Securities

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Recent Enforcement Actions Target Broker-Dealer Operational and Systems Issues

In recent months, securities regulators have brought a series of cases highlighting their resolve to address operational weaknesses and systems failures at broker-dealer firms. These proceedings signal a willingness on the part of the regulators to bring disciplinary actions even in the absence of demonstrable customer harm, and may have implications for the forthcoming CEO certification process, under which NYSE and NASD member firms will be required to attest to their supervisory controls. As NYSE Director of Enforcement Susan Merrill noted this past summer, "[i]nternal controls at our member firms cannot run on auto-pilot, but must be reviewed periodically to ensure that firms are complying with their responsibilities under federal securities laws and NYSE Rules."[1] Similarly, NASD Vice Chair Mary L. Schapiro has stated that, "[a] firm's duty to supervise automated systems is every bit as important as its duty to supervise employees. When critical tasks are automated, firms must verify that the automation functions as intended."[2]

1. SEC and FSA Actions

The NYSE and NASD are not alone in this regard. Lori Richards, Director of the Office of Compliance Inspections and Examinations at the SEC, has stated that the Commission, in conducting examinations of internal controls and risk management, will focus on a firm's "controls over operational risks," including "segregation of duties, checks and balances, protection of customer funds and securities, operating systems, management information systems, management reporting, [and] front and back office operations . . . ."[3] Indeed, in several recent actions, the SEC has used its enforcement powers to address operational failures. In October 2005, (contemporaneously with the NASD), the Commission instituted an administrative and cease-and-desist proceeding against Instinet, LLC and INET ATS, Inc. for publishing monthly execution reports containing inaccurate order execution quality information.[4] The Commission found that the inaccuracies were the result of programming and systems errors, that the firms did not adequately test their automated systems, and did not adequately respond to findings of errors in circumstances in which errors were discovered. In another proceeding, the Commission affirmed an NASD disciplinary action against Castle Securities Corp. for that firm's failure to transmit required order information to the NASD's Order Audit Trail System, and comply with the requirements of the NASD's Automated Confirmation Transaction Service.[5] The Commission rejected Castle's arguments that any late reporting to OATS and ACT was not intentional, did not cause any economic harm to customers, and was promptly corrected when brought to its attention.[6]

Emphasis on operations has not been limited to the US. Recently, the UK's Financial Services Authority fined HSBC Bank plc for the failure of its brokerage division to ensure that HSBC's IT systems were accurately reporting securities transactions.[7] According to the FSA's Final Notice, the error in reporting occurred when HSBC reorganized its divisions. Recognizing that the reorganization would affect its transaction reporting, HSBC made changes to its systems, but failed to change the buy/sell indicator to reflect the correct transaction from the firm's perspective. As a result, HSBC inadvertently reported purchases and sales from the perspective of the client and not from the firm's perspective. Although the FSA found that the inaccuracies were not deliberate or reckless, it nevertheless fined HSBC for its failure to ensure the accuracy of its transaction reports.

2. NYSE Disciplinary Actions

Among the more significant recent cases involving operational failures are those involving prospectus delivery. In a December 2004 disciplinary action against Morgan Stanley and a July 2005 action against Merrill Lynch, the NYSE cited the firms for failing to deliver prospectuses in connection with sales of registered securities. Morgan Stanley's failure was found to have resulted from operational errors and a breakdown in communications within the firm, as well as supervisory failures prompted by the absence of comprehensive procedures to ensure that prospectuses were delivered as required.[8] In the Merrill case, operating system modifications, absence of codes in its securities master database triggering the delivery of prospectuses and product descriptions for ETFs, and replacement of its operating system for the offering of auction rate preferred securities with a system that did not include proper coding instructions, resulted in a failure to deliver prospectuses.[9]

In other NYSE actions focused on operational issues, Prudential Equity Group was censured and fined in March 2005 for inaccurately reporting its short interest positions, failing to provide for appropriate procedures of supervision and control to ensure accurate reporting, and failing to implement a separate system of follow-up and review to ensure compliance with short interest reporting requirements and to detect and prevent violations.[10] Charles Schwab & Co., Inc. was censured and fined in November 2005 for supervisory and control violations concerning accounts of customers maintained at the firm that were managed by non-employee investment advisors, including a lack of adequate procedures for transfer of funds from customer accounts to third parties.[11] And most recently, in December 2005, the NYSE disciplined Oppenheimer & Co. Inc. F/K/A Fahnestock & Co. Inc. for operational and supervisory failures arising from customer account conversion during Oppenheimer's acquisition of Fahnestock, including the issuance of inaccurate customer monthly account statements.[12]

3. NASD Disciplinary Actions

The NASD has also been active. On September 29, 2005, the NASD announced that it had censured and fined Edward D. Jones & Co., L.P. for failing to disclose the yield to maturity on transaction confirmations issued to customers who sold municipal securities.[13] Because of a change in Edward Jones' automated systems, the yield information was inadvertently omitted from confirmations issued to customers who sold municipal bonds. Nevertheless, the NASD found Edward Jones accountable, targeting the inadequacy of its supervisory system and its written supervisory procedures. Likewise, on October 18, 2005, the NASD announced its own proceeding against Instinet, LLC and INET ATS, Inc. for publishing inaccurate reports on order execution quality, failing to report orders, and failing to reasonably supervise the accuracy of data generated and reported by its automated systems.[14]

