

NEW YORK STOCK EXCHANGE, INC.

EXCHANGE HEARING PANEL DECISION 05-190

December 29, 2005

OPPENHEIMER & CO. INC. F/K/A FAHNESTOCK & CO. INC.  
MEMBER ORGANIZATION

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**Violated Exchange Rule 342, in that the Firm failed to supervise and control and provide for appropriate procedures of supervision and control over various business activities, and failed to establish a separate system of follow-up and review to determine that any authority and responsibility delegated pursuant to the Rule was being properly exercised; violated Exchange Rule 401, in that the Firm did not adhere at all times to the principles of good business practice, including, but not limited to, the following: by failing on one or more occasions to notify the Exchange immediately upon discovery of any existing or impending condition which it reasonably should have believed could lead to (i) capital problems; (ii) operational problems; (iii) impairment of recordkeeping; and/or (iv) impairment of control functions; by issuing inaccurate monthly account statements to customers; by failing to conduct a necessary daily reconciliation of a bank concentration account and by failing to timely reconcile other bank accounts; by failing to have adequate procedures in place to monitor activity in suspense accounts and accounts effectively functioning as such; by failing to age items in such accounts and determine they were being reconciled; and by transferring General Ledger money suspense account out-of-balance amounts into an unrelated stock record position suspense account; by not maintaining adequate safeguards and controls over manual security price changes; violated Exchange Rule 416 and Exchange Rule 476 (a) (10), in that the Firm filed Key Indicator Operational Reports with the Exchange that misstated and/or omitted information; violated Section 17(a) of the Securities Exchange Act of 1934 and Rule 17a-11 (d) and (g) thereunder, and Exchange Rule 351(a), in that the Firm failed to timely give required notice to the SEC and to the Exchange that it did not make or keep current certain required books and records; violated Section 17(a) of the Securities Exchange Act of 1934 and Rule 17a-3 thereunder, Exchange Rule 440 and Exchange Rule 409, in that the Firm failed to make and/or keep current certain books and records, including records pertaining to customer account statements, suspense accounts, and bank reconciliations; violated Section 17(a) of the Securities Exchange Act of 1934 and Rule 17a-13(b)(5) thereunder, and Exchange Rule 440.10(3), in that the Firm did not timely record into a security difference account all unresolved security count differences; violated Section 15(c) of the Securities Exchange Act of 1934 and Rule 15c3-1 thereunder, Rule 15c3-3(e) thereunder, and Exchange Rule 326, in that the Firm at certain times: did not prepare accurate computations of net capital and did not prepare accurate reserve formula computations; violated Section 17(a) of the**

**Securities Exchange Act of 1934 and Rule 17a-5 thereunder, and Exchange Rule 476(a)(10), in that the Firm filed one or more inaccurate FOCUS Reports with the Exchange; violated Exchange Rule 476(a)(6) by engaging in conduct inconsistent with just and equitable principles of trade; and Section 15(c) of the Securities Exchange Act of 1934 and Rule 15c2-8(b) thereunder, by failing to ensure the delivery of all preliminary prospectuses in connection with certain sales of registered securities; by failing to ensure in connection with a private placement offering that there was no general solicitation of the investment being offered, in violation of Section 4(2) and Section 5 of The Securities Act of 1933; in that the Firm charged certain customer accounts fees that were higher than the commissions would have been in light of the limited or zero trading activity in the accounts; in that the Firm failed to disclose to customers that it had entered into revenue sharing arrangements with certain mutual fund companies whose mutual funds were made available for purchase through the Firm; violated Exchange Rule 412, in that in connection with customer account transfers, the Firm did not timely transfer to the receiving broker-dealer residual credit balances that had accrued to the transferred customer accounts – Consent to censure and a fine of \$1.35 million.**

**Appearances:**

For the Division of Enforcement  
Susan E. Light, Esq.  
Dorian M. Gross, Esq.

For the Respondent  
George Brunelle, Esq.

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

- I. Exchange Rule 342, in that the Firm failed to supervise and control and provide for appropriate procedures of supervision and control over various business activities, and failed to establish a separate system of follow-up and review to determine that any authority and responsibility delegated pursuant to the Rule was being properly exercised.
- II. Exchange Rule 401, in that the Firm did not adhere at all times to the principles of good business practice, including, but not limited to, the following:
  - A. by failing on one or more occasions to notify the Exchange immediately upon discovery of any existing or impending condition which it reasonably should have

- believed could lead to (i) capital problems; (ii) operational problems; (iii) impairment of recordkeeping; and/or (iv) impairment of control functions;
- B. by issuing inaccurate monthly account statements to customers;
  - C. by failing to conduct a necessary daily reconciliation of a bank concentration account and by failing to timely reconcile other bank accounts;
  - D. by failing to have adequate procedures in place to monitor activity in suspense accounts and accounts effectively functioning as such; by failing to age items in such accounts and determine they were being reconciled; and by transferring General Ledger money suspense account out-of-balance amounts into an unrelated stock record position suspense account;
  - E. by not maintaining adequate safeguards and controls over manual security price changes.
- III. Exchange Rule 416 and Exchange Rule 476 (a) (10), in that the Firm filed Key Indicator Operational Reports with the Exchange that misstated and/or omitted information.
  - IV. Section 17(a) of the Securities Exchange Act of 1934 and Rule 17a-11 (d) and (g) thereunder, and Exchange Rule 351(a), in that the Firm failed to timely give required notice to the SEC and to the Exchange that it did not make or keep current certain required books and records.
  - V. Section 17(a) of the Securities Exchange Act of 1934 and Rule 17a-3 thereunder, Exchange Rule 440 and Exchange Rule 409, in that the Firm failed to make and/or keep current certain books and records, including records pertaining to customer account statements, suspense accounts, and bank reconciliations.
  - VI. Section 17(a) of the Securities Exchange Act of 1934 and Rule 17a-13(b)(5) thereunder, and Exchange Rule 440.10(3), in that the Firm did not timely record into a security difference account all unresolved security count differences.
  - VII. Section 15(c) of the Securities Exchange Act of 1934 and Rule 15c3-1 thereunder, Rule 15c3-3(e) thereunder, and Exchange Rule 326, in that the Firm at certain times:
    - a. did not prepare accurate computations of net capital;
    - b. did not prepare accurate reserve formula computations.
  - VIII. Section 17(a) of the Securities Exchange Act of 1934 and Rule 17a-5 thereunder, and Exchange Rule 476(a)(10), in that the Firm filed one or more inaccurate FOCUS Reports with the Exchange.

- IX. Exchange Rule 476(a)(6) by engaging in conduct inconsistent with just and equitable principles of trade:
- A. and Section 15(c) of the Securities Exchange Act of 1934 and Rule 15c2-8(b) thereunder, by failing to ensure the delivery of all preliminary prospectuses in connection with certain sales of registered securities;
  - B. by failing to ensure in connection with a private placement offering that there was no general solicitation of the investment being offered, in violation of Section 4(2) and Section 5 of The Securities Act of 1933;
  - C. in that the Firm charged certain customer accounts fees that were higher than the commissions would have been in light of the limited or zero trading activity in the accounts;
  - D. in that the Firm failed to disclose to customers that it had entered into revenue sharing arrangements with certain mutual fund companies whose mutual funds were made available for purchase through the Firm.
- X. Exchange Rule 412, in that in connection with customer account transfers, the Firm did not timely transfer to the receiving broker-dealer residual credit balances that had accrued to the transferred customer accounts.

