

NEW YORK STOCK EXCHANGE, INC.

EXCHANGE HEARING PANEL DECISION 00-22

February 10, 2000

CHARLES SCHWAB & CO., INC.
MEMBER ORGANIZATION

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Violated Rule 342 by failing to establish adequate procedures to supervise the opening of and trading in new customer phone accounts, by permitting registered representatives to override trading restrictions and by failing to conduct reasonable follow-up on new customer phone accounts; violated Rule 405(3) by failing to give timely supervisory approval to new customer account documents; violated Exchange Rule 440 and SEC Rule 17a-3 and 17a-4 by entering inaccurate information into the Firm's computer system and by failing to maintain required new account documentation; and violated Rule 351(d) by failing to properly code and report sales practice complaints – Consent to censure and \$250,000 fine.

Appearances:

For the Division of Enforcement
Margaret T. Roussel, Esq.
Adeline Liu, Esq.

For the Respondent
Andrew J. Wertheim, Esq.

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An Exchange Hearing Panel met to consider a Stipulation of Facts and Consent to Penalty entered into between the Exchange's Division of Enforcement and Charles Schwab & Co., Inc. ("Schwab" the "Firm"), a member organization. Without admitting or denying guilt, the Firm consents to findings by the Hearing Panel that between approximately August 1995 through January 1998 it:

- I. Violated Exchange Rule 342 by:
 - A. Failing to establish adequate procedures to supervise the opening of and trading in new customer accounts opened by phone prior to timely receipt of signed customer documents, including, among others, options agreements, margin agreements and IRA agreements;
 - B. Permitting registered representatives to override trading restrictions on customer accounts without supervisory approval; and

- C. Failing to conduct reasonable follow-up on supervisory deficiencies regarding the new customer accounts by phone program.
- II. Violated Exchange Rule 405(3) insofar as numerous customer accounts opened under a new accounts by phone program failed to receive timely supervisory approval of customer new account documents.
- III. Violated Exchange Rule 440 and SEC Rule 17a-3 and 17a-4 by:
 - A. Routinely entering inaccurate information into the Firm's internal computer system indicating receipt of new customer account documentation when such documents had not yet been received for new accounts by phone; and
 - B. Failing to maintain required new account documentation with respect to numerous new customer accounts.
- IV. Violated Exchange Rule 351(d) by failing to properly code and report approximately 192 customer complaints as sales practice related during the period January 1996 through June 1997.

For the sole purpose of settling this disciplinary proceeding, the Division of Enforcement and Schwab stipulate to the following:

Background and Jurisdiction

1. Schwab was incorporated in 1971 and adopted its current name in 1973.
2. Schwab is a member organization of the Exchange, which is Schwab's designated examining authority. Its primary business is discount securities brokerage and related financial services.
3. On or about May 26, 1998, Schwab filed a "Submission of Required Information pertaining to Members, Member Organizations..." (Form RE-3) with the Exchange, reporting that its customer account opening and documentation gathering and processing had resulted in certain misplaced or missing required customer account documentation.
4. In 1997, the Exchange's Division of Member Firm Regulation ("MFR") conducted a Sales Practice Examination of Schwab which was also referred to Enforcement.
5. By letters dated March 19, 1998 and July 23, 1998, Schwab was notified of the Exchange's investigation of the above matters.
6. Schwab launched a program called New Accounts by Phone ("NABP") to open certain new retail accounts by telephone prior to the receipt of signed, original customer account documents. NABP was in operation from August 1995 through

January 1998 (the “relevant period”). For much of its existence, however, NABP lacked proper controls, which resulted in opening accounts without timely supervisory approval of receipt of customer account documents, including customer agreements and documents relating to IRA accounts, as set forth below.

7. In addition, from January 1996 through June 1997, on a routine basis, Schwab was incorrectly reporting to the Exchange the nature of its customer complaints.

