N E W Y O R K S T O C K E X C H A N G E, I N C.

EXCHANGE HEARING PANEL DECISION 02-196 **October 2, 2002**
A.G. EDWARDS & SONS, INC.
MEMBER ORGANIZATION

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Violated Rule 342 by failing to maintain appropriate procedures for supervision and control; recommended and sold unsuitable securities; made misrepresentations and/or omitted to disclose material facts in connection with the sale of securities; violated Rule 410 by effecting account designation changes without prior written authorization; violated Rule 405(2) by failing to supervise diligently accounts handled by registered representatives; violated Rules 405 and 401 by failing to use due diligence to learn essential facts relative to customer accounts; violated Rules 401 and 440 and SEC Rules 17a-3 and a-4 by failing to make and preserve required and timely records; and violated Sec. 220.8(b) and (c) of Reg. T by failing to adhere to requirements with respect to the imposition of 90 day restrictions – Consent to censure, $400,000 fine and an undertaking.

Appearances:

For the Division of Enforcement
James D. O'Donnell, Esq.
Audra A. Acquavella, Esq.
Steven M. Tanner, Esq.
Tina A. Higgins

For the Respondent
Saul S. Cohen, Esq.
Lionel E. Pashkoff, Esq.
Stephen G. Sneeringer, 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 A.G. Edwards & Sons, Inc. (the "Firm"), a member organization. Without admitting or denying guilt, the Firm consents to findings by the Hearing Panel that it:

I. Violated Exchange Rule 342 in that the Firm failed to establish and maintain appropriate procedures for supervision and control, including a separate system of follow-up and review, to ensure compliance with Exchange rules and federal securities laws, with respect to:

   A. The marketing and sale of Callable CDs.

B. The recommendation and sale of one or more securities to one or more customers which was unsuitable in light of the customer's age, investment objectives, financial resources and/or the concentration levels of the security in the customer's account.

C. Producing BOMs who handled their own customer accounts reviewed and approved their own correspondence and communications with the public, account designation changes, and order errors.

D. Maintaining accurate customer account information.

E. Employee trading of securities on Firm research department's restricted securities list.

F. Account statement pricing of bond and mutual fund positions.

G. Timely allocation of orders.

H. Extension of credit.

I. Preventing statutorily disqualified individuals from being associated with the Firm.

I. Engaged in conduct inconsistent with just and equitable principles of trade in that it: (i) recommended and sold securities to customers which were unsuitable in view of the customers' age, investment objectives, investment experience, financial resources and/or the concentration levels of the security in the customers' account, and (ii) made misrepresentations and/or omitted to disclose material facts to customers, in connection with the solicitation and/or sale of securities to customers.

II. Violated Exchange Rule 410 in that the Firm effected account designation changes and order errors without prior written authorization by a person designated under Rule 342(b)(1).

III. Violated Exchange Rule 405(2) in that the Firm failed to supervise diligently all accounts handled by registered representatives in connection with the marketing and sale of Callable CDs and high yield bonds, account designation changes, order errors and correspondence, communications with the public, and extensions of credit.

IV. Violated Exchange Rules 405 and 401 in that the Firm failed to use due diligence to learn essential facts relative to customers' accounts and failed to adhere to principles of good business practice in the conduct of its business affairs in connection with: (a) the marketing and sale of Callable CDs; (b) maintaining accurate customer account information; (c) the pricing of certain securities on customer account statements; (d)

policies and procedures regarding employee trading of securities on Firm's research restricted list; and (e) extensions of credit.

V. Violated Exchange Rules 410 and 440, and SEC Rules 17a-3 and 17a-4 in that the Firm failed to make and preserve required and timely records relating to designation and execution of customer orders.

VI. Violated Section 220.8(b) and (c) of Regulation T, in that the Firm failed to adequately adhere to requirements with respect to the imposition of 90 day restrictions on certain customer accounts as required by Regulation T.

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

Background and Jurisdiction

1. The Firm has been registered as a member of the Exchange since 1982. The Firm, which is primarily engaged in retail securities brokerage, has its home office in St. Louis, Missouri. The Firm currently maintains more than 700 branches nationwide.

