraud in general and penny stock fraud in particular. Our answers to the other questions posed by Senators Collin and Glenn demonstrate that we — along with the SEC, the other SROs and the states — are aware of the problems of fraud in our securities markets, have formulated thoughtful approaches to reducing it to as low a level as possible. We are constantly in the process of implementing and improving those approaches.

We have focused on the microcap market in particular and are moving quickly to implement proposed regulatory reforms in that area. We have also focused enforcement effort on the microcap area, including, for example, the recent decision issued against La

Jolla Securities, and settlements reached in GKN, and DH Blair. These cases follow our significant earlier actions in this area, including cases brought against Stratton Oakmont, Hibbard Brown, and Sterling Foster.

We understand the need for speed in the prosecution of our cases, and, as of August 7, 1997, are operating under a new Code of Procedure, with each case assigned to a professional hearing officer. Those hearing officers will bring added efficiency to the process by hearing and disposing of motions expeditiously and actively supervising their cases as they progress through the disciplinary process.

Of course, our jurisdiction is limited to registered firms and their associated persons. When we become aware of unlawful activity of those outside our jurisdiction, such as consultants, we immediately refer the matter to the SEC, the States, or the criminal authorities.

Our focus on regulation is evident through our commitment to resources. In 1996, we significantly increased the number of staff dedicated to regulation and enforcement by adding more than 150 new positions. By the year 2000, NASDR plans to spend more than \$100 million to enhance its systems for market surveillance and increase examination, surveillance, enforcement, and internal audit staff.

We are already beginning to see the fruits of our additional investment. In 1996, disciplinary actions brought by the NASD reached 1,200, an increase of 12 percent over the prior year. Last year 394 individuals were barred and 204 were suspended. Disciplinary fines collected increased by almost two-thirds and the number of firms expelled from the NASD increased by approximately 20 percent. In addition to disciplinary fines, orders of restitution to investors reached \$21.8 million in 1996.

Nasdaq Backgrounder

THE NASDAQ STOCK MARKET

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What Is The Nasdaq Stock Market?

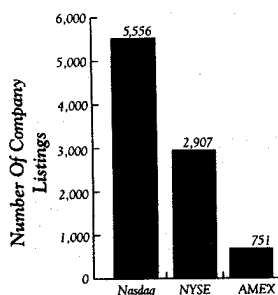
Nasdaq®, the fastest growing stock market in the U.S. and the world's first electronic stock market, began operating in 1971. Just over 25 years later, it serves millions of investors around the globe, has more listed companies than any other market in the world and is the second largest securities market in terms of dollar volume—ahead of London and Tokyo combined. Many of Nasdaq's more than 5,500 companies are industry leaders in computers, data processing, pharmaceuticals, telecommunications, biotechnology and financial services. In addition, Nasdaq outpaces all other U.S. markets in listings of new public companies—a total of 87 percent of all companies making initial public offerings traded on Nasdaq in 1996.

What distinguishes The Nasdaq Stock MarketSM from other U.S. markets is its use of today's information technologies—computers and telecommunications—to unite its participants and enable securities firms to compete with one another in a screen-based, floorless market. In addition to its use of sophisticated technology, Nasdaq is unique in its use of multiple Market Makers—-independent dealers that compete openly with one another for investors' orders in each Nasdaq security.

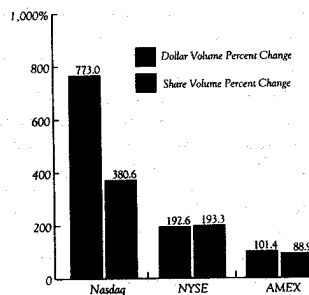
Nasdaq is a quote-driven market. Market Makers post firm quotes (bids and asks) that can be viewed by all other Market Makers. The best bid (highest price a Market Maker will pay for a stock) and the best ask (lowest price a Market Maker will sell a stock at) is called the inside price, and is available to all investors through broker workstations or news terminals.

Companies listed on Nasdaq are separated into two tiers—The Nasdaq SmallCap MarketSM, for small- to medium-sized companies, and the Nasdaq National Market®, for larger companies with higher capitalization.