**Deficient Recordkeeping and Supervisory Controls for
Widespread Program to Open New Accounts by Phone**

8. In August 1995, Schwab initiated NABP as a pilot program. NABP was originally designed to permit the opening of retail customer cash accounts over the telephone. In addition, customers were permitted to place one trade prior to receipt of the customer’s signed new account documents.
9. From at least October 1996, at any given time, the Firm did not know the number of registered representatives using NABP, nor did it know how many accounts were opened using NABP.
10. During the relevant period, Schwab’s retail brokerage enterprise was divided into various organizations, including Branch Management (comprising branch offices accepting walk-in business), Customer Activation (including special projects to increase retail business), Advertising and Brand Management (including “inbound” and “outbound” telemarketing programs) and National Investor Service Centers (handling solely call-in business). Each of these organizations reported to different senior managers.
11. Although the Firm permitted all the organizations listed in Paragraph 10 above, to use NABP at various times during the relevant period, the Firm failed to establish a reasonable system for monitoring and supervising such units’ use of NABP.
12. Opening an account using NABP entailed inputting required new account information into the Firm’s computer database. This resulted in the immediate opening of an account. The Firm’s operations center used the database information to print completed new account documents. Exchange rules and Firm practice required that these documents be reviewed and approved by a Series-8 qualified supervisory person, and mailed to the customer for review, signature and return. This, however, did not occur in a timely fashion at all times during the relevant period.
13. To open a cash account under NABP, the Schwab account opening database required a “yes” response in the “COMPLETED DOC” field. The word “yes” in this field normally indicated that the Firm had received signed new account documents from the customer. For cash accounts opened under NABP, however, new account documents had not yet been signed or received. Accordingly, the entry of a “yes”

- response created an inaccurate Firm record for each and every cash account opened under NABP.
14. Initially, only the Firm's Inbound Telemarketing Team, located in Denver, Colorado, was permitted to use NABP (the "Denver Telemarketing Team"). Inbound calls were calls received from customers, usually in response to Schwab advertising or promotional materials. The Firm offered financial incentives to members of the Denver Telemarketing Team for converting these advertising "leads" into open accounts using NABP.
 15. By spring 1996, numerous branch offices in California and four National Investor Service Centers ("NIS Centers") began using NABP to open cash and IRA accounts. The Firm failed to take reasonable steps to supervise expansion of NABP. Among other things, other branches began to offer NABP without approval in all instances, and both the branches and the NIS Centers lacked proper supervisory controls.
 16. In January 1996, the Firm authorized the use of NABP to open customer IRA accounts over the telephone in those areas of the Firm engaged in the NABP program. The Firm, however, lacked a reasonable system of follow-up and review to ensure that required documentation was obtained for these accounts on a timely basis.
 17. In April 1997, the NABP was further expanded when the Firm authorized the creation of a national outbound telemarketing team with the authority to utilize NABP (the "Outbound Telemarketing Team"). By August 1997, the number of accounts opened under NABP (excluding accounts opened in the non-pilot branch offices) averaged approximately 292 per business day.
 18. After NABP expanded beyond the Denver Telemarketing Team, operational support became inadequate. Among other things, a shortage of Series-8 qualified personnel to review and approve documents, resulted in mailing delays to customers of new account documents. At times, these delays were as much as three weeks.
 19. The Firm lacked a reasonable system of follow-up and review to ensure that NABP new account documents were approved in a timely fashion and promptly mailed to customers. As early as February 1996, 208 of 654 accounts opened under NABP were reported on the Firm's Missing Document Report, an internal Firm report listing accounts opened for more than 30 days with incomplete account documentation.
 20. In addition, the Firm lacked a system of follow-up and review to ensure that new account documents were returned by the customer in a timely fashion. During the relevant period, the Firm had a procedure to impose trading restrictions on accounts identified as having "missing documentation" for more than 30 days. This restriction, however, was inadequate since Schwab registered representatives lifted the account restriction without supervisory approval in order to place a trade.