For the sole purpose of settling this disciplinary proceeding, and without admitting or denying any of the facts or matters referred to in the Stipulation of Facts and Consent to Penalty, Enforcement and Respondent Firm stipulate the following:<sup>1</sup>

### **Background and Jurisdiction**

1. Oppenheimer is a securities broker-dealer located in New York City. Oppenheimer is a subsidiary of Oppenheimer Holdings, Inc. The Oppenheimer Private Client Division was owned by (“C”) until January 2003, when Fahnstock & Co. acquired certain retail brokerage activities of C. Fahnstock changed its name to Oppenheimer in September 2003. As a result of that acquisition, the Firm expanded and greatly increased the size of its customer base, number of its offices and employees. During 2004, Oppenheimer had total revenue of \$606 million and net income (before taxes) of \$45.8 million. As of June 30, 2005, Oppenheimer had total assets of \$1.9 billion.
2. After it completed its acquisition of the retail brokerage business acquired from C, Fahnstock announced that the acquired business would for a time, be operated as the

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<sup>1</sup> The facts, allegations, and conclusions contained in paragraphs 1-89 are taken from the executed Stipulation of Facts and Consent to Penalty between Enforcement and Respondent. No changes have been made to the stipulated paragraphs by the Hearing Panel, except that certain names have been deleted to protect the privacy of non-parties.

Oppenheimer & Co. Division of Fahnestock. The former C customer accounts are hereinafter referred to as the “Oppenheimer customers”.

3. Although Fahnestock was a self-clearing firm at the time of its acquisition of the accounts of the Oppenheimer customers, during the period from approximately January 3, 2003 through May 27, 2003, C continued to be responsible for the clearance activity of the Oppenheimer customers, and for issuing monthly account statements to them. The accounts of the Oppenheimer customers under Fahnestock’s control were cleared on a fully disclosed basis through C.
4. On May 27, 2003, Fahnestock transferred the accounts of the Oppenheimer customers from C onto Fahnestock’s books and records via a conversion (the “Conversion”). After the Conversion, Fahnestock assumed various responsibilities relating to the servicing of the accounts of the Oppenheimer customers. Among these, Fahnestock became responsible for the preparation and transmittal of accurate customer monthly statements to the Oppenheimer customers.
5. On or about June 20, 2003, staff of the Division of Member Firm Regulation of the Exchange (“MFR”) became aware of a complaint by one of the Oppenheimer customers. The customer had complained that positions were omitted from the customer’s May 2003 monthly account statement that Fahnestock had caused to be sent to the customer. This prompted an inquiry to the Firm by MFR, and to the discovery that tens of thousands of other Oppenheimer customers had also received from the Firm an inaccurate monthly account statement. As a result, during approximately June 2003 through January 2004, MFR conducted an unscheduled special examination of the Firm’s compliance with applicable financial and operational requirements (the “Special Examination”) and set forth findings in a report dated March 18, 2004 (the “Special Examination Report”). The Firm responded to the Special Examination Report in a submission to the Exchange dated May 17, 2004.
6. In addition, between 2002 and 2005, MFR also conducted other examinations of the sales practices and supervisory standards at the Firm (“Sales Practice Exam”) and other examinations of the financial and operational procedures established and maintained at the Firm (“Financial/Operational Exam”). In addition, the Exchange conducted a review of Firm supervision relating to disbursement and delivery of customer checks, in connection with an investigation of a misappropriation involving a Firm employee and an outside third party. The dates of these various other MFR examination reports (or date of exit interview) and type of examination, are as follows:

<b><u>Date</u></b>	<b><u>Examination Type</u></b>
January 10, 2003	Sales Practice Exam
March 17, 2004	Sales Practice Exam
March 19, 2004	Financial/Operational Exam

January 11, 2005	Financial/Operational Exam
June 6, 2005	Sales Practice Exam
November 1, 2005	Financial/Operational Exam (exit interview)
December 13, 2005	Sales Practice Exam (exit interview)

7. In letters from the Exchange to the Firm, including a letter dated October 22, 2004, the Firm was advised that it was a subject of Exchange investigations relating to findings set forth in the above-mentioned examinations.

### **Summary of Recent Exchange Discipline**

8. The Firm and its predecessor firms, Fahnestock and Josephthal & Co., Inc., has been the subject of previous Exchange disciplinary actions:
- a. In *Fahnestock & Co.*, HPD 03-100, the Firm consented to a censure, \$500,000 fine and two undertakings, as more fully set forth in paragraphs 76 and 77, below.
  - b. In *Josephthal & Co.*, HPD 03-126,<sup>2</sup> former member firm Josephthal consented to a censure and \$150,000 fine based upon a finding that it failed to comply with a previously imposed Exchange undertaking; failed to review and approve customers' letters of authorization for fund transfers and customer change of address requests; failed to have account designation changes authorized by qualified supervisors; and failed to diligently supervise trading in employee and employee-related accounts and active customer accounts.
  - c. In *Fahnestock & Co.*, HPD 98-48, the Firm consented to a censure, fine of \$100,000 and an undertaking based upon a finding that it violated SEC regulations concerning documentation on foreign custody accounts; books and records violations; and supervisory violations in failing to establish supervisory controls concerning separation of Firm departments and potential conflicts of interest. The Firm was required to retain an Exchange-approved independent consultant to prepare a report on Firm policies and procedures and recommend new policies and procedures designed to both take into account the Firm's past and future growth, as well as to detect violative conduct and prevent its recurrence.

### **Overview**

9. On May 27, 2003, Fahnestock through an account conversion, undertook to transfer onto its books and records, customer accounts pertaining to the retail brokerage business that Fahnestock had acquired from C. After the Conversion in May 2003, the Firm experienced various significant operational problems. The Firm issued tens of thousands of inaccurate customer monthly account statements to the Oppenheimer

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<sup>2</sup> Fahnestock acquired Josephthal & Co. in September 2001. These activities occurred prior to Josephthal & Co. being acquired by Fahnestock.

customers; experienced an increase in items in suspense accounts and in accounts effectively operating as such, and was unable to timely reconcile such accounts, or timely reconcile certain bank accounts. The Firm also failed to prepare accurate net capital computations and reserve formula computations; and filed inaccurate FOCUS Reports with the Exchange.

