

NEW YORK STOCK EXCHANGE, INC.

**EXCHANGE HEARING PANEL DECISION 04-110**

July 8, 2004

FIDELITY BROKERAGE SERVICES, LLC  
MEMBER ORGANIZATION

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**Violated Exchange Rule 342 in that, in connection with its annual branch inspection process and the creation and maintenance of its books and records, the Firm failed to provide for appropriate supervisory control to comply with the federal securities laws and Exchange rules, including a separate system of follow-up and review; violated Exchange Rule 440 and Section 17(a) of the Securities Exchange Act of 1934, and SEC Rule 17a-4 thereunder, by failing to preserve certain books and records and failing to preserve other books and records accurately – Consent to censure and a total fine of \$2,000,000.**

**Appearances:**

For the Division of Enforcement  
Susan E. Light, Esq.  
Steven J. Brostoff, Esq.  
George Tidona, Esq.

For the Respondent  
Lena G. Goldberg, Esq.  
Charles V. Senatore, Esq.  
Anmarie Ciccolo, Esq.  
Ben A. Indek, Esq.  
David Boch, 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 Fidelity Brokerage Services, LLC (the "Firm"), a member organization of the Exchange. For the sole purpose of settling this disciplinary proceeding, and without admitting or denying guilt, the Firm consents to findings by the Hearing Panel that the Firm:

- I. Violated NYSE Rule 342 in that, in connection with its annual branch inspection process and the creation and maintenance of its books and records, the Firm failed to provide for appropriate supervisory control to comply with the federal securities laws and NYSE rules, including a separate system of follow-up and review.
- II. Violated NYSE Rule 440 and Section 17(a) of the Securities Exchange Act of 1934, and SEC Rule 17a-4 thereunder, by failing to preserve certain books and records and failing to preserve other books and records accurately.

For the sole purpose of settling this disciplinary proceeding, and without adjudication of any issues of law or fact, or admitting or denying any of the facts set forth in the Stipulation of Facts

and Consent to Penalty, the Division of Enforcement and the Firm stipulate to certain facts, the substance of which follows:

### **Background and Jurisdiction**

1. The Firm is a broker-dealer registered with the Securities and Exchange Commission (“SEC”) pursuant to Section 15(b) of the Securities Exchange Act of 1934 (“Exchange Act”). The Firm is a Delaware limited liability company based in Boston, Massachusetts. It is an NYSE member. The Firm is a large multi-service broker-dealer with more than 3.4 million clients.

### **Summary**

2. Between January 2001 and July 2002, the Firm violated the broker-dealer record-keeping requirements of the NYSE rules and the Exchange Act and failed reasonably to supervise employees. These violations related to the Firm’s annual internal inspections. The Firm’s inspections were designed to determine whether branch offices were complying with Firm policies and procedures, NYSE rules, and the federal securities laws. The Firm’s Western Region managers pressured branch office employees to obtain “no concerns” reports at the conclusion of the branch inspection. To achieve such results, Western Region managers told its branch office employees when the inspections would occur, provided information and materials to branch office managers, and encouraged branch office managers to review applicable branch office documents in preparation for the inspection. As a consequence, in connection with certain inspections, a number of branch office employees altered or destroyed or, in one branch, hid certain documents. These actions were not discrete or isolated. At least 62 employees had engaged in some form of this conduct in at least 21 branch offices, primarily in its Western Region.

