

NEW YORK STOCK EXCHANGE, INC.

EXCHANGE HEARING PANEL DECISION 05-110

October 17, 2005

CHARLES SCHWAB & CO., INC.
FORMER MEMBER ORGANIZATION

* * *

Violated Exchange Rules 342(a) and (b) by failing to establish and maintain appropriate procedures for supervision and control with respect to disbursement of customer assets from firm accounts managed by non-employee investment advisors and by failing to protect customer assets in those accounts; violated Section 17(a) of the Securities Exchange Act of 1934 and Rules 17a-4(b)(4) and 17a-4(f) thereunder and Exchange Rule 440 by failing to preserve and maintain electronic communications in required format and for required retention periods – Consent to censure, \$1,000,000 fine and undertaking to hire outside consultant to provide recommendations on measures to be taken to prevent future misappropriation.

Appearances:

For the Division of Enforcement
Steven F. Korostoff, Esq.
Laura Cooper, Esq.
Jeremy Bloom, Esq.

For the Respondent
Neal E. Sullivan, Esq.
Linda Drucker, Esq.

* * *

A Hearing Panel of the New York Stock Exchange, Inc. (the “Exchange”) met to consider a Stipulation of Facts and Consent to Penalty entered into between the Exchange’s Division of Enforcement (“Enforcement”) and Charles Schwab & Co., Inc. (“Respondent Firm”). Without admitting or denying guilt, Respondent Firm consented to a finding by the Hearing Panel that it:

- I. Violated Exchange Rules 342(a) and (b) in that Respondent Firm failed to establish and maintain appropriate procedures for supervision and control, including a separate system of follow-up and review, with respect to certain business activities relating to protection of customer assets in accounts managed by non-employee investment advisors and carried by Respondent Firm; and
- II. Violated Section 17(a) of the Securities Exchange Act of 1934 (the “1934 Act”) and Rules 17a-4(b)(4) and 17a-4(f) thereunder and Exchange Rule 440 by failing to preserve and maintain certain electronic communications in the required format and for the required retention periods.

For the sole purpose of settling this disciplinary proceeding, Enforcement and Respondent Firm stipulate to certain facts, the substance of which follows:

Background and Jurisdiction

1. Respondent Firm became a member organization of the Exchange in 1982. Respondent Firm currently has its home branch office in San Francisco, CA and approximately 310 branch offices, and it employs a total of approximately 10,000 individuals. Respondent Firm engages in various businesses including retail brokerage. Respondent Firm withdrew its membership from the Exchange on January 31, 2005.
2. By letters dated March 24, 2003, and January 9, 2004, Enforcement notified Respondent Firm that Enforcement was investigating matters that were referred to it by the Exchange's Division of Member Firm Regulation as a result of an examination of financial and operational issues and sales practice and supervisory issues, respectively.
3. Thereafter, Respondent Firm appeared, represented by counsel, and provided documents, information and testimony in connection with the Exchange's investigation.

Summary of Violative Conduct

4. During the period 1998 to the first quarter of 2003, Respondent Firm violated Exchange Rules 342(a) and (b) by failing to establish and maintain appropriate procedures for supervision and control, including a separate system of follow-up and review, with respect to certain business activities relating to disbursement of customer assets from accounts managed by certain non-employee investment advisors and carried by Respondent Firm, and by failing to protect customer assets in those accounts. At various times during the period June 2002 to December 2003, Respondent Firm also violated Section 17(a) of the 1934 Act and Rules 17a-4(b)(4) and 17a-4(f) thereunder and Exchange Rule 440 by failing to preserve and maintain certain electronic communications in the required format and for the required retention periods.

Respondent Firm Failed to Supervise Reasonably Disbursements of Customer Assets From Customer Accounts Managed By Certain Non-Employee Third-Party Investment Advisors

5. Exchange Rule 342(a) provides that each "business activity of a member or 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." Exchange Rule 342(b) states that:

The general partners or directors of 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 . . . business activity, and provide for appropriate procedures of supervision and control[;] (2) establish a separate system of follow-up and review”