10. The Firm entered into revenue sharing arrangements with certain mutual fund companies from whom the Firm received during 2003 and 2004 approximately \$1.2 million in payments from the mutual fund companies, but failed to disclose these payments to its customers. In 2004, the Firm failed to comply with requirements concerning the solicitation of a private placement offering by contacting certain individuals with whom the Firm had no prior relationship, and thereafter voluntarily offered rescission to the customers. The Firm, in connection with its non-managed fee-based account program, failed to monitor client activity levels, which resulted in charging certain customer accounts fees between 2003 and 2004, that were higher than the commissions would have been in light of the inactive trading activity in the accounts. In 2004 the Firm could not evidence the delivery of preliminary prospectuses in connection with the sales of registered securities.
11. In addition, during 2003 and 2004, the Firm failed to timely transfer customer assets to other broker-dealers; failed to properly monitor the activities of its Floor broker; had inadequate controls concerning electronic and other communications; had inadequate controls regarding manual price changes of securities; and utilized reports to monitor mutual fund and other customer account activity which were inadequate for their intended purpose. Between 2002 and 2004, the Firm also permitted some producing branch office managers to service customer accounts without ensuring that their activities received an independent supervisory review.
12. Further, the Firm failed to make timely notification to the Exchange about certain significant problems that arose after the Conversion, although the Firm knew or should have known such notification was required (since it had been sanctioned by the Exchange around the time of the Conversion for failing to make such timely notifications); and failed to notify the Exchange about the solicitation of a private placement offering to individuals with whom the Firm had no prior relationship, and the subsequent rescission of the offer. The Firm also failed to supervise by having inadequate systems or procedures in place with respect to the foregoing matters.

#### **Issuance of Inaccurate Customer Monthly Account Statements**

13. Pursuant to Section 17(a) of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 17a-3 thereunder, and Exchange Rule 440 and Rule 409, Fahnstock was required to make and keep current certain books and records, which included a requirement that monthly account statements that it issued to customers accurately reflect customer holdings.

14. The first monthly account statement that Fahnestock undertook to send to the Oppenheimer customers, was for the period ending May 31, 2003 (the “May 2003 Oppenheimer statement”). Fahnestock undertook to create a customer statement for the Oppenheimer customers that would closely resemble the format of the statement that the customers had formerly received from C. The new monthly statement that Fahnestock created for the Oppenheimer customers had a “Portfolio Holdings” section, which was intended to provide a detailed listing of account assets, including the name of the security/asset, quantity, price and current market value. The first page of the new monthly statement contained an “Asset Summary” section, which was intended to give total asset values for the different asset types.
15. Fahnestock did not adequately supervise the planning and testing of the new statement, as the Firm did not cause the Portfolio Holdings and Asset Summary sections of the statement to accommodate all of the asset types held by the Oppenheimer customers. For example, while the current value for a Certificate Of Deposit (“CD”) was reported in the “Equities” portion of the Portfolio Holdings section in the May 2003 Oppenheimer statement, the current value was not similarly reflected on the Asset Summary section on the first page of the statement, which did not have a CD, miscellaneous, or other default asset category. Consequently, the total asset value on the Asset Summary section of customer statements for affected accounts was out of balance with the total portfolio value reflected in the Portfolio Holdings section on those same statements. This problem impacted approximately 8,073 customer accounts, causing the May 2003 Oppenheimer statements that these customers received to be inaccurate.
16. Another problem with the May 2003 Oppenheimer statement arose from Fahnestock’s failure to monitor its internal process whereby it created the files that it provided to its statement vendor that were used to generate the statements. Accounts of the Oppenheimer customers were designated by Fahnestock by the prefix “G”. In preparing the customer statement files, during a second occurrence of the process, Fahnestock did not allocate sufficient storage space on its computers for the process in question. As a result, certain account information was missing from the files created pertaining to Oppenheimer customers with “G” branch codes above a certain number. This affected such geographic areas as Seattle, Dallas and Washington D.C. This storage problem also affected all of the IRA accounts belonging to the Oppenheimer customers.
17. Fahnestock did not immediately detect that it had transmitted statement files to its statement vendor that had missing information, nor did it immediately detect that the statements that were produced were similarly inaccurate. Over 63,000 May 2003 Oppenheimer statements were issued to Oppenheimer customers that did not reflect any customer assets in a Portfolio Holdings section of the statement, and did not reflect any asset values on the Asset Summary section.
18. Another problem impacting the May 2003 Oppenheimer statement, was that various securities on the statements were not priced or were inaccurately priced. As a result

- of the Conversion, Fahnstock set-up on its books approximately tens of thousands of new CUSIPS pertaining to securities owned by the Oppenheimer customers. In the statement planning process, Fahnstock did not take adequate steps to ensure that the newly acquired securities could be priced using its existing pricing subscription services. As a result, thousands of securities held by the Oppenheimer customers were not priced or were inaccurately priced on the May 2003 Oppenheimer statement.
19. The May 2003 Oppenheimer statements were mailed to customers on or about June 6, 2003. The full extent of the problems affecting the statements became known to Fahnstock by or about June 9, 2003. On or before June 15, 2003, Fahnstock issued corrected May 2003 Oppenheimer statements to affected customers. Corrected May 2003 Oppenheimer statements were also issued to customers in July 2003.
  20. Fahnstock sent a letter of apology to Oppenheimer customers dated June 15, 2003 (the "Apology"), which was signed by the Firm's Chief Executive Officer. In the Apology, the Firm stated that "[i]n the past few days many of you have received inaccurate May month-end statements from us that contained un-priced securities, securities with inaccurate prices or incomplete security descriptions and incorrect summaries. You may also have been unable to access current information on our website or have found the data to be similarly inaccurate. You may have experienced other operational inconveniences." The letter further stated that "[a] simple apology is obviously inadequate; nevertheless we extend it."
  21. Moreover, in 2005, Exchange examination staff determined that the Firm's systems truncated the hundred million-digit numbers on portfolio balances in customer monthly account statements.
  22. As more fully discussed below, although required to do so, Fahnstock did not advise the Exchange or the United States Securities and Exchange Commission ("SEC") (either verbally or in writing) about any problems with the May 2003 Oppenheimer statements, or about the Apology, about other "operational inconveniences" identified in the Apology, or about other operational problems that arose after the Conversion, as set forth below.

#### **Failure to Identify and Reconcile Suspense Accounts**

23. After the Conversion, the Firm experienced a significant increase in the number of items in its suspense accounts and in accounts at the Firm that were effectively functioning as such. At the time of the Conversion, the Firm did not have adequate systems or procedures in place to identify accounts at the Firm that were being used as suspense accounts, and to reconcile items in such accounts, including properly aging money or security positions in such accounts.
24. At the onset of the Special Examination, the Firm was unable to provide Exchange examination staff with a comprehensive list of Firm suspense accounts and a schedule of related charges. On July 3, 2003, the Firm was only able to identify and compute

