

NEW YORK STOCK EXCHANGE LLC

**NYSE HEARING BOARD DECISION 06-98**

SCOTT & STRINGFELLOW, INC.  
MEMBER ORGANIZATION

June 26, 2006

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**Violated NYSE Rule 476(a)(6) by placing customers in classes of mutual fund shares which were inappropriate in view of funds' fee structures; violated NYSE Rule 410 by failing adequately to describe errors and account-designation changes of orders and evidence supervisory review or approval prior to submission; violated NYSE Rule 342 by failing to reasonably supervise its business activities and provide for appropriate procedures of follow-up and review and by failing to have adequate policies and procedures with respect to review, prior to dissemination, of Research Analysts' e-mails – Consent to censure and \$75,000 fine.**

**Appearances:**

For the Division of Enforcement  
Linda S. Riefberg, Esq.  
Martin S. Mazur, Esq.  
Kathleen Lynch, Esq.

For Respondent  
Thomas J. McGonigle, Esq.

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A Hearing Officer on behalf of the New York Stock Exchange LLC (“NYSE”) considered a Stipulation of Facts and Consent to Penalty entered into between NYSE Regulation, Inc.’s Division of Enforcement (“Enforcement”) and Scott & Stringfellow, Inc. (“Respondent” or the “Firm”), an NYSE member organization. Without admitting or denying guilt, Respondent consented to a finding by the Hearing Officer that it:

- I. Violated NYSE Rule 476(a)(6) in that it engaged in conduct inconsistent with just and equitable principles of trade by placing customers in classes of mutual fund shares which were inappropriate in view of the funds' fee structures.
- II. Violated NYSE Rule 410 relating to preservation of records of orders in that errors and account-designation changes of orders were not adequately described and did not evidence supervisory review or approval prior to submission.

III. Violated NYSE Rule 342 in that it:

- a) failed to reasonably supervise its business activities and provide for appropriate procedures of follow-up and review to prevent the above violations; and
- b) did not have adequate policies and procedures with respect to review, prior to dissemination, of Research Analysts' e-mails.

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

**Background and Jurisdiction**

1. The Firm is a member organization first established in 1893 and has been a member of the NYSE in its present form since May 1999. The Firm is also registered as an investment advisor. The Firm has 44 branches and employs approximately 975 individuals including approximately 705 registered representatives and 270 support personnel.
2. This investigation was opened as a result of an examination conducted by the Division of Member Firm Regulation of NYSE Regulation ("MFR") of the Firm's supervisory standards/sales practice procedures in April 2003 the results of which are contained in the report dated June 12, 2003 (the "2003 MFR Report"). Subsequently, the Philadelphia District Office of the Securities and Exchange Commission ("SEC") reviewed the Firm's sales practice procedures in 2004 ("SEC 2004 Report") and referred certain findings of such review to NYSE Regulation.

**Overview**

3. The 2003 MFR Report disclosed supervisory issues involving cancel and corrects of customer orders in the Norfolk, Va. Branch. A review of order and account designation changes at the Branch, during the relevant period, disclosed that as a general practice, supervisory staff did not review or approve corrections until after they were made. The SEC 2004 Report noted purchases of mutual funds for certain customer accounts which exceeded the maximum amount recommended in the fund prospectuses, and in some cases, the specified amount in the Firm's written supervisory procedures. The SEC 2004 Report also noted that the Firm also failed to properly review e-mails of research analysts.

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\* Hearing Officer Note: The facts, allegations, and conclusions contained in paragraphs 1 to 16 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 Officer, except that pseudonyms have been provided to protect the privacy of non-parties.

### **Violations of NYSE Rule 410**

4. NYSE Rule 410 entitled “Records of Orders”, with respect to changes in account name or designation requires that, “No change in such account name (including related accounts) or designation (including error accounts) shall be made unless the change has been authorized by a member, allied member, or a person or persons designated under the provisions of NYSE Rule 342(b)(1). Such person must, prior to giving his or her approval of the account designation change, be personally informed of the essential facts relative thereto and indicate his or her approval of such change in writing on the order....”
5. The MFR 2003 report found that the Norfolk, VA branch was not in compliance with NYSE Rule 410. A review of order errors and account designation changes at the Norfolk, VA branch office for the period January 2003 through March 2003 disclosed that on two occasions, corrections were not described or approved until after they were made.
6. During the time period, January 2003 through March 2003, it was a practice for the branch office manager (“BOM”) or person designated under the provisions of NYSE Rule 342(b)(1) to approve the cancellation or correction of trades after they were effected. In one instance, an error involved placing the wrong symbol for XYZ on an options trade ticket. The subsequent correction of that error was approved by the BOM after the correction was effected. On another occasion, a sales assistant purchased the incorrect amount of options in ZYX. In that case, the BOM also approved the correction after it was effected.

