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# ONE BROKER GONE BAD: PUNISHING THE CRIMINAL, MAKING VICTIMS WHOLE

## HEARING

BEFORE THE

SUBCOMMITTEE ON
OVERSIGHT AND INVESTIGATIONS

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED SEVENTH CONGRESS

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# ONE BROKER GONE BAD: PUNISHING THE CRIMINAL, MAKING VICTIMS WHOLE

**Thursday, May 23, 2002**

U.S. HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS
COMMITTEE ON FINANCIAL SERVICES
*Washington, D.C.*

The subcommittee met, pursuant to call, at 9:30 a.m., in Room 2128 House Office Building, Hon. Sue W. Kelly [chairwoman of the subcommittee] presiding.

Present: Representatives Kelly, Ney, Cantor, Tiberi, Inslee, Jones of Ohio, Clay, and Oxley (ex officio).

Also Present: Representatives Hastert and LaTourette.

Chairman KELLY. Good morning, ladies and gentlemen. This hearing of the Oversight and Investigations Subcommittee of the House Committee on Financial Services will come to order.

I want to thank all members of Congress who are present today. Without objection, all members present will participate fully in the hearing, and their opening statements and their questions will be made part of the official hearing record.

On January 11, 2002, Frank Gruttadauria, a Cleveland branch manager and broker, mailed a letter to the FBI admitting to 15 years of wilful fraud and theft of his clients' savings, and he disappeared. In the aftermath of this revelation, law enforcement, the regulators, the successive owners of that branch, and Gruttadauria's clients, began to uncover the extent of this one broker's deceitfulness and the intricate web of lies that he employed to perpetrate his fraud.

We do know that Mr. Gruttadauria is accused of at least—stealing at least $40 million of his client's savings, while sending his clients fake statements stating that their savings had grown to an estimated combined total of $260 million. Today, Mr. Gruttadauria is in federal custody after less than a month of being on the run.

It appears that his efforts to evade detection by the firms and regulators were much better than his ability to evade the law. One issue is clear: Mr. Gruttadauria and any who assisted him will be punished for their crimes. From my initial review of this case, Mr. Gruttadauria had the ability to perpetrate this fraud because of his position in the Cleveland branch as both manager and a broker. This put him in the position of supervising himself, which is a key point in this case.

Another key point is the lack of complaints in regard to Mr. Gruttadauria's actions. The majority of investigations against problem brokers appear to be triggered by five or more complaints. Since Mr. Gruttadauria was able to send false statements to his clients and forged any authorization he needed, he appears to have avoided scrutiny, including anything that occurred through traditional warning signs.

The purpose of this hearing is to examine this case in an effort to determine what steps are warranted to ensure that similar fraud and theft is prevented. Our responsibility is to ensure that scams such as this will not go undetected again. In order to do this, we must take a step back from the particulars of this case and examine the systems that firms and regulators have in place to detect such fraud by managers' brokers.

We know that the securities industry is very full of intelligent people. If they put their mind to it, they could potentially inflict a great deal of harm on the savings of many families and investors. To preserve and bolster investor confidence, we must gain an understanding of how the current systems were defeated so consistently over the course of approximately 15 years by Mr. Gruttadauria.

I want to thank all of our distinguished witnesses for taking the time out of their busy schedules to join us here today. The committee understands the constraints that some of our witnesses are under and their inability to discuss some of the specifics of the case due to the ongoing nature of the Gruttadauria investigation. The last thing we want to do is to inadvertently harm the prosecution of Mr. Gruttadauria or any of his accomplices.

We appreciate your willingness to come here today to discuss the issues to the best of your ability. I also want to make it clear to the members of this committee, and to our witnesses, it is my intention to enforce the five-minute rule, which limits statements and questions to a five-minute period. This will ensure that everyone has an equal chance to state their views, and I thank you all in advance for this effort.

I want to now recognize the Speaker of the U.S. House of Representatives, our Speaker, Mr. Dennis Hastert, for an introduction.

Mr. Hastert, we welcome you here today. Your presence lends a great deal to this hearing. Thank you. Mr. Speaker, your mike needs to be turned on.

[The prepared statement of Hon. Sue Kelly can be found on page 64 in the appendix.]

The. SPEAKER. I haven't done this for a while. No.

[Laughter.]

Chairman Kelly, thank you very much for holding this hearing today. I also want to thank Mr. LaTourette, because he worked to bring this about, and also the Chairman of the full committee for making this happen.

You know, one of our bases of wealth in this country is the people having confidence in securities and 401Ks and money markets and mutual funds that they can invest their money, the money that they worked hard or inherited or saved or scrimped, or however they accumulated it, and to see that money grow, so that they can have something to live their life with and to pass on to their chil-

dren and their grandchildren. And we have seen that wealth grow in this country over the last few years.

But I have a constituent here today, Mrs. Golda Stout, from Elgin, Illinois, who invested over $600,000, or her life savings, everything she had, with a broker, the same broker that you had mentioned in your opening statement. She lost that money, not because of fault of her own, in good faith, under the confidence that she was investing with a brokerage house that had a good name, a good reputation, and all of a sudden that fortune, that savings, that lifetime investment that she had, was gone.

We need to make sure that, first of all, those people who perpetrated those deeds are punished. But that certainly doesn't make whole those people who were the investors. We also need in this Congress, the body that makes the laws for this country, to make sure that we have a system in place that people have confidence that they can invest in the markets, invest in the security systems that we have today, that they have confidence that if a brokerage house is there and has a good name, it is something that they can have confidence in, and that there is a system, that we have checks and balances, that this type of thing doesn't happen again.

So, Madam Chairman, thank you for having this hearing today. Again, I want to thank Mr. LaTourette for bringing this forward, and for the Chairman of the full committee for allowing this hearing. But most important, I also want to thank those people who are here today to bring this issue forward, to lay out what the problem is, and try to help us to start to find the solutions to this problem.

I also, again, want to thank my constituent, Mrs. Golda Stout, for being here today and testifying.

So thank you very much, Madam Chairman.

Chairman KELLY. Thank you very much, Mr. Speaker.

We go now to the Chairman of the full committee, Mr. Oxley, for an opening statement.

Mr. Oxley.

Mr. OXLEY. Thank you, Madam Chairwoman.

And, Mr. Speaker, thank you for your appearance before the committee today. We welcome you back anytime.

I want to take this opportunity to thank you, Mrs. Kelly, for this important hearing. The subject of today's hearing, Mr. Gruttadauria, who had as many as 470 clients during the height of his success, earning more than $6 million in commissions in a good year, for some unknown reason that was apparently not enough. It appears that over 15 years he sent false statements to two dozen or more of his clients.

It is further alleged that over the same 15-year period he misappropriated possibly hundreds of millions of dollars, somewhere between $125- and $700 million from those clients, several of whom treated him as warmly as they would members of their own families. One client even made him the executor of his estate.

He was never caught. Apparently, feeling that he was on the verge of being found out, he called his activities to the attention of the FBI, fleeing to Colorado where he eventually surrendered to authorities. State and federal authorities, as well as the brokerage firms which employed him, are continuing their months-long effort to uncover the extent of his activities. We can only hope that those

efforts will bring a sense of closure to his many victims and their families.

It is my sincere hope that our efforts today will be of help in this ongoing investigation. We will have the opportunity to hear directly from several of Mr. Gruttadauria's victims, and we will learn first hand from them how he concocted a scheme whereby he misdirected their brokerage account statements to post office boxes which he rented and personally controlled. He then created false statements in order to mislead his clients about the real value of their investments.

Although some may feel that outages of the sort that were inflicted by Mr. Gruttadauria upon his trusting clients are systemic, the efforts being undertaken by the law enforcement prosecutors, SEC, and New York Stock Exchange, Lehman Brothers, and S.G. Cowen Securities would certainly indicate that this is certainly not the case. Hindsight is always perfect, yet our examination revealed that there were missed opportunities for the various authorities to stop his criminal activity.