### **Books and Records and Supervisory Violatons**

3. During the relevant period, the Firm had 88 branch offices, called “investor centers,” throughout the United States. At the Firm’s branch offices, clients met with registered representatives to discuss their accounts, learned about investments and placed orders to buy and sell securities. In addition, clients were able to initiate wire transfers of funds, open new accounts, and issue account instructions. The Firm maintained certain communications relating to customer accounts in its branch offices. It was the Firm’s practice to produce branch office copies to the SEC and NYSE staff during on-site regulatory examinations.
4. Each branch office employed registered representatives who were supervised by an on-site branch office manager. The Firm’s branch offices in Arizona, California, Colorado, Oregon, Utah and Washington comprised its “Western Region,” which was supervised by a team of managers in the region.
5. Employees from the Firm’s internal inspection department conducted on-site internal inspections of branch offices on an annual basis. At the conclusion of an inspection,

branch managers were provided with an Annual Compliance Examination Report. Items reflected as “concerns” required managers to provide written responses describing the actions taken (or to be taken) to address those issues. Items reflected in the report as “observations” required no response. At certain times during the relevant period, branch offices were notified in advance of the dates on which the inspections would occur. Certain employees in the Western Region took advantage of the advance notification and improperly prepared for the inspection.

6. Regional managers were involved in the inspection preparation process. Firm regional managers instructed branch managers to prepare for the inspections. They provided training for branch office managers using the previous year’s inspection module. The training focused on preparing for internal inspections. Certain branch managers intended to use this training “to beat” the inspection rather than to comply with the Firm’s record-keeping requirements. Regional managers instructed employees at branch offices that had already been inspected to share information about the inspections with employees at branch offices that had not yet been inspected. Regional managers also pressured branch office managers to have “no concerns” inspections and implied that they could be fired if there were more than a few inspection exceptions.
7. In preparing for the internal inspections during the relevant period and in an effort to achieve “no concerns” inspections, 62 branch office employees from 21 branch offices, principally in the Western Region, discovered that some of the records maintained in the branch office omitted information or were not completed in accordance with Firm policies and procedures. These employees altered or destroyed new account applications, letters of authorization, and variable annuity forms maintained at Firm branch offices. Such conduct caused the Firm to maintain inaccurate or incomplete books and records.
8. Two employees in one branch office concealed branch documents from the Firm’s inspectors during the annual inspection by temporarily removing branch documents that they believed included signature guarantees that were not completed by branch employees in accordance with the Firm’s policies and procedures.
9. The Firm learned about the matters described above in July 2002 when a registered representative reported concerns relating to the branch inspection at one branch office to the Firm’s ethics office. The Firm immediately conducted an internal investigation and disciplined those employees who were involved, including the termination of 13 branch employees, including three branch managers. The Firm also replaced four members of the Western Regional management team and the region’s compliance officer. In addition, the Firm contemporaneously shared its investigative findings and disciplinary actions with the SEC and the NYSE.
10. After its investigation, the Firm developed and implemented enhancements to the Firm’s branch inspection program and made improvements to various policies, procedures and controls.

### **Legal Discussion**

11. Section 17(a)(1) of the Exchange Act provides that each member of a national securities exchange, broker, or dealer “shall make and keep for prescribed periods such records, furnish such copies thereof, and make and disseminate such reports as the SEC, by rule, prescribes as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this title.”
12. The SEC and the NYSE have emphasized the importance of the records required by the rules. See In the Matter of Deutsche Bank Securities, Inc., Goldman, Sachs & Co., Morgan Stanley & Co., Inc., Salomon Smith Barney, Inc., and U.S. Bancorp Piper Jaffray Inc., Exchange Act Release No. 46937, 2002 SEC Lexis 3083 (December 3, 2002).
13. SEC Rule 17a-4(b)(4) provides that brokers and dealers shall preserve for a period of not less than three years, the first two years in an accessible place: “[o]riginals of all communications received and copies of all communications sent by such member, broker or dealer (including inter-office memoranda and communications) relating to its business as such . . . .”
14. NYSE Rule 440 requires that: “every member organization shall make and preserve books and records as the [NYSE] may prescribe and as prescribed by [SEC] Rule 17a-3. The record keeping format, medium and retention period shall comply with Rule 17a-4 under the Securities Exchange Act of 1934.”
15. The Firm maintained certain records required to be preserved under SEC Rule 17a-4(b)(4) and Exchange Rule 440 in its branch offices. It was the Firm’s practice to provide branch office copies to the SEC and NYSE staff during on-site regulatory examinations.
16. Certain employees at the Firm altered some of the records maintained in the branch offices such that they did not represent accurate records of the original communications.
17. Accordingly, as the altered records were maintained for regulatory purposes (i.e., to comply with SEC Rule 17a-4 and Exchange Rule 440), the Firm violated Section 17(a) of the Exchange Act and SEC Rule 17a-4(b)(4) thereunder and Exchange Rule 440, and its employees aided and abetted these violations.
18. Section 15(b)(4)(E) of the Exchange Act authorizes the SEC to impose sanctions against a broker-dealer if the firm has “failed reasonably to supervise, with a view to preventing violations [of the federal securities laws], another person who commits such a violation, if such other person is subject to his supervision.” See e.g. In the Matter of Smith Barney, Harris Upham & Co., Inc., Exchange Act Release No. 21813, 1985 SEC Lexis 2051 (March 5, 1985).