2. Beginning in 1998, Enforcement initiated a series of investigations concerning the Firm following receipt of referrals from the Exchange's Division of Member Firm Regulation ("MFR") Sales Practice Review Unit ("SPRU"). The referrals were based upon exceptions noted by MFR examiners in their 1997, 1998, 1999, 2000 and 2001 supervisory standards/sales practice examinations of the Firm. The exceptions were noted in several reports (collectively, the "SPRU Reports") and were provided to the Firm.

3. Enforcement consolidated its investigations concerning the exceptions noted in the five SPRU Reports.

Summary of Violative Conduct

4. As set forth below, from August 1996 through December 2000 (the "Relevant Period"), the Firm failed to provide reasonable supervision of certain business activities and engaged in other violative conduct. The Firm's failure of supervision related to the marketing and sale of callable certificates of deposit ("Callable CDs"); the recommendation and sale of securities to customers which were unsuitable; producing branch office managers who handled their own customer accounts reviewed and approved their own correspondence and communications with the public, account designation changes, and order errors; maintaining accurate customer account information; employee trading of securities on Firm research department's restricted securities list; account statement pricing of bond and mutual fund positions; timely allocation of orders; the extension of credit; and preventing statutorily disqualified individuals from being associated with the Firm.

Violative Conduct

5. Exchange Rule 342(a) requires, among other things, that "[e]ach office, department or business activity of a member organization shall be under the supervision and control of the member or member organization establishing it and of the personnel delegated such authority and responsibility."

6. Exchange Rule 342(b) requires, in relevant part, that "each member organization shall provide for appropriate supervisory control and shall designate a general partner or principal executive officer to assume overall authority and responsibility for internal supervision and control of the organization and compliance with securities' laws and regulations. This person shall: (1) delegate to qualified principals or employees responsibility and authority for supervision and control of each office, department or business activity, and provide for appropriate procedures of supervision and control [and] (2) establish a separate system of follow-up and review to determine that the delegated authority and responsibility is being properly exercised."

7. During the Relevant Period, the Firm violated Exchange Rules 342(a) and (b), and other related rules, as follows.

Marketing and Sale of Callable CDs

8. Callable CDs, like traditional bank CDs, are issued by a bank, insured by the Federal Deposit Insurance Corporation up to $100,000, pay interest at a specified rate and at regular intervals, and carry a specific duration or maturity, at which time the full principal amount is to be returned to the investor.

9. Callable CDs differ from traditional bank CDs in several significant respects. While traditional bank CDs typically have maturities of between three months and ten years, the Callable CDs sold by the Firm were typically long-term investments, having maturities exceeding 10 years. Callable CDs may be sold prior to maturity date, but in such instances, the customer receives the prevailing price in the secondary market.

10. Callable CDs have a call feature, which allows, but does not obligate, the issuer, or its successor in interest, to redeem the security after a specified period, typically 12, 18 or 24 months. Issuers will likely exercise their call option when interest rates fall, leaving the investor to reinvest funds at a lower rate of return. When the call feature is exercised by the issuer, the principal is returned to the investor in full.

11. In return for the uncertainty created by the call feature, Callable CDs offer to investors a rate of return that is higher than traditional bank CDs. However, the same uncertainty makes Callable CDs generally unsuitable investments for individuals who need their principal investment returned at a date certain in the future.

12. In or about 1993, the Firm began to market and sell Callable CDs. From about 1994 to 2000, the Firm sold Callable CDs, valued at approximately $3.5 billion, to more than 125,000 customers. Generally, the Firm would purchase Callable CDs from another firm at a 1.25% discount to par value, and then mark up the issue to par for resale to customers.

13. During the Relevant Period, the Firm failed to properly supervise the marketing and sale of Callable CDs by its RRs, in violation of Exchange Rules 342(a) and (b).

14. The Firm did not have policies or procedures reasonably designed to ensure that RRs understood, and properly informed customers of, the features of Callable CDs.