The presence of representatives today from the SEC, New York Stock Exchange, the SIA, National Association of Securities Dealers, and North American Securities Administrators, underscores their commitment to ensure that violations of securities law such as this particularly egregious case do not occur in the future, and I look forward to hearing from them today about their efforts.

Let me also note that this committee was pleased to work with the SEC in order to provide it with a significant increase in its budget to allow for a much needed escalation of its enforcement capabilities. As a matter of fact, we provided in the reauthorization bill that passed this committee unanimously a 50 percent increase in the budget in the Enforcement Division of the SEC.

Apparently, the SEC also had some information years ago on Mr. Gruttadauria, and I also look forward to hearing from the SEC about how it will improve its processes.

Before I close, Madam Chairwoman, I want to particularly pay tribute to our good friend, Steve LaTourette, for his doggedness and his determination on this case. Steve was a renowned prosecutor before he came to Congress, and he has taken those skills with him on this committee. We are pleased to have him on the committee as a very aggressive and active member, and this hearing, in many ways, is a tribute to his steadfastness on this issue.

And I am pleased to yield back the balance of my time.

[The prepared statement of Hon. Michael G. Oxley can be found on page 65 in the appendix.]

Chairman KELLY. Thank you very much, Mr. Chairman.

We now go to Ms. Tubbs Jones.

Mrs. JONES OF OHIO. Thank you, Madam Chairwoman.

To our Chairman of the committee and my colleagues, I find myself this morning in a sad situation. I look out in the audience, and I see people from the 11th Congressional District, who I have known for many, many years, in a position where their life savings have been denigrated as a result of the conduct of Frank Gruttadauria.

When I look out in the audience, I see former Council President Jim Stanton from the great city of Cleveland; Mary Boyle, a Coun-

ty Commissioner from Cuyahoga County; Mr. Carl Fazio—and we have a great relationship because his grandson Anthony and my son Mervin attended school together.

It is, in my opinion, a shame that we would be here this morning where we have someone who has literally deprived hardworking people, who have worked all of their lives, of their life savings, of that blanket to cover them in a time of most need.

As we come today before this subcommittee, there are several questions that we will all want to have answered, but particularly of interest to me will be what, in fact, the SEC, in 1993, knew about Frank Gruttadauria and did not do enough to keep him from being engaged in a conduct subsequently.

I do want to have admitted to the record at some point, Madam Chairwoman, a finding by the New York Stock Exchange from 1998 of conduct of Frank Gruttadauria and S.G. Cowen's failure to supervise producing branch manage officers acting in the capacity of registered representatives. In this instance, we have Frank Gruttadauria acting as a branch manager/officer, who—and the compliance officer within that company was the person who reported directly to Frank Gruttadauria. If that is not a signal that something is going wrong, I don't know what is.

[The following information was subsequently furnished by Hon. Stephanie Tubbs Jones for the hearing record.]

Chairman KELLY. Without objection.

Mrs. JONES OF OHIO. Thank you.

It is our job as members of Congress to sit and listen intently, constantly try to keep our sympathies for the victims of these crimes from clouding our objectivity that we must maintain. However, it is a tough piece to try and keep that sympathy from clouding part of our judgment in this instance.

But be that as it may, Frank Gruttadauria, who—frankly, whose conduct is shocking—is alleged to have stolen tens of millions of dollars, and I won't repeat that because everyone said that. But for the record, everyone knows the amount of dollars and the people involved. But how was he able to gain the trust of so many people? How was he able, for 15 years, to engage in this conduct and go undetected? How is it that there were prior violations by—noted by the New York Stock Exchange and the SEC where he was able to continue in his conduct?

And by the end of this hearing this morning, it is my hope that we will have information sufficient to assist these victims in the process of attempting to collect their dollars back from either Frank Gruttadauria or his supervisors, or the investment companies that are involved.

But even more so, that we will have information and opportunity to see that we put in place rules and regulations that will not allow other people to be victimized as a result of such conduct, and that we will be able to look past and maybe even foreshadow some of the other conduct that investors are engaged in in this instance.

I yield the balance of my time, Madam Chairwoman. I want to compliment you and my colleague from northeast Ohio, Steve LaTourette, for giving us the opportunity to have this hearing this morning.

Thank you very much.

[The prepared statement of Hon. Stephanie Tubbs Jones can be found on page 67 in the appendix.]

Chairman KELLY. Thank you very much, Mrs. Tubbs Jones.

We turn now to Mr. Tiberi.

Mr. Tiberi, do you have an opening statement?

Mr. TIBERI. I do not have an opening statement, Madam Chairwoman.

Chairman KELLY. Thank you.

We turn to Mr. LaTourette. Mr. LaTourette, we are pleased to have you join us this morning.

Mr. LATOURETTE. Thank you very much, Madam Chairwoman, and I want to thank you, and also the Chairman of the full committee, Mr. Oxley, for convening this hearing today.

I also want to compliment your staff, Madam Chairwoman, for the outstanding investigatory work that they have done in getting us ready for this hearing. And there is a number of people we could talk about, but Andy Cochran, who is seated to your left, has really done an outstanding job, and he deserves our thanks for getting us to where we are today.

Madam Chairwoman, many of us in the greater Cleveland area were startled, shocked, and dazed when we found out that a number of our friends and neighbors had been victimized by a broker who worked for Lehman Brothers, Frank Gruttadauria. We discovered that he had fled town, leaving a note and a computer disk for the FBI, after bilking the firm's clients out of money that has ranged from $40 million, it has been complained of, to, as the Chairman of the full committee indicates, up to $700 million.

I know we have Mr. Fazio here today, who will talk about $26 million that he and he alone lost. His victims ranged from some very wealthy people to moderate income people, who were investing for their retirement years.

By maintaining a desktop computer, in violation of his firm's rules, by setting up a phony post office box, by mailing fraudulent statements and juggling funds, it appears that Mr. Gruttadauria was able to craft a Ponzi scheme that lasted for 15 years, and only collapsed, despite what I read in The Wall Street Journal today, only collapsed because there was a cash call on a divorce case of a rather wealthy client, and also because of the persistence of Mrs. Golda Stout. And I think that perhaps the SEC and some of the regulators should hire Mrs. Stout to supervise and watch things. It is my understanding that she initially indicated she wanted to view her investments online, was told that, "Oh, we don't offer that service," and it is only because she kept pushing and pushing and pushing that eventually Mr. Gruttadauria, among other reasons, left town.

Some will come before this subcommittee today and say that this is just one very crooked broker gone bad, we are really sorry, but it happens, but that there are no systemic difficulties or problems that require the attention of this committee or any other committee in the Congress. That might be the case were there not some historical context not only for the Book of Business while it was maintained by S.G. Cowen, but also after it was purchased by Lehman Brothers.

Mrs. Tubbs Jones and others have mentioned the 1993 complaint, and in that complaint the SEC discovered that Mr. Gruttadauria was in charge of an account that had an equity of $96,000. It had losses of $86- to $88,000, and commissions charged of $39,000 in a six-month period. It is my understanding—and we are looking forward to hearing from the SEC today—but they neglected to talk to the account holder and only talked to Mr. Gruttadauria.

Someone who will not show up today as a witness is a friend of mine from Cleveland, Dominic Visconsi, Sr. His accounts will enter into evidence later, returned over a four-year period 54 percent, 99 percent, 19 percent, 100 percent, and 43 percent.

Also, Ms. Tubbs Jones mentioned the fine levied by the New York Stock Exchange for failure to supervise in 1998. And at the same time, Madam Chairwoman, Lehman Brothers was involved in litigation by another broker by the name of Ahmed Dahouk, who maintained a desktop computer, set up phony post office boxes, mailed fraudulent statements, juggled funds, and apparently in doing the due diligence when they purchased the Cowen business this did not seem to raise any red flags.

Lastly, Madam Chair, it is my understanding that the supervising partner at Lehman Brothers, who supervised Mr. Gruttadauria for the year that he had the business, earned a base salary of $450,000, received bonuses of $8 million, and stock options of $29 million. And the question that I think needs to be raised is: why should he be worried about what happened with Mr. Gruttadauria and his clients?