- capital charges on seven suspense/difference accounts. According to the Firm's computation, as of July 3, 2003, the seven accounts required a net capital charge totaling approximately \$15,869,689. On or about July 7, 2003, the Firm identified to the Exchange approximately 21 additional accounts that it classified as suspense and difference accounts. According to a net capital computation prepared by the Firm as of July 7, 2003, these suspense and difference accounts required a net capital charge totaling approximately \$18,210,245. According to another net capital computation prepared by the Firm as of July 17, 2003, suspense and difference accounts required a net capital charge totaling approximately \$26,815,360.
25. Among the suspense accounts that the Firm did not properly reconcile after the Conversion (which included aging items in the accounts for purposes of financial regulatory reporting) were the Firm's P&S Suspense Account and the Firm's Julian Date Accounts.
  26. During relevant times the P&S Suspense Account carried security and money positions created as a result of settling trade differences. The Firm experienced a significant increase in the number of items posted to the P&S Suspense Account after the Conversion. During June 2003, the Firm's Trial Balance reflected large money balances in the P&S Suspense Account, for instance: June 20, 2003 (approximately \$132 million net debit balance), and June 30, 2003 (approximately \$79.5 million net debit balance). By way of comparison, the Firm's reported excess net capital as of June 30, 2003, was approximately \$51.5 million.
  27. During at least June 2003, the Firm was not properly tracking items in the P&S Suspense Account to determine their age. Thus, at the onset of the Special Examination, the Firm was unable to identify to the Exchange which items in this account were aged. On or about June 30, 2003, the Firm placed all of the items in the P&S Suspense Account into a newly opened account (the "Aged P&S Suspense Account"). The intent of the Firm was that the P&S Suspense Account could start anew, and the items put in the Aged P&S Suspense Account would be isolated and all would be considered as aged. On or about July 3, 2003, the Firm computed net capital charges on the items in the Aged P&S Suspense Account in the amount of approximately \$6.7 million. It thereafter took the Firm several months to reconcile all of the items in that account.
  28. The "Julian Date Account" is a suspense account used by the Firm to balance the Firm's General Ledger.<sup>3</sup> The General Ledger is the primary bookkeeping record of a broker-dealer. On a daily basis (including after the Conversion) the Firm prepared a General Ledger. If the General Ledger was out of balance, it was automatically put in balance by use of a "plug" (dollar amount) number. This "plug" number is assigned a julian date, and becomes a Julian Date Account on the Firm's General

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<sup>3</sup> The term "julian date" refers to a discrete numbered day of the year (numbers 1 through 365). For example, May 27, 2003 (the date of the Conversion) was julian date 147.

- Ledger. Thus, the components of the “plug” money number (various Firm-wide debit and credit cash entries that net to the “plug” number) can be tracked by their julian date for aging and reconciliation purposes. Each day’s General Ledger out-of-balance “plug” amount should become a separate Julian Date Account.
29. Beginning at or about the onset of the Conversion (May 27, 2003) the Firm was unable on a timely basis to reconcile its Julian Date Accounts. Moreover, during relevant times, the Firm’s reconciliation process for the Julian Date Accounts proved to be inadequate given the increased volume of transactions following the Conversion. The Firm’s attempts at reconciliation did not entail creating a record by which it could be demonstrated how a Julian Date Account had been reconciled and balanced to zero by appropriate bookkeeping entries.
  30. As a result of the added volume following the Conversion, there was a significant increase in the number of cash differences in Julian Date Accounts at the Firm that required reconciliation. Instead of making appropriate bookkeeping entries to reconcile the differences, one or more employees in the Firm’s Operations Department attempted to complete the reconciliation process on a subsequent day by improperly causing unreconciled Julian Date Account out-of-balance amounts to be “rolled-over” into the next day’s Julian Date Account out-of-balance amount. This caused the Julian Date Account that was part of the “roll” to disappear from the General Ledger, and created a false appearance that the account had been reconciled and balanced to zero, when in fact, that had not occurred.
  31. By at least June 19, 2003, the Firm learned that this intentional “rolling” had occurred, and caused it to stop. As a result, when new Julian Date Accounts were created, and could not be balanced to zero by valid bookkeeping entries, they continued to appear on subsequent days on the Firm’s General Ledger. On July 7, 2003, the Firm transferred out-of-balance amounts from 10 separate Julian Date Accounts into the Firm’s Stock Record Suspense Account. (The 10 Julian Date Accounts had been created between June 19, 2003 and July 2, 2003.)<sup>4</sup> The Firm’s Stock Record Suspense Account normally only contained security positions and not General Ledger money balances, such as in a Julian Date Account. Thus, this transfer was contrary to prior Firm practice, and good business practice, because it caused General Ledger money balances to be commingled with unrelated security positions. The transfer also caused the Julian Date Account balances to be netted together, and also eliminated the individual julian date tracking information on each Julian Date Account.
  32. It was not until on or about August 20, 2003, that the Firm was able to prepare a formal reconciliation of Julian Date Accounts on a going forward basis. In October 2003, the Firm was still reconciling Julian Date Accounts created in July and August 2003. As of May 17, 2004 (the date of the Firm’s response to the Special

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<sup>4</sup> Due to the “rolling”, one or more of these accounts may have improperly contained out-of-balance amounts from a Julian Date Account created on May 27, 2003, or on a date thereafter.

Examination Report) the Firm was still in the process of reconciling three Julian Date Accounts that were created in July 2003.

### **Failure to Conduct Bank Account Reconciliations**

33. The Firm uses an XYZ Bank (“XYZ”) Concentration Account for multiple banking activities. Although it had been the Firm’s procedure in its Operations Department before the Conversion to reconcile this account on a daily basis, the Firm was unable to reconcile daily after the Conversion until approximately the end of September 2003. Moreover, the Firm’s Accounting Department was responsible for reconciling the XYZ Concentration Account on a monthly basis for purposes of preparing the monthly FOCUS Report. The daily reconciliation by the Operations Department was necessary to facilitate the monthly reconciliation by the Accounting Department. The Accounting Department was unable to complete a reconciliation of this account as of the time of the August 2003 FOCUS filing due date (September 24, 2003). The reconciliation was not completed by the Accounting Department until October 10, 2003.
34. In addition, the Firm’s Accounting Department was unable to complete approximately 22 other required bank account reconciliations as of the time of the August 2003 FOCUS filing due date (September 24, 2003). Thus, the Firm’s August 2003 FOCUS Report entry for “cash on hand” was not accurate.

### **Failure to Timely Book Quarterly Security Count Differences to a Security Difference Account**

35. The Firm conducted a quarterly security count as of the close of business on June 27, 2003. Pursuant to Section 17(a) of the Exchange Act and Rule 17a-13 (b)(5) thereunder, and Exchange Rule 440.10(3), the Firm was required to record into a security difference account all security count differences unresolved after seven business days. Approximately 20 unresolved security count differences were recorded by the Firm into a securities difference account one day late.

### **Failure to Prepare Accurate Reserve Formula Computations**

36. Fahnestock was required by Section 15(c) of the Exchange Act and Rule 15c3-3(e) thereunder, to compute the amount of cash or qualified securities required to be on deposit in Fahnestock’s Special Reserve Bank Account For the Exclusive Benefit of Customers in accordance with the formula for determination of reserve requirement for brokers and dealers (the “reserve formula computation”). As set forth below, weekly reserve formula computations prepared by the Firm after the Conversion were not accurate.
37. It was not the Firm’s practice during relevant times to “broaden-out” the net money balance on the Firm’s Trial Balance relating to the P&S Suspense Account, in order to properly ascertain what amount, if any, were aged credit amounts that should be