6. The business activity involved here is Respondent Firm's non-employee investment advisor platform. Respondent Firm currently offers certain services to approximately 5,000 non-employee investment advisors. These investment advisors manage approximately 1.3 million client accounts with Respondent Firm. As of May 30, 2005, these accounts represented approximately \$350 billion in assets at Respondent Firm.
7. Respondent Firm provides these investment advisors and their clients with clearing and related support, including a dedicated website providing access to client accounts. The customer account assets managed by these non-employee investment advisors are custodied by Respondent Firm. The customer accounts can be cash, margin or option accounts. In general, the customers grant their investment advisors authority to trade securities in their accounts at Respondent Firm.
8. Respondent Firm charges commissions for trading in the customer accounts and/or other fees.
9. The investment advisors who manage accounts at Respondent Firm do not have any affiliation with Respondent Firm. These investment advisors are not subject to the jurisdiction of the Exchange, but are regulated by the Securities and Exchange Commission (the "SEC") or the state securities regulators that register them.
10. During the period 1998 to the first quarter of 2003, certain non-employee investment advisors misappropriated customer assets. Neither Respondent Firm nor any of its employees were involved in the misappropriation of customer assets by the non-employee investment advisors referenced above.
11. For example, in 2001, a non-employee investment advisor named Fred Schlupe presented fraudulent letters of authorization and unauthorized journals and checks in an effort to evade Respondent Firm's procedures and to misappropriate customer money from customer accounts at Respondent Firm. The SEC has brought enforcement actions against certain of these investment advisors, including Schlupe.
12. Beginning in 1998, Schlupe forged signatures on letters of authorization submitted to Respondent Firm. Schlupe used the forged letters of authorization to transfer assets into the account of a co-conspirator, and from the accounts of certain customers at Respondent Firm to accounts held by other customers at Respondent Firm. In 1998, Respondent Firm identified the suspicious conduct when one of Schlupe's clients complained at a branch office. Respondent Firm contacted Schlupe and sent letters notifying accountholders of the transfers.

13. In 1999, Schlupe forged customer checks to transfer assets out of accountholders' accounts. Respondent Firm identified three customer accounts managed by Schlupe that had checks returned for insufficient funds and other accounts where deposits were made by Schlupe to cover previously returned checks. In 2001, Respondent Firm determined that Schlupe had misappropriated funds and had forged accountholder signatures. Respondent Firm contacted Schlupe's customers, notified them it would no longer honor Schlupe's trading authority over accounts carried at Respondent Firm, and notified the Federal Bureau of Investigation ("FBI") and SEC.
14. Schlupe, over whom the Exchange does not have jurisdiction because he is not employed by any member firm, was the subject of an SEC enforcement action in September 2003 for misappropriating approximately \$5 million from 26 customers by forging customers' signatures on letters of authorization to transfer funds and on checks written on Respondent Firm accounts and for writing checks from other customer accounts to cover funds that he had misappropriated. On or about November 10, 2003, Schlupe consented to findings that he violated, among other things, the anti-fraud provision of the Investment Company Act of 1940 and Section 10(b) of the Securities Exchange Act of 1934 and paid a civil penalty of \$120,000, disgorgement of \$1,597,115 and prejudgment interest of \$236,993. Court Enters Final Judgment Against Fred Albert Schlupe, Litigation Release No. 18,466, 81 S.E.C. Docket 2124, 2003 WL 24028600 (Nov. 17, 2003).
15. Schlupe is an example. A number of non-employee investment advisors misappropriated assets held in customer accounts at Respondent Firm. After being contacted by Respondent Firm, several of these advisors' customers sent complaints to Respondent Firm.
16. During the period 1998 through the first quarter of 2003, Respondent Firm's procedures relating to the transfer of assets from customer accounts managed by non-employee investment advisors, and its system of follow-up and review, were not reasonable to supervise and control money movements, and to protect assets in such accounts adequately, as follows:
17. Until 2001, Respondent Firm did not routinely conduct a comparison of a signature on a letter of authorization to transfer assets to third parties (i.e., persons or entities other than the account holder) to a signature on original account documents.
18. During the period 2001 to 2003, Respondent Firm conducted a comparison of a signature on a letter of authorization to transfer assets to third parties to a signature on original account documents for amounts above a specified, but inadequate, dollar amount threshold.
19. In 2003, Respondent Firm lowered the dollar threshold for signature comparison of letters of authorization to original account documents.