Thank you. I yield back.

[The following information was subsequently furnished by Hon. Steve C. LaTourette for the hearing record.]

Chairman KELLY. Thank you, Mr. LaTourette. And without objection, we will accept that in the record.

Also, without objection, I would like to enter into the record a copy of the letter that Mr. Gruttadauria sent to the Cowen & Company and to Chase Manhattan and to the FBI. He sent copies of it to a number of people, not just those two listed. And without objection, that letter will also be included in the record.

With that, if there are no further opening statements, I am going to introduce the first panel. We sincerely appreciate the effort it took for all of you to prepare your testimony, and the two of you who have traveled here some distance to be here today with us.

Our panel includes Mr. Carl Fazio of Aurora, Ohio; and Mrs. Golda Lewis Stout of Elgin, Illinois; both of whose finances were devastated by Mr. Gruttadauria's fraud. Lori Richards, the Director of Office of Compliance, Inspections, and Examinations at the Securities and Exchange Commission. We welcome you, Ms. Richards. And Mr. David Doherty, Executive Vice President for Enforcement at the New York Stock Exchange.

I want to thank each of you for agreeing to testify before us today, and I welcome you on behalf of the committee.

Without objection, your written statements and any attachments will be made a part of the record. You will each now be recognized for a five-minute summary of your testimony. There are lights in

front of you that will indicate how much time you have. You see the boxes there on the table.

The green light signifies that you are in the first four minutes of your summary. The yellow light will turn on when you have a minute remaining. And the red light will turn on when your time has expired.

And we will begin now with you, Mr. Fazio. Thank you for being here.

**STATEMENT OF CARL FAZIO, AURORA, OHIO**

Mr. FAZIO. Thank you, Chairman Kelly, Members of the House Financial Services and Oversight and Investigations Subcommittee. Thank you for inviting me to be with you today. I will share with you my family's story of betrayal by four of America's great institutions—Lehman Brothers, Cowen & Company, S.G. Cowen, and Hambrecht & Quist.

Caution shown by today's investors not only reflects the lack of confidence the public has in corporate accounting; it demonstrates that the public also understands that major investment banking firms only say the right thing. They do not do it, and, more importantly, they apparently turn a blind eye when investors are hurt.

I am Carl Fazio. I came to this country at the age of three. Through great effort and energy, my family was able to build one fruit stand into Fisher-Fazio's, a major chain of supermarkets which ultimately became a New York Stock Exchange company. At the time of its sale, I was its chairman, and we employed approximately 20,000 people.

Today, as I stand before you, although I earned and invested a handsome amount of money, I have a few liquid assets. I am unable, at the age of 85, to pay my bills as they become due, and I am forced to sell my home, all because of the greed of Lehman Brothers, Cowen & Company, S.G. Cowen, and, possibly, Hambrecht & Quist.

While focusing on generating fees, they failed to police their own brokers and employees. We have only recently learned that the New York Stock Exchange, in a disciplinary proceeding against Cowen & Company dealing with 1994 and 1995, criticized it for having compliance people subordinate to branch office managers. Even though the Stock Exchange found this deficiency, it was never corrected.

In Cleveland, Robert Semanek, the firm's compliance person, reported to Frank Gruttadauria. This is wrong. Neither Cowen & Company, S.G. Cowen, nor Lehman Brothers changed their procedures. That is a key reason why Frank Gruttadauria could generate fraudulent statements on his personal computer which he had in his office.

He had the computer even though, according to some newspaper reports, it was against company policy. My assets have been stolen from me, not just by Frank Gruttadauria, but by the collective efforts of the brokerage firms that lent them their credibility and resources and turned their backs on protecting me.

After the sale of my company, at the request of my first wife, through her close friend, I entrusted some of my funds to Frank Gruttadauria and his firm. Over the years, he became as close to

me as one of my own sons. I viewed him as a member of my family and proudly watched him receive accolades in the investment community and rise up the ladder to becoming a senior director of S.G. Cowen and the branch office manager for Lehman Brothers.

His positions in the companies gave me confidence. Little did I know that at some time, from the little records that I have been able to get since Frank Gruttadauria admitted his frauds and ran away, maybe as early as the 1990s, he took my money and misappropriated it in order to grow his commission income, all the while sending me false statements which reflected the trades I sought in the market.

He did this while encouraging me to deposit more and more money. Ultimately, all of my liquid assets were put under the control of Frank Gruttadauria, who stole them.

I believe I am a very knowledgeable investor. I told Mr. Gruttadauria what I wanted to buy and what I wanted to sell. I made my own trades. I was in constant contact with him and his office, and I reviewed what I believed to be confirmations and my statements. Little did I know that I was dealing with smoke and mirrors.

Now their greed has devastated me. And if the brokerage firm's actions are not bad enough, S.G. Cowen, a brokerage firm I sued, is now attempting to manipulate the court system by removing my claim to arbitration. As they said in their motion, and I quote, "Plaintiffs must pursue their claims in arbitration before a panel of—an appropriate self-regulatory organization."

I am 85 years old. I need this money to live on now. On January 28, I met with Lehman Brothers and told them of my urgent need for money.

And I would like to close by reading you a portion of Lehman's mission statement. I quote, "We are one firm, defined by our unwavering commitment to our clients." In my situation, they not only wavered, they punted, and now they just don't care.

Thank you for your time.

[The prepared statement of Mr. Carl Fazio can be found on page 126 in the appendix.]

Chairman KELLY. Mr. Fazio, we thank you for your statement. That is certainly a very, very moving statement.

I want to explain to the people here, and to our panel, that the business on the floor today is such that we may be moving back and forth to vote. We have a vote that has just been called.

So what I am going to try to do in order—because I know some of you have planes that you need to meet, and so forth, I am going to be trading off the Chair with people, so that we are going to have a rotating group of people moving back and forth, so that we can keep this hearing open and keep it going.

So with that being said, I hope you will indulge us in changing people sitting in this char. I am still running the hearing, and I will be back. I am going to be going back and forth to vote now and then.

With that, I want to go to you, Mrs. Stout.

**STATEMENT OF GOLDA LEWIS STOUT, ELGIN, ILLINOIS**

Mrs. STOUT. I, too, want to thank the members of the Financial Service Committee and the subcommittee for inviting me to testify. Over the past months, I have watched others testify. I am impressed with their apparent confidence and calm demeanor. I assure you that this is not my state at this moment.

As my opening statement, I want to share with you an edited version of a letter sent to my Congressman for my district, Dennis Hastert. I met Dennis Hastert in Elgin many, many years ago when he was campaigning for his first term of the House of Representatives. We were both much younger at that time.

I was born in 1915 on a small farm in central Iowa. I suffered, along with millions of other American citizens, the ravages of depression. I made a commitment to work hard and save. My life has been productive, and I am very proud of my accomplishments. I have a family which I truly love, and they have the same feeling for me.

As a result of my savings and investing, I felt secure in knowing that my remaining years of life would be without financial worry, but all that was changed in January of 2002 with the news of the fraud perpetrated on many others and on me by the managing director of the Cleveland office of Lehman Brothers, Frank Dominic Gruttadauria, who formerly worked for S.G. Cowen, Cowen & Company.

The complete story of Mr. Gruttadauria will not be known, if ever, for years to come. However, by his own witness statements to the FBI, he has defrauded his clients for over 15 years. Given some of the most recent articles, it appears to me that the process of recovering my lost investments may be long and expensive.

While I trusted my broker as many investment companies are stressing in their television advertising, I was not passive with the respect to monitoring the stockmarket and investment portfolio. I tracked the markets daily and have records going back to 1992. And I also verified my portfolio balance with each monthly report.

However, I did not receive the true reports. They were sent elsewhere by the brokerage firm as a result of Mr. Gruttadauria's actions. Instead, I received a very authentic-looking account statement, which agreed with my own personal records. I also received yearly the 1099s, which my accountant used to prepare for the individual tax returns. And over the years, Mr. Gruttadauria was privately looting my account. All of this occurred without detection by myself.