- included in a reserve formula computation. This included the large net debit balances relating to the P&S Suspense Account described in paragraph 26 above. The Firm took zero charges with respect to the P&S Suspense Account on each of the weekly reserve formula computations that it prepared in June 2003.
38. The Firm prepared a weekly reserve formula computation as of June month-end (June 30, 2003). This month-end reserve formula computation was finalized by July 2, 2003. The Firm did not include in this reserve formula computation numerous suspense credit charges that the Firm included in the June month-end (also as of June 30, 2003) reserve formula computation that it subsequently prepared for inclusion in its June 2003 FOCUS Report.
39. The omission by the Firm of significant suspense credit charges from the weekly (as of month-end) reserve formula computation made that computation inaccurate. The omission further demonstrated that the Firm was unable to timely identify and/or reconcile accounts being used at the Firm as suspense/difference accounts. On the weekly reserve formula computation (as of month-end) the Firm computed a suspense related credit charge of approximately \$16 million. However, on the month-end reserve formula computation prepared for the FOCUS Report, the Firm computed suspense/difference account related credit charges of approximately \$50 million (a difference of approximately \$34 million from what the Firm previously computed). Among the more significant differences in suspense related charges between the two reserve formula computations (both prepared as of the same June 30, 2003 month-end date) were the following:

	<u>Weekly (as of Month End)</u>	<u>FOCUS (as of Month-End)</u>
Stock Record Suspense Acct.	0	10,003,333
P&S Suspense Acct.	0	7,149,142
Daily Julian Date Accts.	0	5,368,571
SIAC CNS Acct.	0	3,102,818
MFD Trade Difference Acct.	0	1,561,999
Cashier/Cage Suspense	0	651,313

40. Due to the Firm's inability to establish to the Exchange its control over its suspense accounts, the Exchange requested that the Firm include an additional \$40 million credit item in its reserve formula computations, beginning in July 2003, for the protection of customers.
41. In the Firm's weekly reserve formula computation prepared for July 11, 2003, the Firm took charges relating to the Stock Record Suspense Account in the amount of approximately \$15,384,140. This charge was inaccurate, because the trade date net money balance in the Stock Record Suspense Account of \$9,347,633 was not "broadened-out" by the Firm (credits were not separated from debits). Gross aged suspense credits in that money balance were approximately \$22 million. Thus, the charge taken by the Firm was understated by at least \$6 million dollars.

42. Exchange examination staff conducted a review of weekly reserve formula computations prepared by the Firm for the computation reporting dates of July 25, 2003; August 15, 2003; September 5, 2003; September 19, 2003 (including the PAIB computation) and September 30, 2003.
43. As a result of the reviews by Exchange examination staff, the Exchange determined that numerous significant dollar adjustments with respect to both credits and debits were required to be made to each of the reserve formula computations identified in paragraph 42 above. Amongst numerous other things, the reviews disclosed that:
  - a. For a period of time, the Firm's Allocation Summary Report (which reflects balances that are includable or excludable from the reserve formula computation) did not accurately reflect the market value of securities, due to a problem in the Firm's allocation system. The report applicable to the July 25, 2003 reserve formula computation reflected an unallocated short (which could have resulted in a credit in the formula) of over \$1.9 billion. The Firm stated that its report and this balance was not accurate.
  - b. Adjustments made by Exchange examination staff to the reserve formula computation prepared by the Firm for August 15, 2003 (the day after a power failure throughout the Northeastern United States), caused total customer credits to be decreased by approximately \$38.9 million, and total customer debits to be decreased by approximately \$75.4 million. These adjustments resulted in a hindsight deficiency of approximately \$26,571,034.

**Failure to Prepare Accurate Computations  
of Net Capital and to File Accurate FOCUS Reports**

44. At all relevant times, the Firm was subject to the requirements of Section 15(c) of the Exchange Act and Rule 15c3-1 thereunder, in connection with the Firm's computations of net capital. During relevant times, the Firm monthly submitted FOCUS reports to the Exchange that were required to be accurate, pursuant to Section 17(a) of the Exchange Act and Rule 17a-5 thereunder, and Exchange Rule 476(a)(10).
45. In connection with being put on an "Alert" status by the Exchange in early July 2003, the Firm was required to prepare daily net capital computations, which included charges on suspense accounts. The Exchange did not verify the charges relating to suspense accounts on each such computation prepared by the Firm. However, the Exchange determined that the suspense account related net capital charge of approximately \$18,210,245, computed by the Firm as of July 7, 2003 was not accurate. Among other things, the Firm could not provide contract values to the Exchange, which were necessary to accurately compute mark-to-market in order to determine the correct charge for some suspense accounts. Also, the Firm had not "broadened-out" certain money balances (into separate debit and credit amounts) so the Exchange (and the Firm) could attempt to ascertain the actual debit money

balance amount. The Exchange determined that the Firm failed to deduct an additional \$10 million in net capital charges.

46. The Firm inaccurately prepared one or more other daily net capital computations, because the Firm did not take an appropriate net capital charge pertaining to the money balance in the Stock Record Suspense Account. For instance, on July 15, 2003, the Firm took a capital charge of approximately \$2,071,249, which pertained to the short market value of security positions in the Stock Record Suspense Account. However, the Firm did not “broaden-out” the net money balance of approximately \$10.5 million in the Stock Record Suspense Account. The Exchange “broadened-out” that net money balance, and determined that there were approximately \$13.9 million in gross aged debits, which should have been additionally included by the Firm in the capital charge taken.
47. The Firm’s August 2003 FOCUS Report and/or September 2003 FOCUS Report were inaccurate for the following reasons:
  - a. As stated in paragraph 34 above, the Firm failed to reconcile approximately 23 bank accounts as of the August FOCUS filing date. Also, the Firm failed to apply the appropriate net capital charges pertaining to approximately five bank accounts. The Firm only computed net capital charges for unresolved differences and failed to compute net capital charges for aged unfavorable differences. The Exchange computed charges totaling approximately \$2,269,360, as compared to charges computed by the Firm totaling approximately \$263,577. Further, the Firm was netting a Bank RST cash concentration account with a Bank RST ZBA Account, but did not have a required legal opinion from outside counsel that stated the accounts could be netted. This resulted in an adjustment of approximately \$2,281,085 to both cash and bank overdrafts.
  - b. The Firm did not perform an analysis of accounts where customers were extended credit on control or restricted securities, nor did the Firm conduct a required Rule 326 Charge Analysis. The Firm conducted a hindsight analysis with respect to both requirements. The Firm’s hindsight analysis disclosed that it: (i) failed to apply net capital charges of approximately \$5,480,494 (August) and approximately \$5,122,121 (September); (ii) failed to apply reserve formula computation charges of approximately \$3,141,111 (August) and approximately \$2,606,356 (September); and (iii) failed to report Rule 326 charges totaling \$66,644,980 (August) and \$63,845,051 (September).

### **Failure to Timely Transfer Customer Assets**

48. Pursuant to Exchange Rule 412, which governs processing of automated customer account transfer (ACAT) requests, the Firm was required to transfer to the receiving broker-dealer, for a minimum period of six months after an account transfer is completed, residual credit balances (both cash and securities) that occur in such transferred account within 10 business days after the credit balance accrues to the account. Residual credit items include, but are not limited to, dividends and interest.
49. The Exchange received a written complaint from ABC ("ABC") dated July 24, 2003, indicating that the Firm was not delivering in a timely manner residual credits to ABC's subsidiary (DEF) relating to hundreds of full customer account transfers made by the Firm's customers.
50. During relevant times, the Firm had the ability to monitor the residual ACAT process through an internal report that it could generate (the "Residual Response Report"). The Firm's Residual Response Report for July 25, 2003, reflected that as of July 10, 2003, the Firm maintained approximately 555 aged ACAT residuals that had not been delivered to ABC.
51. In addition, as of July 10, 2003, the Residual Response Report reflected that the Firm had not delivered approximately 1,779 other ACAT residuals to other broker-dealers within 10 business days after the residuals had accrued to the customer accounts.
52. Exchange examination staff determined that in 2004, the Firm still was not making timely transfers of ACAT residual credit balances.