20. Until August 2001, Respondent Firm did not routinely conduct a comparison of a signature on a wire transfer request to transfer funds to third parties to a signature on original account documents.
21. In August 2001, Respondent Firm began conducting a comparison of a signature on a wire transfer request to transfer funds to third parties to a signature on original account documents for amounts equal to or greater than a specified, but inadequate, dollar amount threshold.
22. Until the first quarter of 2002, checks payable to another Respondent Firm account holder were treated as journal transfers, with the procedure for comparing signatures as described above for letters of authorization.
23. Until 2002, Respondent Firm did not have an adequate system in place to detect the use of blank printable checks for funds transfers between accounts of Respondent Firm customers whose accounts were managed by the non-employee investment advisors.
24. Between 2002 and 2004, Respondent Firm adopted new controls to prevent and detect the use of blank printable checks for withdrawals from customer accounts managed by investment advisors, including requiring that checks be sent directly to the customer unless otherwise authorized by the customer and no longer processing checks between Respondent Firm customers as journal transfers.
25. Until January 2003, Respondent Firm did not have a reasonable system to review accounts that either had a check drawn on a Respondent Firm account returned for insufficient funds or a deposited check returned.
26. During the period 1998 through 2003, when a customer check was about to be dishonored for insufficient funds (but had not yet been dishonored), as a matter of courtesy, Respondent Firm informed the investment advisor in order to give the customer a chance to deposit sufficient funds. Respondent Firm did not routinely contact the customer directly. For example, Schluep used this courtesy to conceal his misappropriation by moving funds into a customer account that Respondent Firm informed him was about to dishonor a legitimate check.
27. Until 1999, Respondent Firm did not routinely send letters to customers to confirm transfers of assets to third parties other than the person or entity on the account.
28. In 1999, Respondent Firm began sending confirmation letters for third-party transfers of assets equal to or greater than a specified, but inadequate, dollar amount threshold.
29. In March 2003, Respondent Firm lowered the dollar amount threshold for sending a confirmation letter for third-party transfers of assets.

Corrective Action Taken by Respondent Firm

30. In November 2002, Respondent Firm initiated the Insight Surveillance System (“Insight”), an automated surveillance system that generates alerts, which, in turn, are sent to the compliance and investigation groups of Respondent Firm, depending on the type of alert. The alerts are investigated by one of Respondent Firm’s compliance groups. Insight also generates an alert when there are journal transfers of assets to an unrelated account and the amount is equal to a specified dollar amount threshold, either in one transfer or an accumulation of several deposits in over one month’s time. The alerts are reviewed by one of Respondent Firm’s compliance groups.
31. As of October 2002, all wire transfer instructions are verified with the customer.
32. As of January 2004, customers are sent a confirming letter with respect to all money movements they initiate to third parties (with the exception of checks, which are monitored through a separate process outlined below).
33. In January 2003, Respondent Firm began receiving a report from its bank that shows customers who have written three or more dishonored checks on their Respondent Firm account in the prior four-week period. In January 2003, Respondent Firm began generating an internal report on accounts that are reviewed when five or more checks are written against insufficient funds in a Respondent Firm account; accounts that have debit balances; and accounts that have two or more deposits into Respondent Firm accounts dishonored for insufficient funds.
34. In March 2003, Respondent Firm instituted a policy requiring a comparison between signatures on letters of authorization and new account forms for amounts equal to or greater than a specified dollar amount threshold.
35. Between 2002 and 2004, Respondent Firm instituted enhanced controls and procedures relating to the detection of counterfeit checks and check ordering. These procedures are designed to ensure that customers use pre-printed checks that meet certain specifications and that are sent to the customer directly, unless otherwise authorized by the customer.
36. As of September 2004, Respondent Firm confirms incoming third-party checks made payable to Respondent Firm with the maker of the check.
37. As set forth below, Respondent Firm’s corrective actions are the subject of the undertaking.

Respondent Firm Failed to Preserve and Maintain Certain Communications

38. Rule 17a-4(b)(4) under the Securities Exchange Act of 1934 (the “1934 Act”) requires member organizations to maintain “[o]riginals of all communications received and copies of all communications sent by such member . . . (including interoffice memoranda and communications) relating to [its] business as such” for a period of three years. Rule 17a-4(f) under the 1934 Act requires that if records are stored

electronically, they must be in a “non-rewritable, non-erasable format,” among other things. Rule 17(a)-4(f)(2)(ii). Exchange Rule 440 requires that every member or member organization make and preserve certain books and records and that “[t]he recordkeeping format, medium and retention period shall comply with Rule 17a-4 under the Securities Exchange Act of 1934.”