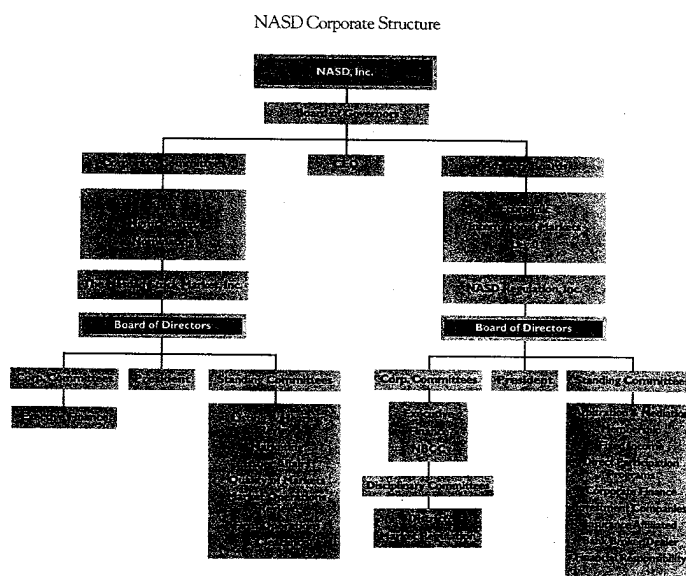
Nasdaq Is First In Company Listings



Nasdaq—Fastest Growing Equities Market In The U.S.: 1986-1996



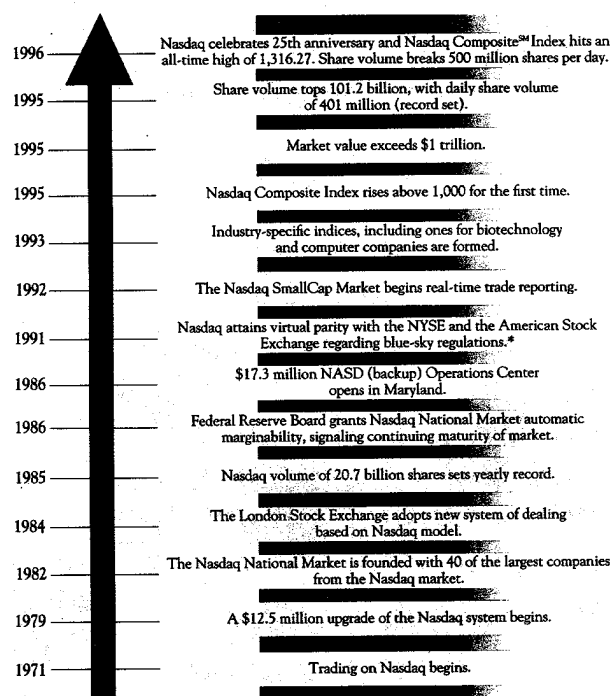
Who Owns And Runs The Nasdaq Stock Market?



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The Nasdaq Stock Market is distinctly separate from the U.S. over-the-counter (OTC) market and the OTC Bulletin Board® quotation system, although they are all regulated by the NASD. For more than one-half century, the NASD has fulfilled its statutory responsibilities and has protected investors through the enforcement of federal securities laws, as well as the broader ethical requirements of its own rules, which obligate members to observe high standards of commercial honor.

The Evolution Of Nasdaq



*Blue-sky laws require issuers of securities to register their offerings with the state before they can be sold to residents. Most blue-sky laws include provisions on fraudulent activities and the licensing of people selling securities. Nasdaq National Market securities, subject to higher qualifications standards, are exempt from registration requirements under most states' blue-sky laws.

The Nasdaq Stock Market Today

In 1996, Nasdaq's share volume exceeded 138 billion shares and its dollar volume reached \$3.3 trillion, gains of 381 and 773 percent, respectively, over levels a decade earlier.

Today, Nasdaq lists more:

- companies than any other stock market in the world,
- initial public offerings (IPOs) than any other U.S. stock market, and
- non-U.S. companies than the NYSE and AMEX combined.

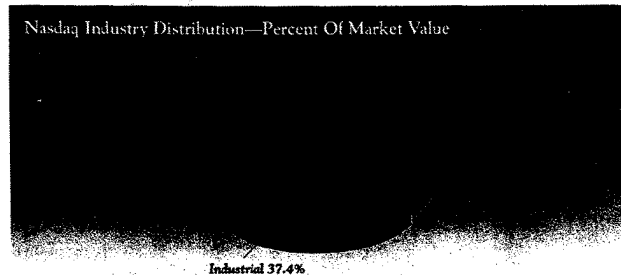
Wide Spectrum Of Companies List On Nasdaq

The Nasdaq Stock Market includes many major, well-known companies. U.S. companies include: Apple, American Greetings, Boatmen's Bancshares, Microsoft, Intel, Amgen, Cisco, Nordstrom, Oracle, McCormick, SAFECO, Tyson's Foods, Sun Microsystems, U.S. HealthCare, Netscape and Northwest Airlines.

Nasdaq companies cover the whole spectrum of the U.S. economy, from agriculture, mining, construction and manufacturing to transportation, retail, banking and insurance. The largest concentration of firms is in dynamic growth sectors, such as information technologies (software and hardware), telecommunications, pharmaceuticals, biotechnology, finance, banking and insurance.

There are 225 stocks with a market capitalization of more than \$1 billion, up from 82 in 1991.

Nasdaq Industry Distribution—Percent Of Market Value



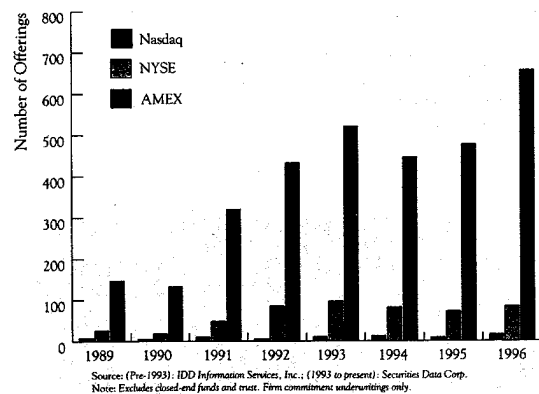
Innovative, Emerging Companies Found On Nasdaq

The Nasdaq Stock Market is home to hundreds of emerging companies in fast-growth sectors like information technologies and biotechnology.

Among the many reasons companies have given when explaining why they joined Nasdaq are: Market Maker sponsorship; floorless, modern trading; liquidity; lower listing fees. Nasdaq also offers many services to companies once they join Nasdaq. They are assigned a representative who can help them with any questions regarding their listing. A Nasdaq listing analyst keeps in close contact with listing companies to assist them in filing the proper documents and making sure they maintain the minimum listing requirements.

A total of 655 initial public offerings (IPOs) raised \$24.1 billion in new capital during 1996 on Nasdaq.