15. Callable CDs were introduced to the Firm through the syndicate desk of its fixed income department. At that time, the Firm offered informational material to its RRs concerning the product but did not provide formal training sessions with specific instructions concerning the proper disclosures to be made to customers when soliciting the purchase of a Callable CD.

16. When the Firm began offering formal training sessions about Callable CDs to its RRs in January 1996, it did not make attendance at such training sessions a requirement before RRs could solicit the purchase of a Callable CD.

17. During the Relevant Period, several RRs made misrepresentations, and/or omitted to disclose material facts, to customers in connection with the recommendation and/or sale of Callable CDs.

18. The features of Callable CDs caused confusion among certain customers. By early 2000, more than 400 customers, who primarily were elderly and were seeking short-term, fixed income investments, complained about 220 RRs who had sold them Callable CDs.

19. Specifically, during the Relevant Period, the complaining customers alleged that they had not been fully informed regarding: (i) call risk, *i.e.*, that the call feature creates uncertainty as to the ultimate maturity of the investment; (ii) reinvestment risk, *i.e.*, that if the Callable CD is called, the funds would likely have to be reinvested at a lower rate of return, and (iii) market risk, *i.e.*, that because of the issuer's call option, there is a ceiling as to price appreciation, but alternatively, should rates rise, the market price of the Callable CD would fall.

20. Moreover, prior to April 2000, the Firm priced Callable CDs at par on the monthly account statements sent to its customers. This practice prevented customers from learning from account statements of fluctuations in the market value of their Callable CD investments.

21. In April 2000, the Firm instituted a pricing model that provided approximate Callable CD pricing on customer account statements.

Recommending and Selling Unsuitable Securities

22. During the Relevant Period, the Firm's RRs recommended and sold securities to customers that were unsuitable in view of the customers' ages, investment objectives, investment experience, financial resources and/or the concentration levels of the securities in the customers' accounts.

Callable CDs

23. For example, as described above, during the period 1994 to 2000, numerous customers purchased long-term Callable CDs based upon the recommendation of RRs at the Firm. Some of these customers were elderly, lived on a fixed income, had investment objectives of safety of principal, and did not want to commit their principal for a lengthy period of time.

24. Some customers were erroneously told by RRs that they would be able to redeem the Callable CDs at par at any time after one year, with no loss of principal. In addition, certain customers were not told that the price of the CDs would fluctuate in value. In fact, many of the Callable CDs had long maturities and would not mature for many years, leaving the customers to sell their Callable CDs in the secondary market at a loss.

25. To date, the Firm has settled approximately 220 complaints relating to callable CDs for a total of approximately $2 million.

High Yield Bonds

26. As another example, during the period of August 1996 through May 1997, RR, AB, of the Firm's Omaha, Nebraska branch office, solicited and recommended the purchase of XYZ 9.125% 4-15-03 Senior Subordinate Notes, a speculative, high-yield bond, rated below investment grade, and not followed by the Firm's research department, in the accounts of approximately 147 customers. By May 1997, based upon his recommendation, AB's customers had purchased XYZ Bonds at an aggregate total cost in excess of $4 million.

27. Most of the approximately 147 customers who purchased XYZ bonds on AB's recommendation were elderly, with limited financial resources, were not sophisticated investors and relied on AB. Many of the approximately 147 customers solicited to purchase XYZ bonds had primary investment objectives of "safety of principal," "growth" or "income."

28. Upon AB's recommendation, 19 of the customer accounts invested the account's total equity in XYZ bonds, and 49 of the customer accounts had concentrated positions of 50% or greater of the account's total equity in XYZ bonds. The Firm failed to detect these heavily concentrated positions in XYZ Bonds.

29. In May 1997, the Firm's fixed income department issued a research opinion that described the XYZ Bonds as "highly speculative" with expectations that the price of the bonds would continue to deteriorate.

30. In early July 1997, a condensed report of the Firm's research opinion was sent to customers holding XYZ Bonds. On or about July 21, 1997, XYZ filed for bankruptcy protection and, thereafter, in October 1997, defaulted on its interest payments.

31. XYZ Bonds were not priced on most customer monthly account statements until July 1997.

32. To date, the Firm has settled approximately 40 complaints relating to XYZ Bonds for a total of approximately $1.1 million.