### **Failure to Monitor Floor Broker Activities**

53. The Firm's Floor Broker has been an employee of the Firm since 1998 and is a member of the Exchange. He acts as the Firm's Floor Broker on the Floor of the Exchange, and qualifies the Firm as a member organization. The Firm did not have adequate supervisory systems in place pertaining to the activities of its Floor Broker, as follows:
  - a. The Firm did not maintain adequate written Floor Broker supervisory procedures. The procedures did not identify the person who was responsible for performing supervisory reviews, the type of reviews to be performed, and the frequency of any reviews to be performed.
  - b. The Firm did not ensure that the Floor Broker recorded on his Floor order tickets the time of receipt of each order, and the time that each order was executed (which the Floor Broker was not doing) as required of him by Exchange Rules applicable to members, as well as by Exchange Act Rule 17a-3(a)(6).

- c. The Firm improperly permitted the Floor Broker between August 2003 and October 2003, to process three erroneous reports through a Firm error account used by the Floor Broker. The erroneous reports were communicated by or on behalf of the Floor Broker to other Exchange members. In 2004, the Firm permitted at least two other non-bona-fide errors (pertaining to “not-held” orders) to be processed through the error account. In 2005, the Firm failed to maintain required documentation for two errors (including an order ticket), which prevented Exchange examination staff from determining if the errors were bona-fide.
- d. The Firm did not promptly report to the Exchange, or cause the Floor Broker to promptly report to the Exchange, that the Floor Broker maintained two securities accounts outside of the Firm, about which the Firm was aware. Pursuant to Exchange Rule 407A, the Floor Broker was required to promptly report to the Exchange any securities account in which he as a member had a direct or indirect financial interest.
- e. The Firm did not ensure that an individual that it designated with the responsibility to perform Floor Broker supervisory reviews was properly carrying out the delegated responsibility, which in fact the individual was not doing.

**Non-Disclosure to Customers of Revenue Sharing Payments Made to the Firm**

- 54. Revenue sharing payments include, among other things, an arrangement whereby a mutual fund company makes payments to a broker-dealer for the opportunity to participate in certain meetings sponsored by the broker-dealers in which the fund company may promote its products to representatives of the broker-dealer and to encourage the representatives to recommend the products of the mutual fund company to the customers of the broker-dealer.
- 55. During 2003 and 2004, the Firm received revenue sharing payments from ten mutual fund companies totaling approximately \$1.2 million. Such payments were in part utilized to assist in paying for the meetings described in the preceding paragraph. The Firm refers to the mutual fund companies that make revenue sharing payments to the Firm as “Strategic Partners” of the Firm.
- 56. It was not until approximately July 2004 that the Firm began to make disclosures to its customers about its receipt of revenue sharing payments from mutual fund companies. The Firm during relevant times also failed to reasonably provide for a review of prospectuses and Statements of Additional Information of the mutual funds companies with whom it had revenue sharing arrangements, to determine if they adequately disclosed the practice of making revenue sharing payments.
- 57. The Firm’s current revenue sharing arrangements are set forth on the Firm’s website, where it discloses that it seeks to collect a revenue sharing payment from Strategic Partners for “marketing, training, operations and systems support.”

### **Inappropriate Fee Based Accounts**

58. In January 2002 the Firm instituted a “Preference Program”, a non-managed fee-based account program. In this program, the customer does not pay a per-trade commission, but rather pays a fee of a certain percentage of the assets in the account. The Firm charged the customers in the Preference Program approximately 1.5% of the accounts’ billable asset amount, based on the amount of assets in the account.
59. From the time period October 2003 through September 2004, approximately 2000 customer accounts were enrolled in the Preference Program (“the Preference Accounts”). Approximately 280 of the Preference Accounts had five or fewer trades in the year. Approximately 36 of the Preference Accounts had zero trades in the year. Exchange examination staff determined that the Firm in 2005 still was not ensuring that the Preference Program was suitable for all customers enrolled in the program.
60. A sample of 30 customer Preference Accounts with five or fewer trades per year, disclosed that 25 of those accounts would have incurred lower costs had they paid transaction-based commission. The Firm did not contact some of the customers in the Preference Program to determine whether the Preference Program was appropriate for the customer.
61. The Firm did not establish procedures over its non-managed fee-based brokerage business to ensure that fee-based accounts were appropriate for customers. The Firm charged certain customer accounts fees that were higher than what their commissions would have been in light of the trading activity in the accounts and failed to ensure that customers in its Preference Program continued to believe that such a program was appropriate for their needs.

### **Failure to Ensure the Deliver of Preliminary Prospectuses in Connection with the Sale of Certain Registered Securities**

62. Rule 15c2-8(b) of the Exchange Act states in part that “In connection with an issue of securities...such broker or dealer shall deliver a copy of the preliminary prospectus to any person who is expected to receive a confirmation of sale at least 48 hours prior to the sending of such confirmation.”
63. During 2004, the Firm failed to retain records that could evidence the delivery of preliminary prospectuses in connection with sales of certain registered securities. For example, in the initial public offering of LMN. (LMN) in May 2004, the Firm was unable to demonstrate whether it delivered preliminary prospectuses to 10 customers who indicated an interest in the LMN offering.

### **Improper Solicitation of a Private Placement Offering**

64. One of the new products offered by the Firm was a registered investment company with interests sold to investors through a private placement (the "Private Placement"). Section 5 of The Securities Act of 1933 (the "Securities Act") prohibits the sale or delivery of a security unless a registration statement is in effect as to the security. In order to sell an interest in a private placement (and not fall under the provisions of Section 5 of the Securities Act) there must be no general solicitation, as Section 4(2) of the Securities Act exempts "transactions by an issuer not involving any public offering." In general, to avoid a general solicitation, there must be a preexisting relationship between the issuer, or its agents, and the prospective investor.
65. In early 2004, the Firm, through its registered representatives, offered interests in the Private Placement to certain individuals with whom the Firm did not have a pre-existing relationship.
66. When the Firm learned of the improper solicitations, on April 29, 2004, the Private Placement offered a Notice of Offer of Rescission to all Private Placement purchasers by offering to repurchase the security at a price equal to the amount invested, plus interest. On May 29, 2004, 48 investors out of the 183 Private Placement Firm investors accepted the rescission offer and recovered their investments plus interest.
67. The Firm failed to inform the Exchange of the improper solicitations or the offer of rescission until November 8, 2004.