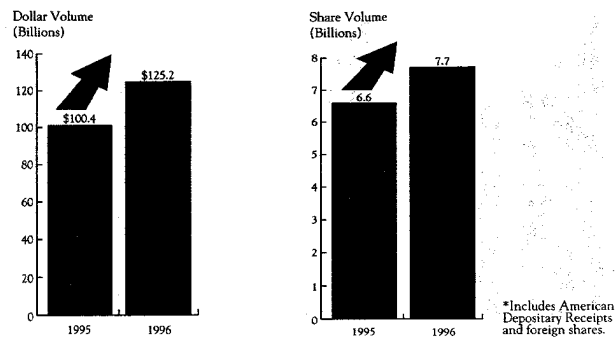
Number of Initial Public Offerings By Market, 1989-1996



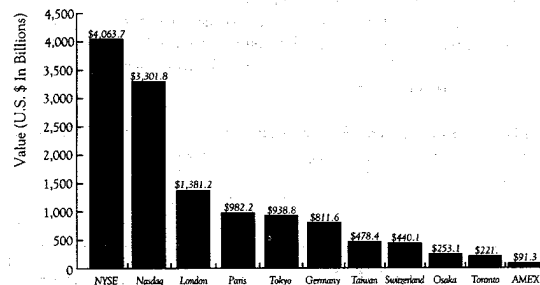
International Activity-Setting Records

Nasdaq lists more foreign-based issues than the New York and the American Stock Exchanges combined. In the international arena, Nasdaq continued its strong trading pace for American Depositary Receipts (ADRs) and non-U.S.-based securities in 1996. Combined trading for ADRs and non-U.S.-based shares on Nasdaq reached a record high in 1996 of 7.7 billion shares and \$125.2 billion in dollar volume. This represents a 16.7 percent increase in share volume and a 24.7 percent gain in dollar volume from 1995.

Nasdaq's Growing International Role*



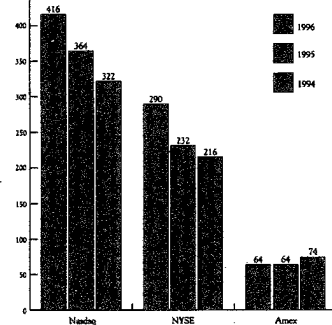
Dollar Volume Of Equity Trading In Major World Markets, 1996



Non-U.S.-Based Companies

Nasdaq is the principal market in the United States for trading shares of non-U.S.-based companies. As of December 31, 1996, there were 139 ADR and 279 foreign companies listed on Nasdaq. World-class non-U.S. companies listed on Nasdaq include: Reuters Holdings plc, WPP Group plc, Carlton Communications plc and Orange plc of the U.K.; Waterford Wedgwood plc and CRH plc of Ireland; L.M. Ericsson Telephone Company, AB Volvo and Swedish Match AB of Sweden; Akzo Nobel N.V., Madge Networks N.V. and Baan Company N.V. of the Netherlands; Hollinger Inc., MacMillan Bloedel Limited, BioChem Pharma Inc. of

Foreign-Based Companies On Major U.S. Markets, 1994-1996

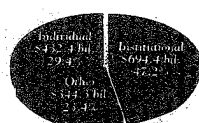


Canada; Scitex Corporation Ltd., ECI Telecom Inc., and Teva Pharmaceutical Industries Limited of Israel; Nissan Motor Co., Canon Inc., and Fuji Photo Film Co. of Japan; Memtec Limited, and Pacific Dunlop Limited of Australia; Banco de Galicia y Buenos Aires S.A. of Argentina; Compania Cervecerias Unidas S.A. of Chile; Business Objects S.A., LVMH Moët Hennessey Louis Vuitton, and Dassault Systemes S.A. of France; Tramford International Ltd. of Hong Kong; and Creative Technology Ltd. of Singapore.

While all of these large companies meet the financial requirements for listing on the NYSE, they have made Nasdaq their market of choice. Nasdaq's lead in the use of screen-based technology and its competitive Market Maker system are the principal reasons why Nasdaq is the market for companies of every type and size in every stage of development.

Distribution Of Holdings Of Nasdaq National Market Common Stocks, September 1996

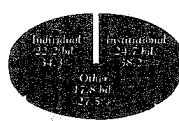
Market Value Of Holdings



\$1,471.1 Billion

Data Source: CDA Spectrum

Shares Held



60.8 Billion Shares Outstanding

Other includes holdings of officers, directors, or related persons, and beneficial owners of 10 percent or more.

Individual and institutional investors are active participants in The Nasdaq Stock Market. Currently, about 11 million individual investors own Nasdaq-listed shares directly. Millions more own Nasdaq stocks through mutual fund and pension plan holdings. But the mix has shifted in recent years toward institutional investors, as Nasdaq gains recognition as a highly efficient, well-regulated market. Measured by market value, institutions now own 47 percent of Nasdaq stocks.

Nasdaq Performance: Growth And Dynamic Companies

In 1996, Nasdaq celebrated its 25-year anniversary. Since its inception on February 8, 1971, the Nasdaq Composite Index has increased 11-fold, compared to the S&P 500 and the Dow Jones Industrial Average (DJIA), which increased respectively 7 and 6 times over the same period. In 1995, the Nasdaq Composite had its best year since 1991, growing 39.9 percent for the year, compared with the S&P 500's 34.1 percent and the DJIA's 33.5 percent. Although 1996 was not as impressive, the Composite Index did increase 22.7 percent, while the S&P 500 increased 20.3 percent and the DJIA 26 percent.

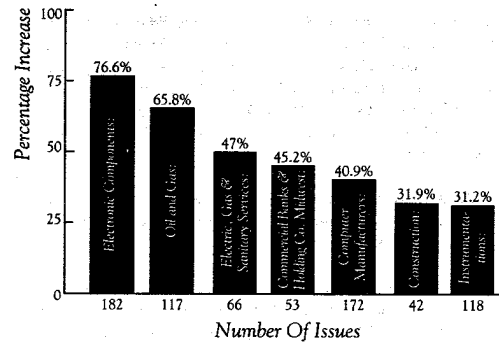
The Nasdaq Composite Index is a broad-based, market-value weighted index of about 5,575 companies listed on Nasdaq (more than 6,300 issues). The Composite Index, although technology heavy, also has many companies from other sectors.