### **Inappropriate Class B Mutual Fund Share Purchases**

7. Customers who invest large amounts in Class B Mutual Fund shares over long time periods generally earn unfavorable returns when compared with investments in Class A shares. Class B Shares typically have a back-end load and a sales charge payable upon redemption. In addition to lower expenses, Class A shares offer reduced sales charges for both large individual purchases and aggregation of funds within the same fund family. Furthermore, purchases of \$1,000,000 or more in Class A shares within the same family do not require any up-front sales charge.
8. On January 16, 2003, the Firm implemented its “Mutual Fund Breakpoint Policy” which established a \$250,000 maximum for all Class B share purchases within one fund family. As illustrated in the following chart, and as a result of cumulative purchases, two customers exceeded the maximum Class B share purchase amounts as dictated by the Firm’s policy and recommended in the mutual fund prospectuses. As a result of cumulative purchases, all six customers’ investments exceeded Class B share purchase amounts recommended in the mutual fund prospectuses.

| Customer   | Fund Family | Maximum B Share Per Prospectus  | Amount Invested in Fund Family as of March 31, 2004 | Reimbursement Made to Customers |
|------------|-------------|---|---|---------------------------------|
| Customer A | BB&T        | \$250,000   | \$355,706   | \$17,795.46                     |
| Customer B | BB&T        | \$250,000   | \$270,039   | \$7,689.88                      |
| Customer C | Davis       | \$100,000   | \$235,039   | \$2,127.21                      |
| Customer D | Davis       | \$100,000<br>Although prospectus recommends \$100,000 in Class B shares, the Statement of Additional Information recommends a \$250,000 Class B limit | \$198,043   |                                 |
| Customer E | Davis       | \$100,000   | \$204,195   | \$13,814.60                     |
| Customer F | Davis       | \$100,000   | \$125,001   | \$744.49                        |

**The Firm did not have Adequate Policies and Procedures Concerning the Reviews, Prior to Dissemination, of Research Analysts' E-Mails**

9. The SEC's 2004 Report disclosed several e-mail communications between a senior research analyst specializing in the real estate investment trust ("REIT") area, and Firm institutional and retail equity sales personnel, regarding future research coverage.
10. The Firm's policies prohibited the selective dissemination of research recommendations before those recommendations are publicly disclosed. The Firm's policy states generally that "[d]epartments [including research department] that obtain material, non-public information in the normal course of business must maintain the confidentiality of that information." The Firm's Equity Research Department Manual Policies and Procedures states that "[n]o employee may be informed of an impending recommendation prior to its official dissemination, except on a 'need to know' basis. . . . Research analysts must have approval from the Supervisory Analyst prior to distributing any written materials regarding rating, estimate or price target changes." Similarly, the Firm's Policies and Procedures states that "[p]recautions should be taken to assure that new research reports are kept confidential until publication, including discreet handling of written materials in progress in public areas. For example, a research analyst may not tell a client or salesperson that a report is being prepared."
11. During the relevant time the Firm did not have adequate procedures in place for the review of communications sent by the research department within the Firm. E-mails

sent by research analysts within the Firm were not reviewed, prior to dissemination, on any systematic basis.

### **Supervision**

12. NYSE Rule 342 requires member organizations to provide for, establish, and maintain adequate supervisory procedures and controls, including a system of follow-up and review of business activities, in order to ensure compliance with NYSE Rules and the federal securities laws.
13. The Firm did not have adequate supervisory systems in place to detect and prevent the violations set forth above.

### **Other Factors Considered**

14. The Firm has enhanced its procedures and the 2003 Policy has been superseded by the new Mutual Fund Share Class Limits policy, effective November 1, 2004. The new procedure created an exception report that focuses on the aggregate amount of any one fund class in an account or related accounts. The B share limit is \$99,999 per household, in keeping with the limit prescribed by the vast majority of mutual fund companies. The C share limit is \$499,999 per household. The policy also states that the Firm and RRs must adhere to stricter limits imposed by certain mutual funds. The Firm has also enhanced surveillance tools to detect any violation of such policy.
15. The Firm reimbursed certain customers to the extent they would have paid less in fees had they purchased Class A mutual fund shares. The Firm also has strengthened its policies and procedures regarding sales of mutual funds with multiple share classes.
16. The Firm implemented new procedures to prevent the disclosure of material, non-public information by research analysts. The revised procedures have three components. First, once analysts become aware of a transaction and are brought “over the wall,” they are prohibited from having any communications (internal or external) about the companies or transaction at issue. Second, under the new procedures, supervisory analysts screen all “internal” e-mails from research analysts for compliance purposes prior to dissemination within the Firm. Third, the research department hired an additional supervisory analyst, which enabled the Firm to become “more proactive” regarding compliance.

**DECISION**

The Hearing Officer, in accepting the Stipulation of Facts and Consent to Penalty, found Respondent guilty as set forth above.

**PENALTY**

In view of the above findings, the Hearing Officer imposed the penalty consented to by Respondent of a censure and a \$75,000 fine.

For the Hearing Board

Peggy Kuo - Chief Hearing Officer