This brings me to the main point. Stockbrokers' misdeeds must be prevented from occurring again to any person who uses a brokerage account as an investment vehicle. As we all know, Social Security should not be the foundation of any retirement plan. IRAs, 401Ks, and other investment activities are the real foundation for retirement. In almost all cases, these activities will involve investments using a brokerage firm.

As pointed out in the article in The Wall Street Journal, the Plain Dealer of Cleveland, active compliance monitoring and reporting is critical. My hope is that you and your colleagues in the Congress can address, to the greatest extent possible, the need to

prevent stockbroker fraud and to require the brokerage firms to monitor and enforce compliance by their officers and employees.

Thank you.

[The prepared statement of Ms. Golda Lewis Stout can be found on page 129 in the appendix.]

Chairman KELLY. We thank you, Mrs. Stout.

We will go next to you, Ms. Richards.

**STATEMENT OF LORI RICHARDS, DIRECTOR, OFFICE OF COMPLIANCE, INSPECTIONS, AND EXAMINATIONS, SECURITIES AND EXCHANGE COMMISSON**

Ms. RICHARDS. Chairwoman Kelly, Chairman Oxley, members of the subcommittee, I appreciate the opportunity to appear before the subcommittee today on behalf of the Securities and Exchange Commission to discuss the Frank Gruttadauria matter and potential measures to prevent theft by registered representatives of stockbrokers.

As I think you know, the SEC filed an enforcement action against Mr. Gruttadauria alleging that he misappropriated customer funds for his own purposes, directing those funds to other customers' accounts, either as purported returns or to satisfy their withdrawal requests. In essence, this was a Ponzi scheme, pure and simple, taking money from some clients to cover the withdrawal requests that were made by other clients.

The SEC alleges that Mr. Gruttadauria forged client signatures on withdrawals, made unauthorized transfers of funds, and took customer funds purportedly to open accounts, but never actually opened accounts. Then, to conceal the fraud from his customers, he created and sent false account statements to customers that greatly overstated the values of their accounts, and caused the clients' actual account statements to be sent to post office boxes under his own control.

I want to say, listening to the victims, Mrs. Stout and Mr. Fazio, how much I empathize with them.

I know that the subcommittee is most interested in what can be done to prevent future conduct like Mr. Gruttadauria's. At the most basic level, firms are responsible for establishing systems of supervision and internal controls that are reasonably designed to ensure that their employees are in compliance with the law. Broker-dealers are required, under current law, to have adequate procedures and controls to identify the kind of sales practices that Mr. Gruttadauria engaged in, and to conduct regular reviews of their employees' activities.

I am pleased to tell you that many firms have in place procedures to help them prevent and detect fraud by brokers. My written testimony that I submitted sets out, in some detail, some of the procedures that firms can use, including things like verifying changes of address directly with the customer, confirming customer authorizations to transfer funds out of their account, paying special attention to post office boxes and other addresses that are not the customer's home address, exercising control over account statements, supervising employees' use of personal electronic devices, and providing independent supervision and review of activity by producing managers. These are, I think, very important.

I would like to switch gears for just a minute and briefly address the SEC's examination efforts. In one of our examinations in 1993, as has been raised today, we came very close to Mr. Gruttadauria. We conducted a cause examination of the Chicago, Illinois, office of Cowen where Mr. Gruttadauria serviced some of his accounts, after receiving an anonymous tip that alleged churning (or excessive trading) in one of his accounts.

While there were some flags that prompted the SEC examiner to conduct a detailed review of that particular account and other Gruttadauria accounts in the Chicago office, the examination was unable to establish sales practice abuse in that account sufficient to warrant further action. Now, I will say that knowing what we know now, I wish I could say that we had detected the fraud in 1993.

Well, what has the SEC done in response to this event? As you would expect, we have worked closely with the New York Stock Exchange and the NASDR to understand the alleged fraud in this case, and we intend to continue to vigorously prosecute Mr. Gruttadauria. Together with the SROs, we are focusing particular attention on examining firm procedures and systems to prevent fraud of this type in the future.

We have reminded securities firms of the importance of these procedures, and we will also be conducting a series of examinations focused solely on firm procedures designed to prevent theft by registered representatives.

We intend to ensure that the best practices that I have described in my testimony become the universal practices in the securities industry.

I am pleased to answer any questions that the subcommittee may have.

[The prepared statement of Ms. Lori Richards can be found on page 69 in the appendix.]

Mr. LATOURETTE. [presiding] Thank you very much, Ms. Richards.

And before I yield to Mr. Doherty, for those of you from Cleveland or Illinois that don't come here on a regular basis, there is a 15-minute vote on the floor, and so I ran as quickly as I could to get to the Capitol and come back so we can keep the testimony going. And our colleagues will come back and join us for the question and answer period.

So I apologize that we are conducting legislative business at the same time we are doing this, but we wanted to not inconvenience anybody.

Mr. Doherty, welcome, and we are looking forward to hearing your testimony.

**STATEMENT OF DAVID DOHERTY, EXECUTIVE VICE PRESIDENT FOR ENFORCEMENT, NEW YORK STOCK EXCHANGE**

Mr. DOHERTY. Thank you. Good morning, Chairwoman Kelly, and members of the committee. I appreciate the opportunity to talk with you this morning about how the New York Stock Exchange regulates our member firms, and to provide some information about actions we have taken concerning Cleveland broker Frank Gruttadauria and others associated with him.

Regulation of the securities industry in the United States depends upon self-regulation and begins with the broker-dealer itself. The Exchange plays a critical role by maintaining an extensive system for monitoring and regulating the activities of its membership with SEC oversight. The regulatory group of the Exchange currently employs approximately 560 people representing over one-third of the entire Exchange's staff, with an operating budget of $142 million.

The Division of Member Firm Regulation, with a staff of 265, oversees 260 member organizations that employee nearly 160,000 registered persons and service nearly 93 million customer accounts. That is more than 85 percent of the public customer accounts carried by broker-dealers in the United States.

Our staff conducts annual on-site examinations of every one of these firms. We visit the main office and approximately 200 branch offices each year, which are selected using a risk-based analysis. Our criteria and methodology for selecting branch offices for review is constantly being upgraded and refined based on experience and new technology. A more complete description of our exam program is included in my written testimony.

Serious or repeated violations found by our examiners are referred to the Exchange's Enforcement Division. The Enforcement Division, which has a staff of about 136, carries an inventory of approximately 700 cases and initiates over 200 enforcement actions a year. Enforcement staff conduct investigations often in cooperation with the SEC and decide whether to institute formal enforcement proceedings. Possible sanctions or penalties include censures, fines, suspensions, or permanent bars from our membership.

The short-term objective of an effective enforcement program is to catch and punish the people who break the rules. The long-term objective is to deter other violative activity, induce compliance, and ultimately enhance investor confidence in the integrity of the market.

I would like to address the matter involving Mr. Frank Gruttadauria, the former broker for Lehman Brothers and S.G. Cowen. The Exchange learned of the Gruttadauria matter on January 22 of this year when we were contacted by officials from Lehman Brothers. We responded immediately by putting together a team of enforcement attorneys and examiners, meeting with the compliance officials at Lehman, discussing the case with the SEC, and beginning an investigation.

That investigation, which is ongoing, focuses on the manner in which Gruttadauria conducted his activities, the supervisory structure and procedures in the Cleveland office, and the overall supervisory structure of both Lehman and S.G. Cowen. The Exchange is working cooperatively with the SEC's Enforcement Division in this investigation.

The Exchange has taken the following actions so far regarding the Gruttadauria matter. On February 5, two weeks after first being notified of this matter, we issued charges against Gruttadauria for misappropriation of customer funds and failure to cooperate with Exchange investigation. A hearing was held, findings were made that he was guilty as charged, and on March 19

he was censured and permanently barred from association with any New York Stock Exchange member firm.