The Nasdaq Composite Index is comprised of eight sub-indices: Industrial, Bank, Insurance, Other Finance, Transportation, Telecommunications, Biotechnology and Computer. The last two indices were created on November 1, 1993. The Telecommunications used to be the Utilities Index, but it now contains only telecommunications firms; all other utility companies were added to the Industrial Index.

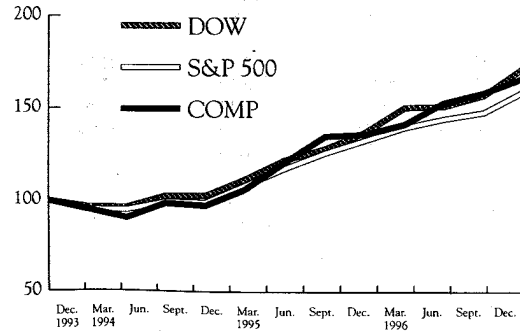
The Nasdaq Composite Index covers more of the share volume and dollar volume than other widely followed indices.

Index	Issues	Percent Of Total	Market Value (\$ Billion)	Percent Of Total
Bank	375	6.7%	39.8	2.7%
Biotechnology	121	2.2%	52.2	3.5%
Computer	685	12.3%	521.1	34.8%
Industrial	3,394	60.9%	560.5	37.4%
Insurance	103	1.8%	281.5	1.9%
Other Finance	610	10.9%	157.1	10.5%
Telecommunications	183	3.3%	111.4	7.4%
Transportation	104	1.9%	27.3	1.8%
Total	5,575		1,750.9	

Nasdaq Major Industry Groups* Ranked By Performance, 1996

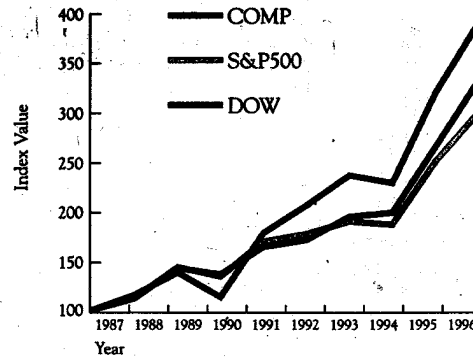


Short-Term Index Performance, 1993-1996



Dec 1993=100

Long-Term Index Performance Comparison, 1987-1996



What's Different About The Nasdaq Trading System?

As mentioned earlier, there are two important features that distinguish The Nasdaq Stock Market from a traditional exchange: its competing Market Makers and its advanced technologies. In an electronic age, it is no longer necessary for people to meet face-to-face in a single location to trade securities. Also, competition in the marketplace benefits the investors, and it is aggressive competition among Nasdaq Market Makers that sets them apart from single-exchange specialists.

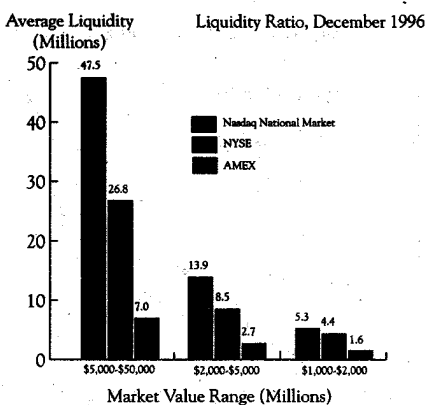
Competing Market Makers

Each company that lists its shares on Nasdaq has a number of competing securities firms that make a market in its stock. These Market Makers include many of the largest and best capitalized securities firms in the world, including Merrill Lynch, Goldman Sachs, Lehman Brothers, Morgan Stanley/Dean Witter, Oppenheimer, Smith Barney, and PaineWebber.

U.S. federal securities laws, and the rules and regulations of the SEC and the NASD, require Market Makers to adhere to specific record-keeping and financial-responsibility standards; make continuous two-sided markets; accept and execute orders up to certain size limits when they are at the best price; disseminate firm, two-sided quotes; and report transactions for public dissemination within 90 seconds of execution.

The liquidity ratio is a measure of the dollar volume of securities associated with a one percent price change in the security. The higher the ratio, the greater the amount of stock that can be traded with little change in price. The higher the dollar volume required, the greater the liquidity of the security.

Data source: Media General Financial Services, Inc.



How do Market Makers make markets? These multiple dealers, about 540, aggressively compete with one another for investor orders by buying and selling for their own accounts over Nasdaq's electronic network of terminals, called "workstations." A minimum of two Market Makers is a prerequisite for a company listing on Nasdaq. The typical Nasdaq stock has 11 Market Makers; some of the more actively traded stocks have 40 or more. It is this highly visible, competitive interplay of many contenders in the marketplace that determines prices in The Nasdaq Stock Market.

All Market Makers in a security are required to quote "firm" bid and ask prices. The bid is the price at which a Market Maker is willing to buy; the ask is the price at which the firm is willing to sell. Market Makers stand ready to execute transactions at their displayed prices on Nasdaq for the normal unit of trading or for their displayed size limit, whichever is greater.

Most transactions are automatically reported through a variety of electronic systems. For all others, the Market Maker must report within 90 seconds, using a Nasdaq workstation. These trade reports are broadcast immediately to market data vendors for dissemination over their networks.

Market Makers provide a sponsorship role by publishing research on the companies they make a market in. This increases the level of a company's exposure to the investment community.

The Nasdaq Market Maker system provides several advantages to investors and listed companies. Among others, it:

- is competitive and assures investors that they are getting the best possible price and execution.