<u>Producing Branch Office Managers Who Handled Their Own Customer Accounts Reviewed and Approved Their Own Correspondence and Communications with the Public, Account Designation Changes, and Order Errors</u>

33. During the Relevant Period, the Firm failed to provide reasonable supervision of certain Branch Office Managers ("BOMs") who handled their own customer accounts because certain BOMs who handled their own customer accounts also reviewed and approved their own correspondence, account designation changes, and order errors, in violation of Exchange Rules 342.16, 405 and 410.

34. Exchange Rules 342.16, 405 and 410 provide, in pertinent part, that reasonable supervision requires that salespersons' communications with the public relating to their business, approval of customer accounts and transactions, account designation changes and order errors be reasonably reviewed by a person authorized to do so pursuant to Exchange Rule 342(b)(1).

35. The 1997 SPRU Report noted as an exception that the Firm failed to provide reasonable supervision in that producing BOMs in certain branch offices who handled their own customer accounts also reviewed their own correspondence and approved their own order errors and account designation changes.

36. Thus, the Firm was put on notice that its procedures were not adequate for supervising producing BOMs. Nevertheless, Exchange examiners noted repeat findings of the same type with respect to other branch offices in the SPRU Reports for 1998-2001.

37. During the Relevant Period, 21 producing BOMs or Assistant BOMs from 17 branch offices reviewed and approved their own correspondence, account designation changes, or order errors with respect to customer accounts they handled.

38. For example, one producing BOM received a letter in which a customer complained that the BOM had effected unauthorized trades in the customer's account. The BOM reviewed his own correspondence and did not report the complaint to the Firm, causing the Firm to violate its obligation under Exchange Rule 351 to report the complaint to the Exchange.

Maintaining Accurate Customer Account Information

39. Exchange Rule 401 requires that every member organization at all times adhere to principles of good business practice in the conduct of its business affairs.

40. Exchange Rule 405 requires, in relevant part, that every member organization learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization, and that it supervise diligently all accounts handled by RRs of the organization.

41. From 1996 through 1999, the Firm violated Exchange Rules 342, 401 and 405, in that its procedures for updating records regarding customer investment objectives and other customer information were not adequate to ensure that trading in a customer account was suitable.

42. During this period, the Firm failed to clearly communicate to its RRs their obligation to ensure that the Firm's customer records were kept updated. As a result, some RRs never updated the Firm's records of customers' investment objectives when changed, or they did so using different methods, which resulted in the Firm's official customer records on file at the main office not being current and accurate.

43. For example, the Firm's procedures permitted RRs in several regions to change a customer's investment objectives without completing an updated new account form ("NAF"). The Firm allowed its RRs to change customer data in a desktop software program called BrokerVision, which was used primarily for marketing purposes. This procedure allowed RRs to alter the Firm's BrokerVision records without necessarily completing an updated NAF, which would have made corresponding changes to the official customer records on file at the main office. Thus, in numerous instances, the Firm maintained information regarding customers' investment objectives that was inconsistent.

44. In addition, the Firm failed to implement a system of follow-up and review by which it could detect that inaccurate or inconsistent records of investment objectives were being created by its RRs.

45. The Firm's procedures did not provide a uniform method of detecting unsuitable trading in customer accounts. The Firm's procedures failed to provide an effective tool for BOMs to supervise the trading of its RRs.

Employee Trading of Securities on Firm's Research Restricted List

46. During the Relevant Period, the Firm's policies and procedures regarding employee trading of securities on the Firm's research restricted list violated Exchange Rule 401, which requires that every member organization adhere to principles of good business practice in the conduct of its business affairs.

47. The Firm's policies and procedures allowed different departments to place securities on the Firm's restricted list for various reasons. During the Relevant Period, the Firm updated its restricted securities list on a daily basis and posted it electronically, making it available to RRs on their desktop computers.

48. During the Relevant Period, the Firm's policies and procedures prohibited employees from trading securities in any employee related accounts until 48 hours after a new "Buy" or "Accumulate" research recommendation had first been issued. "Sell" or "Reduce" recommendations restricted employee trading for three trading hours after the recommendation had been issued.