Also, in February and April, we issued charges against two of Gruttadauria's assistants based on their refusal to provide required information to us. It is worth noting that in 1998 the Exchange brought formal enforcement proceedings against Cowen for a number of violations. A major focus of the case was improper order ticket procedures, failure to comply with margin requirements, but other violations included failure to reasonably supervise producing branch office managers and failure to comply with rules governing discretionary accounts, among others.

This resulted in a decision by consent in which Cowen received a censure, a fine of $380,000, and a requirement was imposed that Cowen correct procedural and supervisory deficiencies. Cowen's compliance with the 1998 decision is one of the matters that is under review in our current investigation.

Since the beginning of this year, the Exchange has undertaken a number of initiatives focusing on compliance systems and procedures at retail firms. These initiatives were partly in response to the Gruttadauria matter, but they also reflect our commitment to continually review, expand, and improve our regulatory program to adapt to new information and technological advances.

So, we have already permanently barred Frank Gruttadauria. We are investigating the supervisory structures at the firms where he worked. We have enhanced our examination procedure, and we have under consideration adoption of new rules to strengthen investor protection in this area.

Let me assure you of the Exchange's continuing commitment to our strong regulatory program. Thank you again for the opportunity to testify today.

[The prepared statement of Mr. David Doherty can be found on page 79 in the appendix.]

Mr. LATOURETTE. Mr. Doherty, we thank you very much for your testimony.

The schedule indicates that other members of the panel, including the Chairman, will be back shortly. And so in light of the fact that there is great interest in asking questions of everyone who has testified so far, I think it is the Chair's predisposition to take a short recess. If you could not wander too far, so that when Mrs. Kelly comes back we don't have to gather people from the far reaches of the building, I would appreciate that.

And the subcommittee will stand in recess, subject to the call of the Chair.

[Recess.]

Chairman KELLY. [presiding] Is Mr. Doherty in the room? Absent Mr. Doherty, I think we will go ahead with some—with the questions. I would like to ask some questions of you, Ms. Richards.

Ms. Richards, on page 5 of your testimony, you refer to firm practices to prevent and detect fraud. One of these policies is, and I quote, "special attention to P.O. boxes." Now, we are aware that this was a key way in which Mr. Gruttadauria was able to perpetuate his scam. Is this policy a requirement of the SEC or just a suggestion?

Ms. RICHARDS. I guess I think that under a broker-dealer's existing duty to supervise, they have an obligation under existing rules and regulations to make sure that their supervision is adequate. And use of P.O. boxes has been found not only in this case, but also in other cases, to facilitate fraud by registered representatives. This is not the first time that this P.O. box trick has been used.

So in light of that, I think that broker-dealers must, under existing obligations to supervise, pay special attention to the use of P.O. boxes. And there is nothing inherently wrong with the customer using a P.O. box. Many customers in rural areas, for example, use a post office box. But when a firm sees that a customer has a post office box, they ought to pay special attention to ensuring that the customer has truly authorized the firm to use the P.O. box.

Chairman KELLY. Perhaps, Ms. Richards, it might be a good idea if the SEC took another look at some kind of oversight on the use of P.O. boxes. Would you agree?

Ms. RICHARDS. Absolutely. And that is exactly what we are doing now. Immediately after the Gruttadauria case broke, we met with the New York Stock Exchange and the NASD and decided to pay collectively, as securities regulators, special attention on these what I think are very basic compliance procedures designed to prevent theft.

So in all of our examinations going forward, we intend to focus on firm procedures, not only in this area but in the other areas that I have identified in my testimony. If through that process we determine that additional rules or regulations are appropriate, we intend to alert the Commission to that early, and to work closely with the self-regulatory organizations in determining whether or not additional rulemaking is appropriate.

Chairman KELLY. So, once again, though, you are looking at allowing the firms themselves to govern what is happening with regard to the relationship of the post offices boxes with regard to their clients and the delivery of the statements for the accounts. Is that correct?

Ms. RICHARDS. Firms have an existing duty to supervise, and this is an area where they have got to pay, in my view, enhanced attention—compliance attention—to. They have got to scrutinize use of post office boxes carefully. I don't think it would be appropriate for regulators to prohibit the use of post office boxes, as I said, because many customers in rural areas in particular need to use post office boxes.

But when the firm sees that a customer has a P.O. box, or an"in care of" address, or any address other than their home address, they need to pay particular attention to that.

Chairman KELLY. Well, let us go to an exam that was conducted by your examiner in 1993. You mentioned it on pages 4 and 5 of your testimony. That they did not contact the customer that was involved. Is it a normal practice to contact the customer when the account is being examined?

Ms. RICHARDS. It is a judgment call that is made by the examiner, based on the facts that are developed during the examination. If I could, I would like to describe to you in a little bit more detail what happened in the 1993 exam.

Chairman KELLY. Prior to your description, I would like to simply say that I understand this was done in December of 1993, that it was signed off by five supervisors, there is five signatures on that. I also would like you to submit that for the record within the next 24 hours. Will you please comply with that request?

Ms. RICHARDS. We have made the entire examination report available.

Chairman KELLY. No, ma'am. I want it submitted for record.

Ms. RICHARDS. I would have to go back to our Commission and ask for authority to do that.

Chairman KELLY. Will you please do that?

Ms. RICHARDS. Yes, I will.

Chairman KELLY. Proceed with what your explanation was.

[The following information was subsequently furnished by Ms. Lori Richards for the hearing record.]

Ms. RICHARDS. In 1993, the Commission received an anonymous complaint about a customer's account that was maintained by Mr. Gruttadauria. The anonymous complaint alleged that there was churning in the account, and churning is simply excessive trading, trading that is not appropriate for the particular customer. It is designed to provide the registered representative with commissions, but involves trading that is not appropriate for the customer.

Based on that anonymous complaint, the Commission went in—examiners in Chicago went in to Cowen's Chicago office and conducted an examination focused primarily on that particular account. They examined the account statements that were provided not by Mr. Gruttadauria but by the firm itself, and the examiner noted that the trading was very significant. There was a lot of trading in the account during a six-month period three years before the examination.

The fact that there was frequent trading, in and of itself, while it is a red flag, it is not in and of itself violative, because many customers engage in frequent trading. So what the Commission then does, after it noted that there was such frequent trading, in fact, the examiner computed a turnover rate in the account of 18 times. That is very significant. That is a lot of trading.

So with that information, the examiner then looked at whether or not the trading was indicative of a violation of the law. And the elements of a churning violation are really just two. First, is the trading excessive for that particular customer? And then, second, does the registered representative have control over that particular account? So the turnover ratio is just one part of the analysis.

The next step was to review the background of this particular investor. The account documents that were provided by the firm, not by Mr. Gruttadauria but by the firm, indicated that this was an experienced investor. This was someone with a very significant net worth of about $5 million and with 10 years or so of trading experience in equities and options. Based on that, it appeared to the examiner that this was an experienced trader, an experienced investor.

The next step was to review who was directing the trades, because this is an element in a churning charge—the trades must have been directed by the registered rep. Based on the registrant and Mr. Gruttadauria, the examiner was told that the trades were

unsolicited. That is, that the investor herself was directing the trades.

The Commission's examination procedures at that time would require the examiner to confirm that statement by looking at the order tickets.

The next step was to review other customers' accounts, because what we often find is that when a registered rep is engaged in churning one account, they will churn other customers' accounts. So we looked at a sample of Mr. Gruttadauria's other accounts in the Chicago office and found no indications of churning. We also—

Chairman KELLY. May I—I am sorry to interrupt you, but the account information that Mr. LaTourette has submitted for record today indicates that there was at least one account, if I am looking at it correctly, that was churned, in 1993, had a turnover ratio of 34 percent. He made a 99 percent commission rate on that.

In 1995, which was post this examination, there were some other really egregious types of churning here that should certainly but the ratio of 34 certainly ought to have had a red flag in 1993. I am going to interrupt your testimony here, but just because I have a question. I am going to run out of time, and I need to talk to Mr. Doherty. I am going to go—I would like to go back to you. I will go back to you. So stop yourself where you are, and we will come back.