- offers market "depth" because with an average of 11 Market Makers in each stock, there typically are a number of Market Makers at the best bid or ask price.
- provides continuous trading activity, even under the most challenging market conditions, without the trading halts common to the single-specialist markets of the exchanges.
- furnishes market depth and continuous trading that, in turn, provide superior "liquidity" (a measure of the dollar volume of trading it takes to move the price of a stock one percent). Academic studies have shown that Nasdaq National Market stocks have greater liquidity than comparable NYSE issues.
- gives companies exposure and visibility. Market Makers' trading and sales departments regularly follow each of the stocks they trade and routinely bring them to the attention of investors. In addition, Market Makers' quotes can be viewed by brokers and investors worldwide. There are currently almost 300,000 terminals receiving Nasdaq trading information in more than 55 countries.

New SEC Order Handling Rules

Two new rules concerning the handling and execution of individual securities orders were recently adopted by the SEC and applauded by The Nasdaq Stock Market for giving individual investors better information, more control over their orders to buy and sell stock, and enhanced access to better prices for the securities they buy and sell. The rules took effect for 50 Nasdaq stocks on January 20, 1997, and will continue to be phased in this year. While the SEC Order Handling Rules apply to all equity markets in the United States, they will benefit those who invest in Nasdaq stocks the most.

Under the Limit Order Display Rule, a Market Maker that receives a limit order (to buy or sell a designated number of shares of a security at a specific price) priced better than its best current quote must display the investor's limit order price and size on the trading screen as the Best Bid or Ask. If a limit order is priced the same as the Market Maker's quote, the Market Maker must reflect the size of the customer's order in its quote. Previously, investors could place limit orders, but they were not routinely displayed in a Market Maker's quotes; now, the investor's limit order can be seen by the entire market. However, exempt from the rules are: all-or-none orders; orders that customers request not be displayed; orders of fewer than 100 shares; and orders of more than 10,000 shares or more than \$200,000 in market value.

The ECN Rule is an amendment to the existing Quote Rule that affects Electronic Communications Networks (ECNs) and applies to all orders of 100 shares or more. The ECN Rule levels the playing field for individual investors by requiring Market Makers to display their best prices publicly, even orders received on an ECN—a private system generally seen only by financial professionals. Nasdaq has integrated certain ECNs into the market, so the price and size of those orders are now displayed publicly so individual investors can see the best possible price at which Market Makers are willing to trade a security.

Nasdaq's Technology

The Nasdaq Stock Market makes use of the most advanced technology available. In 1996, it upgraded three of its most important components. First, the interface which dealers use to access the market has been revamped and given a new Windows-like look: Nasdaq Workstation II™. It allows traders to customize the information they want and need on their computer screens. Secondly, the communications lines have been upgraded to 56,000 baud (from 9,600 baud) digital links to the central data complexes of Trumbull, CT and Rockville, MD. Finally, the mainframe used, among other things, to enter and execute orders, update quotes and send confirmed trades for clearing and settlement, has been upgraded in both our Trumbull and Rockville facilities.

This new technology allows Nasdaq to handle one billion shares per day. Although it is sufficient for today's trading of over 600 million shares per day, Nasdaq is already designing the requirements for a new system which will handle two billion shares a day.

Electronic Trading Services

The Nasdaq electronic or screen-based trading system makes possible efficient, instantaneous transactions. Here's how it works:

When an investor places an order to buy or sell a Nasdaq security at the market (i.e., for the current price), his or her broker will route that market order to the firm's trading room. If the firm makes a market in the security, it will normally execute the order internally, as principal, at a price equal to or better than the best price being quoted on Nasdaq by all of the competing Market Makers.

A firm that is not a Market Maker in the security will execute the order with a Market Maker at another firm. For small orders, the firm is likely to execute the transaction with a Market Maker through an automated execution system.

Electronic Surveillance

Electronic trading also facilitates prompt and accurate surveillance. Through a variety of on-line and off-line systems, the NASD—the securities industry's largest self-regulatory organization—continually monitors trading in Nasdaq issues. Unusual trading patterns are automatically flagged and referred to a Market Regulation analyst for review. If improper trading seems apparent, it is immediately investigated. As an SRO, the NASD disciplines member firms and their registered employees for violating NASD rules or federal securities laws.

The Nasdaq Stock Market uses a variety of centralized automated systems to analyze trading activity on a monthly, weekly, and daily basis. Key among these is the StockWatch Automated Tracking (SWAT™) system. The SWAT system uses state-of-the-art technology to monitor the price and volume of every Nasdaq security for abnormal activity. SWAT evaluates each security traded on Nasdaq using historical price and volume information, industry trends and publicly disseminated news regarding each company.

RADAR: Market Regulation's High Tech Tool

In November 1996, Market Regulation installed a new system designed to bring a greater number of violators to justice. The high-tech, \$4.5 million computerized system, RADARSM (Research and Data Analysis RepositorySM) added many new artificial intelligence features to the existing market surveillance system called StockWatch.

Used by more than 75 analysts in our Market Regulation Department, RADAR provides instant analysis capabilities of trading activity with the aid of pie charts, spreadsheets and line and bar graphs. This tool allows analysts to examine trading patterns in a much more efficient way.

How Does A Company Qualify For A Nasdaq Listing?

Every company listing its shares on a U.S. stock market must register them with the SEC. After registering, the company has to provide the SEC with regular reports on its financial condition and material corporate developments. U.S. companies file these reports quarterly; non-U.S. companies file semi-annually. These reports are available to security analysts and the investing public.

A company that chooses to list on The Nasdaq Stock Market must also meet minimum Nasdaq qualifications.

- Nasdaq has no restrictions for companies that choose to delist, unlike other U.S. exchanges.