### **Inadequate Supervision of Producing Branch Office Managers**

68. Supervision by the Firm of branch office managers that personally serviced customer accounts (known as producing branch office managers) reasonably required the Firm to implement policies and procedures that would ensure that such producing branch office managers not supervise and approve their own activity as it relates to the customer accounts that they personally serviced. Reasonable supervisory policies and procedures would have included the implementation of a system whereby producing branch office managers receive an independent supervisory review of their customer account related activities.
69. The Firm was cited in Sales Practice Exams (conducted between 2002 and 2004) for having inadequate systems or procedures in place with respect to its supervision of its producing branch office managers. Among other things, producing branch office managers at the Firm improperly approved, for accounts that they personally serviced: (i) account openings; (ii) trading activity; (iii) order error corrections; (iv) cancels and rebills; (v) commission adjustments; (vi) changes in account information, such as address changes; and (vii) e-mails and/or correspondence.

**Inadequate Controls Concerning Electronic and Other Communications**

70. During at least 2003 and 2004, the Firm could not evidence adequate controls concerning electronic and other communications, as follows:
71. The Firm's e-mail policy in 2004, as set forth in the Firm's Compliance Manual, required branch office management review of 100% of all incoming e-mail messages, a review of 25% of outgoing e-mail messages, and a review of 100% of all quarantined messages, for each employee. Multiple Firm branch offices could not evidence compliance with e-mail message review requirements, as the Firm's e-mail system was unable to substantiate that the required reviews took place. Also, 16 current and/or former employees of one branch office were missing from the e-mail system reports for the months of August, September and October 2004, and the branch office was unable to adequately evidence compliance with the e-mail reviews for these individuals.
72. During at least 2003, the Firm's internal e-mail communications were not retained in the required format. In addition, the Firm failed to establish sufficient firewalls to prevent employees from accessing third-party e-mail services and to prevent employees from posting messages on third-party message boards and in chat rooms. Further, at three branch offices, there were numerous instances in which the Firm failed to conduct supervisory reviews over incoming and outgoing e-mails. Moreover, there were instances of facsimiles, and incoming and outgoing correspondence, for which the Firm was unable to evidence supervisory review and/or approvals.
73. In 2004, the Exchange determined that the Firm in some instances had inadequate procedures to ensure that communications with the public, including letters, facsimile transmissions, and materials prepared for seminars held for prospective customers, contained necessary disclosures or disclaimers that would make the statements made in the communications more accurate, and not potentially misleading. For example, in one instance, correspondence by a producing branch office manager to a customer contained the statement "very safe, very stable fund," but did not contain the market price at the time the statement was made, and did not contain a required disclaimer.

**Inadequate Controls Regarding Security Pricing**

74. The Firm during the relevant period prior to 2005 failed to maintain adequate safeguards and controls to monitor the manual price changes of securities in customer and non-customer accounts. The Firm did not have written supervisory procedures to document the process whereby designated individuals had the ability to price and/or change a price of a security in the Firm's security master. The deficiencies in the Firm's supervision of this area include, that the Firm:
  - a. did not have the ability to identify the Firm personnel that made a pricing change;

- b. did not require delegated Firm personnel to obtain pre-approval or supervisory authorization prior to pricing or overriding the price of a security;
- c. did not maintain a procedure that required a person pricing or repricing a security to obtain multiple independent pricing sources;
- d. did not perform an independent review to determine the reasonableness of manually priced securities.

### **Other Sales Practice Deficiencies**

75. Sales Practice Exams and other reviews conducted by the Exchange of supervisory standards and sales practice procedures at the Firm identified other sales practice related supervisory deficiencies at the Firm, including the following:
- a. During at least 2004, pursuant to the Firm's procedures, the Firm's branch office managers were primarily responsible for the supervision of mutual fund activity through their review of a daily trade blotter. The Firm's Mutual Fund Department would spot-check the managers' reviews through its use of a Mutual Fund Report (the "Report"). The Report was used to review for breakpoint opportunities and mutual fund switching. The Firm's reliance on these two types of reviews was not deemed to be sufficient to facilitate a proper review of customer mutual fund activity, taking into consideration the large size of the Firm's mutual fund business. The reviews were deficient for the following reasons: (i) the daily trade blotter used by the Firm's branch managers was not suited to review for patterns of activity over a period of time; (ii) the Report captured too broad a range of mutual fund transactions to be deemed an exception report and as a result was too cumbersome to be an efficient supervisory tool; (iii) the Report did not adequately identify instances where a customer was entitled to a mutual fund breakpoint; and the Firm relied on such determinations by its registered representatives, who, however, were not provided adequate tools to track and apply breakpoint discounts, nor was branch supervision provided adequate tools to verify the accuracy of breakpoint calculations prepared by registered representatives; and (iv) the Report was not sufficiently designed to supervise and monitor for mutual fund switching, since transactions that are not switches would also show up on the Report so long as two mutual fund transactions occurred within 12 months of one another regardless of how the transactions were paid for.
  - b. Between 2002 and 2004, the Firm utilized inaccurate and inadequate reports, including supervisory reports utilized by branch office personnel to monitor activity in branch offices that may have been inadequate for their intended purpose. Among these is a monthly active account report known as the Compliance Review Report ("CRR"). The CRR was an inadequate supervisory tool considering the large size and structure of the Firm, and considering that it used surveillance criteria that made it ineffective for its intended purpose. For instance, active account criteria on the CRR (15 or more trades and commissions greater than \$2,499) was set at a level that might not reasonably identify active accounts. Also, the CRR's calculation of account "turnover" (a measure of trading activity in an account) was flawed. In

addition, the Firm failed to evidence Compliance Department review of discretionary accounts for the period from May 8, 2003 through September 6, 2003.

- c. In 2002, the Firm carried customer accounts which maintained post office box addresses but for which the Firm could not provide a legal street address.
- d. During 2001, the Firm did not sufficiently follow-up and review violations of Firm policies relating to disbursements and delivery of customer checks, an area in which the Firm previously had been subject to disciplinary action.
- e. During at least 2004, the Firm's written procedures dealing with hedge funds offerings were inadequate insofar as they failed to address, among other things, (i) how to properly promote hedge funds to its customers; (ii) details regarding customer suitability; and (iii) the supervisory and/or compliance controls in place to review the accuracy of information gathered and appropriateness of suitability determinations made by registered representatives prior to recommending hedge fund investments to its customers.

**Failure to Adhere to Good Business Practice  
and to Make Timely Notifications to the Exchange and to the SEC**

- 76. On April 17, 2003, approximately six weeks prior to the Conversion, the Firm executed a settlement document to settle an Exchange disciplinary proceeding that had been brought against it. A hearing before the Exchange Hearing Board on the settlement agreement, was held on June 4, 2003 (eight calendar days after the Conversion). The Hearing Panel accepted the settlement.
- 77. As set forth in Hearing Panel Decision 03-100, Fahnstock consented, among other things, to a finding that it had violated and/or caused or permitted a violation of Exchange Rule 401, by failing to notify the Exchange immediately upon discovery of any existing or impending condition which it reasonably should have believed could lead to operational problems and/or recordkeeping inaccuracies. In that prior disciplinary matter, the operational problems included an inability by Fahnstock to conduct a reconciliation pertaining to networked mutual fund positions in customer accounts. The customer accounts (containing the positions) were converted onto Fahnstock's books and records as a result of Fahnstock's acquisition of another broker-dealer.
- 78. Thus, during all relevant times, the Firm knew or should have known that Exchange Rule 401 required immediate notification to the Exchange of any conditions at the Firm that fell within the Rule's notification requirement. In addition, the Firm knew, or should have known, that notification was required pursuant to Exchange Rule 351(a).
- 79. In connection with the Conversion, the Exchange required Fahnstock to submit a Key Indicator Operational Report ("KEOP") to report on the status of the Conversion.