19. NYSE Rule 342 requires member firms to provide for appropriate supervisory control over its business activities to comply with federal securities laws and NYSE rules, including a separate system of follow-up and review to determine that supervisory authority and responsibility is properly exercised.
20. The responsibility of broker-dealers to supervise reasonably their employees by means of effective, established procedures is a critical component of the federal regulatory schemes and NYSE rules. See In the Matter of Goldman, Sachs & Co., Exchange Act Release No. 33576, 1994 SEC Lexis 302 (February 3, 1994); In the Matter of Kirkpatrick, Pettis, Smith, Polian Inc., Peter N. Lahti And Gregory D. Adams, Admin. Proc. File No. 3-11328, Release No. 34-48748, 2003 SEC LEXIS 2661 (November 5, 2003) ("The Commission has long emphasized that the responsibility of broker-dealers to supervise their employees is a critical component of the federal regulatory scheme."), citing In the Matter of John H. Gutfreund, et al., 51 S.E.C. 93, 108 (1992).
21. For the purposes of Section 15(b)(4)(E) of the Exchange Act, "no person shall be deemed to have failed reasonably to supervise any other person, if (i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and (ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with." See e.g. In the Matter of Goldman, Sachs & Co., Exchange Act Release No. 33576, 1994 SEC Lexis 302 (February 3, 1994); In the Matter of Prudential Securities, Inc., Exchange Act Rel. No. 43896, 2001 SEC Lexis 155 (January 29, 2001).
22. In general, unannounced branch office inspections can be an important part of branch office supervision. When the timing and subject matter of some of a firm's internal inspections are not announced in advance, a broker-dealer may be able more accurately to assess its branch offices' compliance with the federal securities laws, NYSE rules, and firm policies and procedures.
23. The Firm was unable to detect the conduct described above due to several factors related to inadequate supervisory procedures. These included (i) inadequate branch office procedures that, among other things, failed to address employees' handling of firm documents, such as new account applications, letters of authorization, and variable annuity forms; (ii) an inadequate system for implementing inspections; and (iii) a lack of adequate education provided to branch employees concerning the policies and procedures relating to the proper handling of branch office documents. Moreover, Western Region managers communicated with branch office managers in such a way that led some employees to believe that they should alter or destroy branch documents to achieve good inspection results. Thus, the Firm had inadequate policies, procedures, and systems that would reasonably be expected to prevent and

detect the improper alteration and destruction of documents, and therefore, failed reasonably to supervise its employees within the meaning of Section 15(b)(4)(E) of the Exchange Act and NYSE Rule 342.

**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 penalty in the amount of \$2,000,000. The amount to be paid to the NYSE as a fine to equal \$1 million and the amount to be paid to the U.S. Treasury as a civil monetary penalty in connection with a related Securities and Exchange Commission proceeding to equal \$1 million.

For the Hearing Panel

Milton M. Stein  
Hearing Officer