I want the rest of the—I would like you to read into the record, or state for the record, exactly what happened in the 1993 exam. But I also want to caution you that the committee would expect a response from your organization within the next 24 hours regarding that report.

Mr. Doherty, I wanted to ask you just one question, and I will come back to you. On page 13 of your testimony, you mention your 1998 enforcement action against Cowen for, among other things, and I am quoting— "the failure to reasonably supervise branch office managers acting in the capacity of registered representatives."

And then you also mention on page 14 of your testimony—and, again, I am quoting—"in 1999, outside counsel concluded in its report to the Exchange that Cowen had satisfied its undertaking in all material respects and made significant efforts in addressing areas of deficiency."

I would like you to try to discuss what steps were taken to improve the supervision of branch office managers at that point, and any reasons that you are aware of that this improved supervision didn't detect Mr. Gruttadauria's actions. These people were defrauded. These people have lost their life savings.

Mr. DOHERTY. They certainly have. The enforcement proceeding that we brought in 1998 we considered to be a very significant one. There were a number of violations involved. A small part of it related to failure to supervise producing branch office managers in the 1995 exam in one of the New York offices.

We were sufficiently concerned with the supervisory deficiencies in that case that we not only imposed a significant fine, but we required, as a part of the settlement that Cowen entered into that a consultant be appointed who would come in and look at the systems and procedures that Cowen was putting in place and make

an evaluation as to whether those systems and procedures, as enhanced, were adequate.

And the consultant—it was an outside law firm—did that and filed a report and represented that they had confirmed that a number of enhancements had been made, such as the firm had appointed a senior person full-time whose job was to supervise producing branch office managers.

There was an indication and confirmation that the firm had developed a process where a detailed questionnaire would be sent out to branches required to be answered by the firms, and it got into areas that are involved here dealing with LOAs and post office boxes. That was supposed to be, under the procedures, followed up twice a year by branch office visits from this new supervisory structure that was put in place.

There was also a representation that the branch office manager's correspondence would be put in a separate file that would be reviewed monthly. And there was a general representation that all of the procedures put in place now had adequately enhanced supervision. There was a representation that the Compliance Department had enhanced supervision generally by, among other things, adding resources.

So one of the things that we are looking at carefully in our investigation now is whether these procedures were number one, actually put in place; number two, if put in place, maintained; and, number three, even if the procedures were put in place, were they adequately implemented? Sometimes we see procedures, and they are a great looking set of procedures, but implementation is not carried out.

So this is what we are looking at now in the course of our investigation. We required this enhanced review as a part of that enforcement proceeding, and we received assurances not only from the outside law firm, but the report was filed and it was certified by both the Board of Directors and the CEO that these procedures had been put in place.

Chairman KELLY. Thank you, Mr. Doherty.

Mr. DOHERTY. Now, we are concerned that in light of this, the Gruttadauria activities were continued, and that is very much the focus of our investigation.

Chairman KELLY. Thank you, Mr. Doherty. One of the things that really concerns me about this case is it hasn't been just Mr. Gruttadauria. There have been other cases. We need to do as much as we can to have you do what you need to do to put the public's trust back into the system.

So with that being said, I am going to turn to my colleague, Ms. Tubbs Jones.

Mrs. JONES OF OHIO. Thank you, Madam Chairwoman.

Mr. Fazio, unfortunately, we only have five minutes to question. But it would be a shame that you wouldn't have a couple—another opportunity to be heard, at least briefly. Can you tell me, looking back, sir, what was it that engendered Mr. Gruttadauria to you? If we were going to talk to other senior citizens like you and Mrs. Stout, what would you tell them to look out for?

Mr. FAZIO. Do you mean now that—

Mrs. JONES OF OHIO. Yes, sir.

Mr. FAZIO. —this happened?

Mrs. JONES OF OHIO. Looking back, in hindsight, sir.

Mr. FAZIO. Well, I would say that you need to talk to somebody above the branch manager in New York and check if, in fact, any brokerage company person ever called any investor when there was an address change to check it out, and to be careful because things can be done with these phony statements that we are learning and we know now.

And did any person ever call any customer? I never got a call from anyone else. I never did. And these numbers were changed, and my signature was forged, and so forth, to change them. Never got a call from anyone, and I didn't know what was going on. I really didn't. I didn't know that these box numbers even existed until now, until all of this—everything came up.

Mrs. JONES OF OHIO. But there was something about Mr. Gruttadauria that caused you to place some trust in him. But what I am asking you is: with regard to personality, or whatever, what would you say to another senior citizen who might have been—might be contacted by a broker?

Mr. FAZIO. Well, I would say that sometimes you have got to watch your closest friends. He was a very close friend. I told you I treated him like he was my son. That is how close we were.

Mrs. JONES OF OHIO. Okay.

Mr. FAZIO. And you have got to be careful, and that is all you can do.

Mrs. JONES OF OHIO. Okay.

Mr. FAZIO. But mainly is that companies themselves have to check out their people. You know, you can't do it with the compliance officer, as I pointed out, in the same office reporting to the manager. You have got to do it where the compliance officer reports to somebody else above the manager, somebody in New York to check all these things out.

Mrs. JONES OF OHIO. Thank you.

Mrs. Stout, a short answer if I could get one from you as well. Go ahead.

Mrs. STOUT. Well, I wish that I had been smart enough to analyze why did I have checks with DeGrandis for the signature. Now, it should have been Lehman or Cowen. Instead, it was someone else. I had my own tax person. Why would I be having that firm as a tax representative?

Mrs. JONES OF OHIO. For the record, tell people who DeGrandis is, Mrs. Stout.

Mrs. STOUT. Well, I think that they are a tax firm working in Ohio.

Mrs. JONES OF OHIO. Well, this was someone that Mr. Gruttadauria represented or expected that you might use for your tax purposes, an attorney in Cleveland, right?

Mrs. STOUT. He might have, but I was—never even hinted to say I would like to have or needed—

Mrs. JONES OF OHIO. Okay. Anything else you would say to other seniors who might be considering doing some investment, what they should look out for from your own perspective?

Mrs. STOUT. Well, when they start saying—I wanted to have online for my—so I could watch each day. When I called to ask, he

said, "Oh, no, we do not do that. I will not be harassed." When you start having—saying, "I won't do this. I won't do that," that is a red flag. Watch. And in the future, don't have that person—he said, "If this is the way that you feel so strongly, then I will get you another broker." I was—

Mrs. JONES OF OHIO. And you should have said, "Then, get me another one," right?

Mrs. STOUT. Well, and so what I should have done—you know, I kind of hemmed and hawed there for a minute, and he said, "I will tell you what I will do. I will send you the symbols, but this is against my principles."

Mrs. JONES OF OHIO. Okay.

Mrs. STOUT. You know what? It isn't his principles, it is mine, that I should be thinking about. And that was a mistake. You know what? You should come back on your own intuition. I did not. I was—I am like Carl. I thought he was like my son, and I trusted the firm. After all, it is a good firm. I thought he was in Chicago. I never knew that he was in Ohio. Had no idea.

He visited me, told me about—took me out for dinner, told me about the one daughter that was a candy striper at—

Mrs. JONES OF OHIO. He drew you in, in other words. He drew you in to his confidence.

Mrs. STOUT. Oh, honey, he was right there.

[Laughter.]

Mrs. JONES OF OHIO. Thank you, Mrs. Stout.

Let me go to Mr. Doherty from the New York Stock Exchange. Can you tell us how often brokerage firms incur charges like the one that was brought against Cowen & Company in 1998 with regard to failure to supervise branch manager officers, etcetera?

Mr. DOHERTY. Well, let me answer more broadly.

Mrs. JONES OF OHIO. Okay.

Mr. DOHERTY. In a typical year, our enforcement program will bring about 200 formal enforcement proceedings. The large majority of those charged are individuals. But in a typical year, I would estimate 20 or 25 member firms themselves are charged as Cowen was in the example we have heard about.

Mrs. JONES OF OHIO. And of the—go ahead. I am sorry.