KEOP filings are required to be made as of the end of a week (Friday) and are to be submitted to the Exchange the following Wednesday. Fahnestock was fully familiar with the KEOP reporting process, having previously filed such reports with the Exchange in connection with other account conversions that occurred in prior years.

80. In each of its KEOP filings, Fahnestock was required to identify, among other things, various enumerated money and security differences. Also, Section 8 of each KEOP, captioned "General" imposed upon Fahnestock a requirement that it "[d]escribe any particular problems being experienced or events that have hampered normal operational procedures including but not limited, to" various areas set forth in an enumerated list. The list was clearly not intended to limit any reporting response, as the list also included "Other" as a reporting category.
81. Fahnestock began making KEOP filings in May 2003, before the Conversion. In one or more KEOP filings, the Firm provided inaccurate information, and/or omitted to state significant information, including but not necessarily limited to the following:
  - a. The KEOP filings for the period ending Friday, June 6, 2003 (submitted June 11, 2003) and for the period ending Friday, June 13, 2003 (submitted June 18, 2003) failed to disclose (depending on the KEOP) some or all of the following: that the Firm was aware it had issued over 63,000 inaccurate monthly account statements to the Oppenheimer customers for the May 2003 month-end period (the first statements issued by the Firm after the Conversion to those customers); that the Apology had been issued; and that on or before June 15, 2003 the Firm issued corrected statements to the affected customers.
  - b. The KEOP Report for the period ending Friday, June 20, 2003 did not accurately state the number of aged items and corresponding long and/or short value for various categories. For example, the Firm represented therein that it had zero "[m]oney suspense and balancing differences outstanding 3 business days or longer as of last day of week". However, the Exchange determined that such differences existed in various Firm suspense accounts. In addition, by this time the Firm had knowledge of the internal control problem relating to the Julian Date Account "rolling", which it failed to disclose either in this section, or in the "General" section of this KEOP.
82. In addition to the KEOP reporting omissions, the Firm did not otherwise timely advise the Exchange or the SEC (either verbally or in writing) about significant problems it had experienced after the Conversion, including but not necessarily limited to, problems with the May 2003 Oppenheimer statements, and problems reconciling suspense and other accounts, and problems complying with ACAT requirements.
83. After the Exchange became aware of certain recordkeeping problems experienced by Fahnestock after the Conversion, the Exchange caused the Firm to fulfill its notification requirement to the SEC, pursuant to Rule 17a-11(d) and (g) promulgated

under the Exchange Act. In a letter from Fahnestock to the SEC dated July 10, 2003, the Firm stated it was required to give notification of “certain occurrences.” Among other things, Fahnestock stated that “since the [C]onversion, Fahnestock has had a significant increase in the number of items, and the balances in its operations suspense accounts and in its stock record ‘breaks’.” The Firm further reported that “[p]rior to July 8 [2003], all of these differences were not being completely comprehended and properly dated by Fahnestock so that it could take capital charges and include the appropriate ‘credits’ in Rule 15c3-3 reserve formula calculations.” The Firm further stated that Fahnestock has “hired consultants on a temporary basis to assist in the reconciliation effort.”

### **Failure to Supervise**

84. During times between 2002 and 2005, the Firm did not provide for appropriate procedures of supervision and control and have adequate systems or procedures in place and/or have in place a separate system of follow-up and review, in connection with the following areas:
- a. planning for the Conversion, including but not necessarily limited to, production and testing of the monthly account statement sent to the Oppenheimer customers;
  - b. identifying and/or monitoring accounts being used at the Firm as suspense accounts; aging items in those accounts, and reconciling such accounts;
  - c. timely reconciling bank accounts;
  - d. fulfilling quarterly security count requirements;
  - e. preparing accurate computations of net capital and reserve formula computations; and accurate FOCUS Reports;
  - f. complying with customer account transfer requirements;
  - g. revenue sharing arrangements entered into between the Firm and certain mutual fund companies;
  - h. fee-based customer account program so as to ensure that customer accounts with little or no trading activity were suitable for the fee-based program;
  - i. ensuring that evidence was retained that preliminary prospectuses were issued in connection with sales of registered securities;
  - j. complying with private placement offering solicitation requirements;
  - k. implementing independent reviews of customer related activity conducted by producing branch office managers;
  - l. maintaining controls regarding electronic and other communications;
  - m. maintaining safeguards and controls regarding manual security pricing;
  - n. monitoring Floor Broker activities and error transaction procedures;
  - o. ensuring the adequacy of Firm reports used to monitor customer accounts, including reports used to review mutual fund activity and whether potentially excessive trading is occurring in accounts;
  - p. notifying the Exchange and the SEC on a timely basis of any existing or impending condition that the Firm reasonably should have believed could lead to, among other things, operational, control or recordkeeping problems.

### **Additional Considerations**

85. With respect to the Firm's fee-based Preference Program, the Firm has agreed to review the accounts of all customers to whom fees under that program may have exceeded what the customers would otherwise have paid in commissions and contact all customers with five or less trades per year in the last two calendar years. The Firm will then arrange for an independent third party to determine, based on those surrounding facts, whether the program was suitable for those customers, in light of the customers' trading objectives, activities and preferences, and will (pursuant to a process that will be subject to Exchange review) make appropriate restitution to those customers for whom the program may have been unsuitable.
86. The foregoing events occurred during a period of rapid expansion for the Firm, which acquired four other firms in two and a half years. The acquisitions resulted in the Firm's expansion from approximately 1,000 employees to 3,000, from 56 branches to over 100, and from 600 financial advisors to 1,700. The assets under the Firm's administration increased from \$11 billion to \$50 billion, and the number of its clients from 165,000 to 400,000.
87. Following these acquisitions, the Firm hired and/or promoted individuals to fill the following positions; Chief Operations Officer, Chief Compliance Officer, Regulatory Reporting Officer, Operations Control Manager, AML Senior Analyst. The Firm additionally increased the staffing of its Internal Audit and Compliance Department.
88. During the relevant period, the Firm received assistance from, and had intensive review by, outside consultants, and it adopted recommendations with respect to: systems and procedures, compliance procedures (including the adoption of six new and/or updated compliance manuals), Patriot Act and AML procedures and processes, and mutual fund processes and procedures.
89. The Firm integrated over 50 systems and invested over \$25 million in technology upgrades, including substantially more sophisticated systems and the addition of 100 IT professionals for monitoring its business, including new compliance monitoring systems, including the controls necessary to comply with the Section 404 of Sarbanes Oxley Act, a new corporate actions system, and a new account opening system. The firm also retained an outside vendor to assist in reviewing client identifications for Patriot Act compliance.

### **DECISION**

The Hearing Panel, in accepting the Stipulation of Facts and Consent to Penalty, found Respondent 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 Respondent of a censure and a fine of \$1.35 million.

For the Hearing Panel

Vincent F. Murphy - Hearing Officer

Panelists:

John O'Brien

Thomas A. Tranfaglia