Financial Requirements

The Nasdaq Stock Market has two tiers with separate requirements.

- The Nasdaq National Market, which includes more than 4,147 companies.
- The Nasdaq SmallCap Market with more than 1,409 companies.

The specific requirements for each of these segments are summarized in the accompanying charts.

Corporate Governance Rules

Nasdaq corporate governance requirements apply to Nasdaq National Market companies.

Among the most significant are:

- a minimum of two independent directors on its board
- an audit committee with a majority of independent directors
- annual shareholder meetings
- regular disclosure of material information

Summary Of Financial Requirements For Initial Listing*

The Nasdaq National Market Listing Requirements

	Entry Requirements Alternative 1	Alternative 2	Maintenance Requirements
Registration under Section 12(g) of the Securities Exchange Act of 1934 or equivalent	Yes	Yes	Yes
Net tangible assets ¹	\$4 million	\$12 million	\$1, 2, or 4 million ²
Net income (in latest fiscal year or 2 of last 3 fiscal years)	\$400,000	N/A	N/A
Pretax income (in latest fiscal year or 2 of last 3 fiscal years)	\$750,000	N/A	N/A
Public float (shares) ³	500,000	1 million	200,000
Operating history	N/A	3 years	N/A
Market value of float	\$3 million	\$15 million	\$1 million
Minimum bid price per share	\$5	\$3	\$1 ⁴
Shareholders	N/A	N/A	400 ⁵
-if between 0.5 and 1 million shares publicly held	800	400	N/A
-if more than 1 million shares publicly held	400	400	N/A
-if more than 0.5 million shares held and average daily volume in excess of 2,000 shares	400	400	N/A
Number of Market Makers	2	2	2

¹ Net tangible assets means total assets (excluding goodwill) minus total liabilities.

² Continued Nasdaq National Market inclusion requires net tangible assets of at least \$2 million if the issuer has sustained losses from continuing operations and/or net losses in two of its three most recent fiscal years or \$4 million if the issuer has sustained losses from continuing operations and/or net losses in three of its four most recent fiscal years. Regardless of the foregoing, the issuer must have at least \$1 million in net tangible assets.

³ Public float is defined as shares that are not "held directly or indirectly by any officer or director of the issuer and by any person who is the beneficial owner of more than 10 percent of the total shares outstanding"

⁴ In the alternative, the issuer must have \$3 million in market value of public float and \$4 million in net tangible assets.

⁵ Or 300 shareholders of round lots.

* Please note that these standards will be replaced with new ones in 1997. Visit our Web site at www.nasdaq.com for a comparison of the current and proposed listings.

The Nasdaq SmallCap Market Listing Requirements

	Entry Requirements	Maintenance Requirements
Total assets	\$4 million	\$2 million
Total stockholders' equity	\$2 million	\$1 million
Registration under Section 12(g) of the Securities Exchange Act of 1934 or equivalent ¹	Yes	Yes
Public float (shares) ²	100,000	100,000
Market value of public float ³	\$1 million	\$200,000
Shareholders	300	300
Minimum bid price per share ¹	\$3	\$1**
Number of Market Makers ¹	2	2

¹ This requirement becomes effective 120 days after an initial public offering.

² Public float is defined as shares that are not "held directly or indirectly by any officer or director of the issuer and by any person who is the beneficial owner of more than 10 percent of the total shares outstanding...."

³ A deficiency in the maintenance criteria for market value of public float, Market Makers, and bid price will be determined if the issuer fails any of these requirements for 10 consecutive days. If failure of any of the 10-day test occurs, the issuer will be notified promptly and will be given 30 calendar days to comply with the market-maker criteria and 90 calendar days to comply with the bid price or market value of public float requirements.

** Issuers that fail to meet the \$1 minimum bid price continue to qualify if they maintain \$1 million market value of public float and \$2 million in capital and surplus.

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Internet Sites

The Nasdaq Stock Market's Internet Web site can be viewed at: <http://www.nasdaq.com>. The site has hypertext links to virtually every Nasdaq-listed company that has a home page of its own, more than 2,500 in all. The site also features 15-minute delayed quotes and real-time Nasdaq stock index values. Recent features include mutual fund quotes, news from Reuters, PR newswire and business wire. We will be adding portfolio management in the first quarter of 1997. The Nasdaq Web site is one of the most popular financial sites on the Web, with more than 4 million hits per day.

The Nasdaq site uses the following Internet technology:

- Microsoft BackOffice™ technology and Internet Information Server™
- MCI's high-speed Internet MCI service
- Cisco Systems' latest 7000 series high-speed Internet Routers
- Intel architecture-based Pentium processor servers

In August 1996, NASD Regulation announced the launch of its home page on the World Wide Web: <http://www.nasdr.com>. The site, which investors around the world can access free of charge, contains an overview of NASD Regulation, information on investing wisely, an explanation of how and where customers can file complaints, a description of NASD Regulation's public disclosure program for investors to check out their brokers, and press releases on disciplinary actions and other matters issued by the organization. The site also enables investors to directly file complaints on-line with NASD Regulation, and in the future will allow investors to obtain disciplinary information about brokers.

NASD, The Nasdaq Stock Market, And NASD Regulation Leadership

Frank Zarb
Chairman, President and Chief Executive Officer,
National Association of Securities Dealers, Inc.

Frank G. Zarb became President and Chief Executive Officer of the National Association of Securities Dealers, Inc., on February 24, 1997. Previously, he was Chairman, Chief Executive Officer, and President of Alexander & Alexander Services Inc., from June 1994 through January 1997.