Mr. DOHERTY. Well, those charges range all the way from purely financial and operational kinds of things, a net capital violation, for instance, to, in some cases, inadequate supervisory procedures. And then some of the inadequate supervisory procedures cases relate to sales practice issues.

Mrs. JONES OF OHIO. Well, a firm signs up to be part of the New York Stock Exchange, what commitments do they make?

Mr. DOHERTY. Well, they make a commitment to not only abide by the federal securities laws, but they make a commitment to abide by the New York Stock Exchange's rules, which really impose on the firms not only a variety of particular rules but, importantly, our rules require that our firms operate consistent with ethical standards. So that it is a level of conduct which could be violated that doesn't reach a violation of the federal securities laws.

So our rules require such things as—or preclude conduct inconsistent with just and equitable principles of trade, and the like, ethical standards.

Mrs. JONES OF OHIO. Do you have subpoena power as the New York Stock Exchange?

Mr. DOHERTY. We don't—

Mrs. JONES OF OHIO. To your members.

Mr. DOHERTY. We don't have subpoena power, but—and our jurisdiction is limited to our members and employees, people associated. But we—

Mrs. JONES OF OHIO. So if I fail to agree to provide you information or cooperate, what do you do to me?

Mr. DOHERTY. Well, with respect to the people we have jurisdiction over, we have something better than—

Mrs. JONES OF OHIO. That is what I meant, if I were a member. Okay.

Mr. DOHERTY. And that is we have a rule that requires that our members and people associated comply with our reasonable requests for information in our investigations and that is the provision which we have used to charge three people in this particular investigation. We use it often, and the usual consequence is that people are barred from the industry until they comply or perhaps barred after a certain period of time if they don't. So there are significant consequences.

Mrs. JONES OF OHIO. Two shorter questions with hopefully shorter answers. You have heard Mr. Fazio, Mrs. Stout, and others say that the reason they invested with these companies was because of their reputation long term. Do you, as the Stock Exchange, treat people who have been long-term members any differently than you treat newer members to the Stock Exchange?

Mr. DOHERTY. No. We apply the same standards to everyone. We sue the big firms and the small firms equally.

Mrs. JONES OF OHIO. Do you treat sanctioned firms any differently than you treat non-sanctioned firms?

Mr. DOHERTY. The fact that a person or a firm had engaged in violative activity previously would be considered in the size of the sanction or punishment that would be imposed if there was another violation.

Mrs. JONES OF OHIO. For example, in '98, when you sanctioned Cowen & Company, what was the follow up after that sanction?

Mr. DOHERTY. Well, we haven't—that is the last enforcement proceeding—

Mrs. JONES OF OHIO. Okay.

Mr. DOHERTY. —that we initiated against Cowen to my knowledge.

Mrs. JONES OF OHIO. But who, then, is responsible for overseeing whether or not they have complied with the sanction that you impose?

Mr. DOHERTY. Well, in the first instance, the firm has a continuing responsibility to, under our rules, and as Ms. Richards said, to run their business operation in a way that complies with the rules. Secondly, our examiners will typically go back into a member firm in the follow-on years where they have found problems to do a review to ensure that the problems have been corrected.

Mrs. JONES OF OHIO. Did you go back to Cowen after '98?

Mr. DOHERTY. Yes. We went—

Mrs. JONES OF OHIO. And who went back? And what did you find?

Mr. DOHERTY. Our examiners went back in and reviewed for compliance with many of the exceptions that were found, and they found no deficiencies that they felt were worthy of referring to the enforcement program.

Mrs. JONES OF OHIO. I am out of time, but I—we are going to have another round. Is that correct?

Chairman KELLY. We will see if that is possible.

Mrs. JONES OF OHIO. Because I have a lot of questions for Ms. Richards, but thank you, Madam Chairwoman.

Chairman KELLY. Ms. Tubbs Jones, I am going to hold the record open for 30 days for questions and submitted answers for all members of the committee, because some of the members can't be here today. So by all means, if you have further questions of this panel, you may submit them, and we can expect their responses within 30 days. So feel free to do that, if we are not able to do a second round here.

We turn now to my colleague, Mr. Ney. Mr. Ney, are you ready?

Mr. NEY. Thank you, Madam Chairwoman.

I had a question, Mr. Doherty. A securities attorney quoted in the Cleveland Plain Dealer story said that a turnover rate of six times a year should raise a red flag, and that was reported in the PD. In your opinion, if the SEC could have told you the level of commissions and a turnover rate of 18 times in six months, do you think the Exchange might have wanted to take a more closer look at Gruttadauria's accounts?

Mr. DOHERTY. I think that we would have—it would have been a red flag, and it would have been something that we would have looked at carefully. I can't tell you that we would have done it any differently from what the SEC did. In hearing Ms. Richards' testimony, it sounds as though they brought to bear the same kind of analysis that we would have.

Mr. NEY. Another question I had would be for Ms. Richards and Mr. Doherty. Mr. Gruttadauria apparently created these phony account statements on his own computer outside of the office system. How can that be prevented in the future, that they could be—or can it? Just some thoughts from both of you on that.

Ms. RICHARDS. One of the things that we recommend in our testimony is that broker-dealer firms maintain very tight control over blank account statements and other account documents of the firm, so that registered representatives and other unauthorized employees can't get hold of them, doctor them up, and send them out.

Another thing that many firms are doing now is creating account statements that are very difficult to duplicate. They have holograms or watermarks or special indicia on the original, so that it makes it easier to detect a forgery. So I think control over the actual sending of the account statements by brokerage firms is terribly important.

Mr. DOHERTY. If I could add that in 1999 we added an element to our exam program that required our examiners to do a careful review of this very area, to look to see whether there were any personal computers being used by any salesmen in the office, and to

do an examination of what procedures the firms had in place to supervise the use of those personal computers.

And that is an area we are very much concerned about with electronic communications and use of the internet by registered reps, and we have brought a bunch of enforcement cases against registered reps in that area. This is something that we did at least two or three years ago in terms of extending our exam program.

Mr. NEY. The other question I wanted to ask someone I guess—if people are receiving false statements for a number of years, and they have prepared their taxes, wouldn't Lehman Brothers have to send notification of earnings, and, therefore, the people overpaid their taxes that are sitting here? I don't know who wants to reflect on that, but—

Mrs. STOUT. I don't really see how it could be. I received the 1099s, my monthly statements—

Chairman KELLY. Ma'am, please turn on your microphone. Somehow it has gotten turned off. Pull it closer to your mouth, and then we can all hear what you say.

Mrs. STOUT. All right.

Chairman KELLY. Thank you.

Mrs. STOUT. I did receive the 1099s, my monthly statements. There was no other way that I figure that I could have been alerted.

Mr. NEY. Well, I guess my question—and probably maybe the other panel can answer it—my question is geared towards if you're—you know, you're receiving these false statements. Lehman Brothers, I assume, had to be responsible for notification to IRS of, you know, the real account. So, therefore, you know, I guess there was no IRS catching the difference, which would have alerted you early. I guess there is no mechanism.

But, obviously, Lehman Brothers had to have sent those in. Isn't that correct? Isn't that the way it works? So it would have showed to the IRS, you have Mrs. Stout, here is how much she made, but she shows she made—and over a period of 10 years or nine, surely that should have gotten caught somewhere, I would assume, by IRS.

Mrs. STOUT. Well—

Mr. NEY. Although maybe I shouldn't—

Mrs. STOUT. —maybe I could come back and say now I had Microsoft, I had Cisco. That was—it would grow. I had—I started out with 750 shares. When I got my last statement, I had 12,000 of one and 27,000 of another, which showed that I had all of that, but it wouldn't show on my income tax, because it was still in the firm, and not—

Mr. NEY. I have gone past my time. Maybe later on somebody can clarify, was he sending false statements to Lehman Brothers, to the IRS? No. Right? Yes? No.

Chairman KELLY. Go ahead and ask that question. I will give you—

Mr. NEY. Thank you. If you could—

Chairman KELLY. —a little more time. Ms. Richards, if you could answer that.