Conclusion

These recent cases reflect a sharp regulatory focus on operational and systems integrity—particularly where a problem may impede the regulators' own surveillance capabilities. They also highlight the role of technology in compliance and supervision, as well as the resulting need to manage carefully the relationship between IT and Compliance staffs. Recognizing this need, some firms have created positions for Technology Compliance Officers, whose responsibilities may include monitoring regulatory developments involving technology, learning new rules and regulations pertaining to technology, and serving as the contact for all technology-related compliance issues. To be sure, the new regulatory landscape created by the addition of the CEO certification process and the recent active role taken by the NYSE, NASD, FSA and SEC in targeting operational failures—even in the absence of demonstrable customer harm—emphasize the importance of maintaining adequate controls in all aspects of a firm's business, including the back office.

1. *See* NYSE Press Release, "NYSE Regulation Fines Merrill Lynch $10 Million for Failure to Deliver Customer Prospectuses, Among Other Supervisory and Operational Failures," (Aug. 15, 2005).
2. NASD News Release, "NASD Fines Instinet and INET ATS $1,475,000 for Inaccurate Execution Quality Reports, Inadequate Supervision and Other Violations," (Oct. 18, 2005).
3. Lori Richards, Director, Office of Compliance Inspections and Examinations, Remarks before the Securities Industry Association, Internal Auditors Division 2005 Annual Conference (Oct. 18, 2005).
4. *See* In the Matter of Instinet, LLC and INET ATS, Inc., Exchange Release No. 34-52623 (Oct. 18, 2005).
5. *See* In the Matter of the Application of Castle Securities Corp., Exchange Release No. 34-52580 (Oct. 11, 2005).
6. The SEC noted that Castle had previously been disciplined twice for failure to exercise proper supervision and that, in this case, the firm's supervisory deficiencies once again led to violative conduct. Further, the SEC noted that instead of accepting responsibility for its violations, Castle sought to shift the blame to, among others, the NASD for not apprising Castle sooner that OATS was not receiving the required transmissions.
7. FSA Final Notice to HSBC Bank plc (Dec. 14, 2005), *available at* http://www.fsa.gov.uk /pubs/final/hsbc_14dec05.pdf ("Final Notice"). *See also* "HSBC Case Holds Warnings for Checking IT Systems," 12 COMPLIANCE REPORTER 50 (Dec. 19, 2005), *available at* www.compliancereporter.com. Other recent developments outside of the U.S. underscore the importance of developing adequate control systems and procedures for operations and technology. On December 8, 2005, Mizuho Securities Co. entered an erroneous order to sell 610,000 shares of newly-listed J-Com Co. for 1 yen (instead of 1 share of J-Com Co. for 610,000 yen). The unintended order was entered and executed on the Tokyo Stock Exchange, resulting in a loss to the firm of about 40.5 billion yen. Japan's financial services regulator ordered the firm to improve its business operations and submit a report on measures to improve its computer systems and the way its workers operate those systems. *See* Takashi Nakamichi, "Japan Orders Trading Fix," WALL ST. J., Dec. 23, 2005, at C12.
8. *See* Morgan Stanley DW Inc. and Morgan Stanley & Co. Incorporated, Exchange Hearing Panel Decision 04-184 (Dec. 9, 2004). Morgan Stanley was also held accountable for technical flaws in a version of its electronic trading platform and programming errors that resulted in failure to provide accurate daily program trading reports to the Exchange and to report certain program trades that resulted in violations of short sale rules.
9. *See* Merrill Lynch, Pierce, Fenner & Smith, Incorporated, Exchange Hearing Panel Decision 05-87 (July 21, 2005).
10. *See* Prudential Equity Group, LLC f/k/a Prudential Securities Inc., Exchange Hearing Panel Decision 05-37 (Mar. 24, 2005).
11. *See* NYSE Press Release, "NYSE Regulation Fines Charles Schwab & Co. $1,000,000 for Failing to Supervise and Protect Customer Assets," (Nov. 15, 2005).
12. *See* Oppenheimer & Co. Inc. F/K/A Fahnestock & Co. Inc., Exchange Hearing Panel Decision 05-120 (Dec. 29, 2005); NYSE Press Release, "NYSE Regulation Announced Two Disciplinary Actions Against Oppenheimer & Co. Inc.," (Dec. 29, 2005).
13. *See* NASD News Release, "Edward D. Jones Fined $300,000 for Failing to Disclose Municipal Bond Yields on Confirmations to Customers," (Sept. 29, 2005).
14. *See* NASD News Release, "NASD Fines Instinet and INET ATS $1,475,000 for Inaccurate Execution Quality Reports, Inadequate Supervision and Other Violations," (Oct. 18, 2005).

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