21. During the relevant period, the Firm was unable to determine whether any accounts opened under NABP traded options without signed options agreements on file.
22. Schwab registered representatives using NABP were expected to identify accounts opened under NABP, however, the Firm lacked a system of follow-up and review to ensure that this was done. This omission made it impossible for the Firm to identify all accounts opened under NABP.
23. Except for IRA procedures adopted in early 1997 for use by all retail units, uniform written policies and procedures for NABP were not adopted by the Firm until September 1997, almost two years after the program expanded beyond the Denver Telemarketing Team.
24. In March 1997, the Firm's internal audit department found that the NIS Centers lacked supervisory "tools" or comprehensive supervision procedures to monitor NABP. The Firm failed to take reasonable steps to resolve this deficiency. Among other things, the Firm never implemented any supervisory procedures for monitoring NABP.
25. In June 1997, unsuccessful efforts were made at the Firm to curtail the NIS Center's participation in NABP because its operational support for NABP was too limited to support the expansion of the program. The NIS Centers, nonetheless, continued to utilize NABP until termination of the program in January 1998.
26. Although the Firm created and staffed the position of "project manager" for NABP, the position lacked both authority and resources to adequately monitor or supervise the program.
27. In January 1998, NABP was terminated by Schwab senior management as a result of the unusually high number of missing account documents.
28. In February 1998, the Firm retained outside consultants to conduct an in-depth review of NABP, account opening processes and customer documentation. Among other things, this review found that, as of February 1998, approximately 212,000 required regulatory retail customer account documents had either not been obtained or located, or had not been microfilmed and indexed in accordance with the Firm's routine practice. These documents included margin agreements, options agreements, IRS Forms W-8 and W-9, NYSE Rule 407 letters (employer approval of member firm securities accounts for industry personnel), documents relating IRA accounts, and Schwab account applications evidencing supervisory approval of the new account documents. By July 1998, all but approximately 12,000 these documents had been obtained or located, or the account had been appropriately restricted or closed. Schwab has represented that all required documents were subsequently obtained for each unrestricted active retail account, and that no customers were financially disadvantaged by NABP.

29. In reaching the terms of this settlement, Enforcement has considered the actions taken by Schwab when senior management became aware of the unusual number of missing customer account documents. Such actions were:
- a) Senior management halted NABP and hired outside counsel and consultants to conduct a comprehensive review of NABP as well as of Schwab's account opening and documentation processes, policies and procedures, and to recommend appropriate remedial measures.
 - b) Schwab promptly reported the issue to the Exchange and the Securities and Exchange Commission, informed the Exchange of the results of the internal investigation, and fully cooperated in the Exchange's investigation.
30. Schwab has represented that it has taken the following remedial measures as a result of its review:
- a) revised the Firm's procedures and systems to prevent the lifting of account restrictions by its registered representatives, except with appropriate supervisory approval;
 - c) reduced the document follow-up cycle to accelerate the date on which an account missing documents is either restricted or closed;
 - d) enhanced its compliance department surveillance of the lifting of account restrictions, activity in restricted accounts, and document processing backlogs and also strengthened its compliance and audit departments' examinations to monitor conformity with customer account-opening policies and procedures; and
 - e) replaced NABP with a program to open new accounts by phone or over the Internet that does not permit overriding of account restrictions by its registered representatives (except with appropriate supervisory approval), and that does not permit trading prior to receipt of signed customer documents, thus avoiding the problems associated with NABP

Deficient Quarterly Reporting of Customer Complaints Under Rule 351(d)

31. As part of its 1997 Sales Practice Examination of Schwab described above, MFR conducted a review of the Firm's coding of customer complaints pursuant to Exchange Rule 351(d) during the period January 1996 through June 1997.
32. Among other things, MFR found 192 instances in which customer complaints were improperly coded by the Firm as "operational" in nature. Because these complaints should have been coded as sales practice complaints, the Firm violated Exchange Rule 351(d) in each instance.

33. The Firm has recoded all of the complaints referred to in Paragraph 32 above, and also has corrected any related regulatory filings.

DECISION

The Hearing Panel, in accepting the Stipulation of Facts and Consent to Penalty, found the Firm guilty as set forth above by unanimous vote.

PENALTY

In view of the above findings, the Hearing Panel, by unanimous vote, imposed the penalty consented to by the Firm of a censure and a fine of \$250,000.

For the Hearing Panel

Edward W. Morris, Jr.
Chief Hearing Officer