39. During the period June through December 2002, Respondent Firm failed to preserve and maintain internal e-mail communications.
40. During the period March through December 2003, Respondent Firm failed to preserve and maintain instant messaging communications via Bloomberg terminals.

DECISION

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

PENALTY

Although the Stipulation of Facts and Consent to Penalty only named one non-employee investment advisor who has committed fraud on customer accounts, he is clearly only one example, amounting to the misappropriation of approximately \$5 million. See supra ¶¶ 10-11, 15. The scope of the harm that resulted from Respondent Firm’s failures warrants a significant penalty.

The agreed-upon penalty is consistent with Exchange precedents, in which member organizations have paid heavy fines for a failure to supervise a financial adviser who has defrauded multiple individuals, as in this case. See, e.g., In re Lehman Bros., Inc., Decision 03-157 at 2-3 (N.Y.S.E. Hearing Panel Aug. 6, 2003) (\$2.5 million fine for failure to prevent branch office manager from defrauding over 60 customers by lying about purchases and sales of securities, misappropriating funds and securities and sending falsified documents).

To Respondent Firm’s credit, Respondent Firm has paid out millions of dollars to compensate those customers who were harmed by the violative conduct at issue here and to institute corrective measures to prevent non-employee investment advisors from committing similar wrongdoing in the future. Furthermore, Enforcement is not seeking disgorgement. Thus, while the amount of customer loss is a relevant factor and should be taken into account for purposes of assessing the penalty, the amount should not itself be determinative of any fine imposed. See In re Lehman Bros., Inc., Decision 05-108 (N.Y.S.E. Hearing Panel Sept. 29, 2005) (profit resulting from respondent’s violative conduct must be taken into account in evaluating appropriateness of penalty, although dollar amount is not itself determinative of fine to be imposed).

In view of the above findings, the Hearing Panel, by unanimous vote, imposed the penalty consented to by Respondent of a censure, a fine of \$1,000,000 and an undertaking as follows:

- I. Within 30 days of a Hearing Panel Decision accepting this Stipulation and Consent becoming final, Respondent Firm shall retain an outside consultant (“Consultant”) not unacceptable to the Exchange, at Respondent Firm’s expense, to conduct a review of

- Respondent Firm's policies and procedures relating to disbursement of customer assets from accounts managed by non-employee investment advisors to third parties via letters of authorization, wires and checks and for the protection of customer assets held in those accounts at Respondent Firm from misappropriation. The review shall include Respondent Firm's policies and procedures with respect to signature comparisons on the use of letters of authorization to transfer assets to third parties and Respondent Firm's policies and procedures for detecting potential misappropriation by non-employee investment advisors through the use of letters of authorization, wires and checks and any other means that the Consultant identifies during the review.
- II. At the conclusion of that review, which in no event will be more than 120 days after the date of the Consultant's retention, the Consultant will issue a report ("Report") concerning Respondent Firm's policies and procedures referenced above regarding disbursement of customer assets to third parties and protection of customer assets in those accounts held at Respondent Firm and managed by non-employee investment advisors from misappropriation, and will include the Consultant's recommendations thereon.
 - III. Respondent Firm shall adopt and implement all policies, procedures and practices recommended in the Report; provided, however, that as to any recommendation which Respondent Firm determines is, in whole or part, inappropriate, unnecessary or unduly burdensome, within 30 days of the Report, Respondent Firm may propose in writing to the Consultant an alternative policy or procedure designed to achieve the same objective or purpose; in the event Respondent Firm proposes alternate policies or procedures, it shall supply a copy of such proposal to Enforcement.
 - IV. In the event the Consultant is not satisfied that such alternative policies or procedures achieve the same objective or purpose as the Report's original recommendations, Respondent Firm shall implement the policies, procedures, and practices recommended in the Report.
 - V. Within 60 days of the date of the Report, Respondent Firm shall submit to Enforcement a written representation, setting forth the details of Respondent Firm's implementation of the recommendations contained in the Report or the alternative procedures if agreed to by the Consultant.

For the Hearing Panel

Peggy Kuo – Chief Hearing Officer
Panelists:
Richard M. Jablonski
John P. O'Brien