49. In implementing the above policies and procedures, the Firm interpreted the 48-hour prohibition to include weekends, so that securities restricted on a Friday could be traded on Monday, the next trading day. The Firm also permitted its employees to violate the 48-hour restriction up to three times within a 12-month period before taking any disciplinary action.

50. In 2000, there were 21 employee transactions effected during the restricted periods in three securities selected for Exchange review. The Firm took no disciplinary action against any of the employees for such trading.

Account Statement Pricing of Bond and Mutual Fund Positions

51. During the time period September 1985 through August 1998, many of the Firm's NAFs gave RRs the discretion to select "do not price" or "delay one month", so that the pricing of bonds and mutual funds could be omitted or, alternatively, delayed for a one-month period, on customer monthly account statements.

52. During that period, the Firm did not have policies or procedures in place that gave RRs guidance regarding circumstances under which the selection of one of the options, to omit or delay pricing on a customer monthly account statement, might be appropriate.

53. In addition, the Firm did not have policies or procedures in place to monitor whether

or under what circumstances RRs designated the NAF option of “do not price” or “delay one month” on customer monthly account statements for bonds and mutual funds.

54. As a result, by delaying pricing on customer monthly account statements for a month, RRs had the ability to not show commissions earned for bonds and/or mutual funds. For example, in one branch of the Firm, RRs generally selected the “delay one month” option following a purchase of a bond or mutual fund. This was done to avoid displaying a lower value that would appear on a statement the month immediately following a purchase, which resulted from the Firm commission having been deducted from the investment’s purchase price.

55. In addition, in some instances where the “do not price” option was selected by RRs, the account statements did not disclose current market value of bond and mutual fund positions and thus the customers did not receive from the Firm the information necessary to make informed decisions about their bond and/or mutual fund positions.

Timely Allocation of Orders

56. Regulation 240.17a-3(a)(6), promulgated pursuant to the Securities Exchange Act of 1934 (the “SEA”), requires that a memorandum of each brokerage order be made that includes the time of entry and the account for which it is entered. It also states, in part, that “[t]he term ‘time of entry’ shall be deemed to mean the time when such member, broker or dealer transmits the order or instruction for execution or, if not so transmitted, the time when it is received.”

57. With respect to purchases and sales, SEA Regulation 240.17a-3(a)(7) requires “a memorandum of each order received, showing the time of receipt, the terms and conditions of the order, and the account for which it was entered.”

58. SEA Regulation 240.17a-4(b) requires, in part, that every broker and dealer preserve, for a period of not less than three years, all records required pursuant to SEA Regulations 240.17a-3(a)(6) and (7). Exchange Rule 440 requires that member organizations make and preserve books and records as the Exchange may prescribe, and as prescribed by SEA Regulations 240.17a-3 and 240.17a-4.

59. Exchange Rule 410(a) requires, in part, that every member organization shall preserve, for at least three years, the first two years in an easily accessible place, a record of every order transmitted directly or indirectly to the Floor of the Exchange, which record shall include the name and amount of the security, the terms of the order, the time that the order was so transmitted, and the time at which a report of execution was received. Prior to such orders being executed, an order slip or other record must be prepared showing the name or designation of the account for which the order is to be executed.

60. Exchange Information Memo 00-19, dated July 21, 2000, reiterates the requirements of Exchange Rules 410, 440 and SEA Regulations 17a-3(a)(6) and (7), and states that when orders are entered through a block desk, the terms of each order must be documented prior to, or contemporaneous with, the order's transmission to the block desk. The terms must include all account designations, as well as the number of shares to be allocated to each account.

61. In December 1997, the Firm's procedures for entering individual telephone orders with the Firm's OTC Desk (the "Desk") required that RRs send a wire order ticket within ten minutes of entering the order.

62. From February 1995 to August 1999, the Firm's procedures for entering telephone or computer orders for multiple accounts (bunched orders) required that RRs send a wire to the Desk, providing the account allocations, within one hour after entering the order.