Mr. Zarb was a Vice Chairman and Group Chief Executive of The Travelers Inc. He had previously served as Chairman and Chief Executive Officer of Smith Barney, Travelers' brokerage and investment banking subsidiary, which he joined in 1988. He was named Group Chief Executive on June 24, 1993. Mr. Zarb was elected a Vice Chairman of The Travelers Inc. (formerly Primerica Corporation) on September 25, 1991. Before joining Smith Barney, Mr. Zarb had been a senior partner of Lazard Freres & Co. since 1978.

From 1974 through 1977, Mr. Zarb was the senior official for all U.S. government energy-related activities, serving as Executive Director of the Cabinet-level Energy Resources Council, Administrator of the Federal Energy Administration, and Assistant to the President for Energy Affairs. Prior to these appointments, he had been Associate Director of the Office of Management and Budget from 1973 to 1974 and served as Assistant Secretary of Labor between 1971 and 1972. He has served in various assignments for the Ford, Carter, Reagan, Bush, and Clinton administrations.

Before entering public service, Mr. Zarb acquired considerable experience in the securities industry, where he began his career with Goodbody and Co. in 1962. He later served in various capacities for predecessor firms to Shearson Lehman Bros., as Executive Vice President of marketing, operations, and investment banking as well as Chairman of the Executive Committee.

Mr. Zarb, who earned his bachelor's and master's degrees in business from Hofstra University, was awarded an honorary Doctor of Law degree by the university in 1975, and the school's Outstanding Scholar Award in 1974. In 1976, Quincy College conferred on him an honorary Doctor of Conservation degree.

Richard G. Ketchum
Executive Vice President and Chief Operating Officer,
National Association of Securities Dealers, Inc.

Rick Ketchum joined the National Association of Securities Dealers, Inc., in 1991 as its Executive Vice President of Legal, Regulatory, and Market Policy. In 1993, he was named Chief Operating Officer.

Previously, Mr. Ketchum was Director of the Division of Market Regulation at the SEC. He had been with the SEC from 1977 until he joined the staff at the NASD. From 1975 to 1977, Mr. Ketchum was associated with the New York law firm Milbank, Tweed, Hadley and McCloy.

Mr. Ketchum is a graduate of Tufts University and holds a J.D. degree from New York University School of Law.

Alfred R. Berkeley, III
President, The Nasdaq Stock Market, Inc.

Al Berkeley became President of The Nasdaq Stock Market, Inc., in June 1996. He is the first president since the National Association of Securities Dealers restructured to make The Nasdaq Stock Market an independent subsidiary.

For the last five years, Mr. Berkeley served as Managing Director and Senior Banker of the Corporate Finance Department of Alex. Brown & Sons in Baltimore. From 1989 to 1991, he took a leave of absence from Alex. Brown to serve on the executive committee of Safeguard Scientifics and as Chairman of a number of its subsidiaries. Mr. Berkeley first joined Alex. Brown in 1972 and held various positions, becoming a general partner of the firm in 1983.

Mr. Berkeley graduated from the University of Virginia, then earned his M.B.A. from The Wharton School at the University of Pennsylvania. He served as a major in the United States Air Force from 1968 to 1972.

Mary L. Schapiro
President, NASD Regulation, Inc.

Mary L. Schapiro is the first president of NASD Regulation, Inc., the recently formed subsidiary of the National Association of Securities Dealers, Inc. She assumed this position in February 1996.

In 1994, Ms. Schapiro was appointed by President Clinton as Chairman of the Commodity Futures Trading Commission (CFTC), a post she held until she joined NASD RegulationSM. Prior to that, she was a Commissioner of the SEC beginning in 1988, and served as its Acting Chairman in 1993. Additionally, Ms. Schapiro was General Counsel and Senior Vice President of the Futures Industry Association. She began her career with the CFTC in 1980 as a trial attorney, and later served as counsel and Executive Assistant to the Chairman.

Ms. Schapiro is a graduate of Franklin and Marshall College and earned her J.D. degree from the National Law Center of George Washington University.

March 1997

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What's News—

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Nasdaq's board is expected to vote on whether to drop 3,400 stocks from the OTC Bulletin Board, in a bid to distance itself from some of Wall Street's smallest and most speculative firms.

(Article on Page C1)

Senate Permanent Subcommittee
on Investigations

EXHIBIT # 19

THE WALL STREET JOURNAL TUESDAY, DECEMBER 9, 1997

Nasdaq, in Newest Clean-Up Plan, Might Remove 3,400 OTC Stocks

SMALL STOCK FOCUS

By DEBORAH LOHSE

Staff Reporter of THE WALL STREET JOURNAL
Trying to distance itself from some of Wall Street's smallest and most speculative companies, the Nasdaq Stock Market's parent board is expected to vote on whether to make about 3,400 stocks no longer eligible to trade on the market's lowest rung.

The rung, known as the OTC Bulletin Board, is essentially an electronic-trading forum run by Nasdaq where brokers and dealers can get up-to-date quotes, trading data, and a list of market makers in roughly 6,800 Bulletin Board securities.

But stocks on the board aren't listed on the Nasdaq market itself, which can be a touchy issue, since Nasdaq's name is often linked to them. That is true even though the companies that list on the board either can't meet listing standards at markets like Nasdaq, or they don't want to file

financial statements with the Securities and Exchange Commission. These unlisted issues include foreign securities known as American depositary receipts, and small regional companies, such as banks that don't seek much stock trading.

The latest proposal is part of a long struggle for Nasdaq to shake off an image of being a forum rife with small-stock scams. In recent years especially, Nasdaq has gained credibility by beefing up trading rules and standards for companies that trade in its top-tier National Market, home to such giants as Microsoft and Intel, or its second-tier SmallCap Market. But since April, Frank Zarb, chairman of the National Association of Securities Dealers, Nasdaq's parent, has been trying to find a way to clean up the loosely regulated OTC Bulletin Board, which is run by Nasdaq but which has almost no standards for the companies that list there.