63. In August 1999, the Firm revised its procedures for bunched telephone orders, requiring an RR to prepare an order ticket including an allocation of the order at or before the time the order is placed, and to memorialize on the order ticket the time the order was sent to the Desk. In December 1999, the Firm clarified that this procedure required that an RR give the wire operator the account allocations at the time the order is phoned in; the wire operator then has one hour to transmit the allocations to the Desk.

64. In 1998 and 1999, in several instances, for individual or bunched orders that RRs either telephoned to the Desk or entered directly into the Firm's Broker Order Entry System, the participating accounts were not designated prior to execution. The delayed allocation of bunched orders continued into 2000, after the Firm had revised its procedures. For example, from 1998 to 2000, in approximately 30 examples from several branch offices, the allocation of a trade to a customer's account was made from about one hour to one day after the order had been entered.

65. The Firm's procedures concerning the entry of bunched orders and their allocation to specific accounts did not meet the standards set forth in the SEA Regulations 240. 17a-3(a)(6) and (7), and Exchange Rule 410.

Extensions of Credit

66. Sections 220.8(b)(1)(i) and (c) of Regulation T, promulgated by the Board of Governors of the Federal Reserve System ("Regulation T"), require that full cash payment for customer purchases in cash accounts must be obtained within one payment period from the date of purchase.

67. Section 220.8(b)(4) of Regulation T provides that transactions not paid for within prescribed periods of time shall be canceled or liquidated, resulting in a withdrawal of

the privilege of delaying payment beyond the trade date for 90 calendar days following the date of sale of the security.

68. Exchange Rule 401 requires that every member organization at all times adhere to principles of good business practice in the conduct of its business affairs.

69. In 2000, a review of extension related wires in several branch offices revealed that seven RRs effected transactions in their accounts without making payment on a timely basis, causing the Firm to request extensions for payment in circumstances that were neither exceptional nor unforeseeable at the time the trades were effected.

70. In 1999 and 2000, the Firm failed to prevent trading in four accounts (two of which were employee related) that had been placed on a 90-day restriction.

71. In 2000, the Firm allowed RRs to overextend their own accounts. For example, over a nine-month period, one RR issued 44 checks from his account that were returned for insufficient funds. In another example, an RR was permitted to meet a margin maintenance call in his account by depositing a check for $ 7,500 from the same account.

Preventing Statutorily Disqualified Individuals from Being Associated with the Firm

72. Exchange Rule 346(f) states, in pertinent part, that no member organization shall have associated with it any person "who is known, or in the exercise of reasonable care should be known, to be subject to any 'statutory disqualification' defined in Section 3(a)(39) of the SEA. The SEA states, in part, that a person is subject to a statutory disqualification ("SD") if he has been convicted of any act enumerated in Section 15(b)(4)(B) of the SEA, including larceny, theft, robbery and forgery.

73. SEA Sections 3(a) 39(F) and 15(b)(4)(B) provide that an individual is statutorily disqualified from employment with a member organization upon a conviction of certain designated criminal offenses, including any felony, within 10 years preceding the filing of an application for association with a member firm.

74. During the Relevant Period, although it was the Firm's practice to attempt to obtain information pertaining to arrests or convictions prior to hiring prospective employees, the Firm failed to follow adequate procedures regarding the hiring of registered and non-registered individuals.

75. During 1999, there were three instances where an extended period lapsed between the time the Firm learned, or should have learned, of an employee's criminal conviction and SD status, and the time that the Firm discharged the employee.

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, a fine of $400,000 and an undertaking to retain an outside consultant, not unacceptable to the Exchange, to conduct a review of the Firm's policies, procedures, practices, and supervisory systems relating to the violations described herein, and prepare a report of such systems and procedures, including recommendations for additional systems and procedures, if necessary, reasonably designed to ensure compliance with federal securities laws and Exchange Rules and to prevent recurrence of the violations described herein, and submit such report and recommendations, if necessary, to the Exchange within 120 days from the date that this decision becomes final.

For the Hearing Panel

Edward W. Morris, Jr.
Chief Hearing Officer