Now, board members of Nasdaq's parent organization are expected to tentatively approve a proposal to kick companies off the OTC Bulletin Board if they don't file financial statements to SEC, banking or insurance regulators, according to people familiar with the proposal. NASD officials said that it is their policy not to discuss proposals before the board meets. Board members are also expected to discuss prohibiting brokerage firms from quoting prices for OTC Bulletin Board stocks if the brokers don't have current, reliable financial information on a company.

Also, every broker that recommends a bulletin board stock to a client would have to review detailed financial statements of the company before doing so. Finally, the proposal would also require every investor to get a disclosure statement that would spell out the difference between the bulletin board and other markets, in terms of liquidity (or ease of trading), standards, and market-maker obligations, according to people familiar with the proposal. If the NASD board approves the proposal Thursday, it will be put out for comment by

Please Turn to Page C9, Column 2

Continued From Page C1

members. But these actions won't rid the marketplace of companies that fail to file publicly available financial statements, people familiar with the proposal say. Any of the companies that fails to meet the raised standards of the bulletin board would be able to trade on the Pink Sheets, a less automated system that is owned by the National Quotation Bureau, which isn't affiliated with Nasdaq. Standards for the Pink Sheets aren't expected to be affected by this proposal.

Thus, investors in these speculative stocks likely would find it more difficult to buy and sell them. OTC Bulletin Board stocks are a little more convenient to trade, because Nasdaq provides space on its trading workstations for bulletin-board stock quoting. Investors in the Pink Sheets must get most of their information, and trade, over the phone.

Currently, stocks can trade on either the OTC Bulletin Board or the Pink Sheets as long as one market maker "vouches" that the company has current financial statements. Market makers do this by filing a 15c2-11 form. Because all market makers are NASD members, the NASD has responsibility for ensuring that market makers are abiding by that rule.

Securities regulators have expressed alarm that unscrupulous promoters, brokers and traders have taken advantage of the loosely regulated marketplace to foist worthless stocks on unwitting investors. Securities regulators have brought a steady stream of stock-manipulation and conspiracy cases to stem such abuses, which are considered easier to pull off on the bulletin board because of its thin trading volume and relative obscurity.

BALTIMORE SUN - December 10, 1997

Securities industry

Nasdaq looks to pull 3,400 small stocks

No. 2 market seeking
to distance itself from
tiny, high-risk issues

OTC Bulletin Board

Evicted little guys
could find a home
on the Pink Sheets

FROM STAFF AND WIRE REPORTS

The group that runs the Nasdaq stock market is considering whether to remove some 3,400 small-company stocks from special over-the-counter listings as the nation's second largest stock market tries to distance itself from tiny, speculative stocks.

Stock fraud frequently involves low-priced shares of such high-risk stocks, some-

times called "penny stocks," that are thinly traded and loosely regulated.

Two Nasdaq sources said yesterday that the board of the National Association of Securities Dealers — Nasdaq's parent organization — will vote on the proposal to eliminate about 3,400 stocks from the OTC Bulletin Board, an electronic market of about 6,800 securities.

The sources, speaking on condition of anonymity, said the board will vote on the proposal tomorrow.

The stocks that would be dropped also include many special shares of foreign companies.

Market analysts said such stocks could still be listed on the so-called Pink Sheets, a less automated system not affiliated with Nasdaq — but would be more difficult to trade.

It is unclear which Maryland [See Nasdaq, 8c]

Nasdaq looking to evict 3,400 speculative stocks

[Nasdaq, from Page 1C]

companies that trade on the bulletin board might be affected by the proposal. "I don't think there are any big problems," Boos said. "All of the banks around here would meet the [Nasdaq] requirements. I don't know if any of the local companies would be dragged into it."

Several Maryland-based biotechnology and medical technology companies also trade on the bulletin board but those companies are required to maintain state-ments and probably would lose their listings jeopardized by the proposal.

Neal Sullivan, executive director of the North American Securities Administrators Association, called the proposal "a very positive step."

The proposal, which Sullivan said is being supported by the NASD board, takes into account the "systemic nature of these problems," he said.

Nasdaq runs the Bulletin Board, but its stocks are not actually listed on the Nasdaq market. The small companies don't meet Nasdaq listing standards or don't have enough shares to be traded with the Securities and Exchange Commission. The Bulletin Board stocks often are linked with

Nasdaq's name, however. Under the proposal being considered, companies would have their stocks removed unless they agreed to the statements with the SEC or other financial regulators, according to yesterday's Wall Street Journal.

In addition, brokerage firms could be barred from quoting prices for the stocks unless the brokers had current reliable financial information about the companies.

Spokesmen for Nasdaq and NASD Regulation, the self-police arm of the securities dealers' group, declined comment on the matter.

Barry Goldsmith, executive vice president of NASD Regulation, recently testified at a Senate subcommittee hearing that, "contrary to a popular misconception, the [Nasdaq] market is not a market of over-the-counter securities. It is a market of over-the-counter securities."

"The two are separate and distinct," he said. "It is in the thinly traded (small-company stocks) that characterize the over-the-counter market that the bulk of the potential for fraudulent activity," Goldsmith said.

Such stocks are more easily subject to manipulation by unscrupulous brokers and promoters, he said.

Regulators estimate that American investors are being defrauded of about \$6 billion annually — three times the peak amount during the 1980s before enactment of the Penny Stock Reform Act of 1980.

The SEC has been helping the Justice Department and local authorities to prosecute stock fraud cases and has been looking to close loopholes in the rules governing the penny-stock market.

SEC spokesman Chris Ullman said yesterday that the agency would have to review the new proposal before it would be able to comment on it.