Ms. RICHARDS. I was just going to say our investigation is ongoing. I think if the firm was sending accurate 1099s to the addresses

on file, for many of these customers those were post office boxes. So they would not be getting the accurate 1099s.

Mr. NEY. But they went to the IRS.

Ms. RICHARDS. Yes.

Mr. NEY. Right?

Ms. RICHARDS. Yes. I would think that—yes.

Mr. NEY. So it should show different what Mrs. Stout was reporting from the false—and then what the IRS was getting from Lehman Brothers. It should show a difference, I think.

Ms. RICHARDS. There would be a discrepancy. I just don't—I don't know what the IRS—

Mr. NEY. I mean, it is important to know whether that—I mean, I feel sorry for these people that have been burned. I am just wondering what system should have caught that.

Thanks very letting me exceed my time.

Chairman KELLY. Perfectly all right. It is a legitimate question. It needs answering. It raises a lot of issues, and it is probably part of the ongoing judicial investigation.

Now we go to Mr. LaTourette.

Mr. LATOURETTE. You caught me by surprise, Madam Chairman. I thought Mr. Cantor was still here.

Mrs. Stout, since this story broke, has anyone other than Mr. Gruttadauria from Lehman Brothers come to visit you in Elgin, Illinois?

Mrs. STOUT. Yes. I had representatives of Lehman.

Mr. LATOURETTE. Right. Can you tell us about that exchange or what happened when they came to see you?

Mrs. STOUT. I beg your pardon?

Mr. LATOURETTE. What was the purpose for which they came to visit you, and what happened?

Mrs. STOUT. Well, I had called the office and wanted to have an explanation, and they, I assume, decided they wanted to come I think maybe to check to see if I was going to be an easy customer, if they would be able to hoodwink me, and I—and they left. I had no information from them.

Mr. LATOURETTE. Did you ask them about your money? I mean, what—

Mrs. STOUT. Oh, yes, I did. And I asked if there was a chance that I would be getting it back.

Mr. LATOURETTE. And what did they tell you?

Mrs. STOUT. No answer.

Mr. LATOURETTE. Okay. When Mr. Fazio comes back, I have a couple of questions for him.

But, Ms. Richards, I am going to ask my legislative assistant to hand you a document that the Chairwoman was talking to, and this is—when you were indicating before the—and, Mrs. Stout, just back to you, Mrs. Cuneo is your sister, right?

Mrs. STOUT. Yes.

Mr. LATOURETTE. Your sister.

Mrs. STOUT. Yes.

Mr. LATOURETTE. And that was—Mrs. Cuneo's account was the subject of the 1993 complaint, Ms. Richards, is that the anonymous complaint, the—

Mrs. STOUT. I am not sure, but it could be.

Mr. LATOURETTE. I am asking Ms. Richards. Cuneo was the investor involved in the 1993 anonymous complaint?

Ms. RICHARDS. The identity of the accounts that we examine are typically not public.

Mr. LATOURETTE. Right. But they will be when you comply with Mrs. Kelly's request. And I think it is Mrs. Stout's sister that was ripped off in 1993, and we will determine that.

I have put in front of you a document that is an account belonging to a fellow by the name of Dominic A. Visconsi, Sr., and it goes from '92 to '96. And at the bottom—I think Mr. Ney asked you—it is my understanding under federal law, and also S.G. Cowen's own internal manual, that a turnover ratio of six gives rise to a conclusive presumption of excessive trading or churning. Is that your understanding, or am I mistaken?

Ms. RICHARDS. We would actually look very hard at any account that had a turnover ratio of less than six. We would look at an account that had a turnover—an annualized turnover ratio of two to three. We would then focus hard on those accounts.

Mr. LATOURETTE. What about the ones that are turned over more than six times?

Ms. RICHARDS. Well, certainly, those would trigger our attention.

Mr. LATOURETTE. Well, in the document I have put in front of you, in 1992, Mr. Visconsi's account, with an average equity of $416,000, was charged commissions of $113,000, and turned over 18 times. Would you consider that to be unusual activity worthy of your examination, had you known about it?

Ms. RICHARDS. Absolutely.

Mr. LATOURETTE. And, likewise, in 1993, average equity of $447,000, commissions of $221,000, and a turnover ratio of 34 times. I would imagine that would grab your attention as well, had you known about it.

Ms. RICHARDS. Yes.

Mr. LATOURETTE. And, Mr. Fazio, I have had a chart made of an account that your lawyer was kind enough to give me last night. If we could put the chart up on the easel. It is your account 00-00068. And the year that we have highlighted is 1990, and I would just like you to take a look at it. And, one, does that look familiar to you? Do I read it right that, in 1990, your account had an average equity of $103,000 roughly, that the commissions charged on it were $67,471.70, and the turnover ratio was a little over 15 times, is that a correct reading?

Mr. FAZIO. That is correct.

Chairman KELLY. Excuse me. I want to know if you would like to have that entered into the record.

Mr. LATOURETTE. Yes, please.

Chairman KELLY. So moved.

[The following information was subsequently furnished by Mr. Carl Fazio witness] for the hearing record.]

Mr. LATOURETTE. And, Ms. Richards, likewise, with the Visconsi account, and we are, again, in the same time period as your investigation in 1993 of the account we believe was owned by Mrs. Stout's sister, would you find the information that is on that board to be worthy of your attention and examination?

Mrs. STOUT. I am sorry. I did not—

Mr. LATOURETTE. No, no, I was talking to Ms. Richards. I am sorry, Ms. Stout.

Ms. RICHARDS. We would definitely scrutinize an account with that kind of turnover ratio. I think it is important to note that we focus on firms' exception reports, which would typically flag accounts with turnover ratios of certainly that high. And then we would drill down and focus specifically on those accounts.

So if the firm's exception reports were accurately identifying accounts with those kinds of turnover ratios, we would drill down very hard and focus on them.

Mr. LATOURETTE. And, lastly, let me ask you, it is my understanding, in response to the questions by the Chairwoman, that your investigators made a judgment call not to talk to the investor in 1993 in that investigation. And basically—and, Mrs. Stout, let me come back to you, who was the executor of your sister's estate? Do you recall?

Mrs. STOUT. Frank.

Mr. LATOURETTE. Frank Gruttadauria. Doesn't that create sort of, Ms. Richards, a closed loop? If you go and you talk to Mr. Gruttadauria, who apparently is trusted by people like Mr. Fazio and Mrs. Stout, and apparently her sister, and you have an account that has been turned over 18 times in six months, charged commissions of $39,000 on an equity of $96,000, does due diligence or an appropriate investigation stop with a guy like Frank Gruttadauria? I mean, don't we have an obligation to go out and talk to somebody else besides the thief?

Ms. RICHARDS. Well, again, focusing on the information that the examiner had before him at the time, it was a judgment call. And one of the critical factors that the examiner relied on was whether or not the investor that owned the account had complained. And, in fact, this investor had never complained about the trading in her account.

Looking back on it now, with all that we know about what Mr. Gruttadauria did and what he was capable of, yes, I certainly wish we would have talked to the customer. But, I mean, now, looking back, I don't know what the customer would have said.

Mr. LATOURETTE. Of course not.

Ms. RICHARDS. Truly, I don't know if, looking back on it now, if the customer wished to engage in frequent trading and herself directed the trading, as we were told by the firm.

Mr. LATOURETTE. But I think if you put the '93 account together with the Visconsi account together with the Fazio account, I mean, something smells pretty bad here, and perhaps we should have talked to additional people. And I had a question and now it is out of my head.

Mrs. Stout, back to you, let me—when Lehman Brothers visited you, did you have the impression that it was an attempt to get you to settle any claim you might have against them?

Mrs. STOUT. No.

Mr. LATOURETTE. Okay. Did they inquire as to whether or not you were represented to counsel, whether you had a lawyer?

Mrs. STOUT. I had not had a chance to get counsel.

Mr. LATOURETTE. Okay. And lastly, Ms. Richards—and I appreciate the Chair's indulgence—was the investigation conducted in 1993 shared with S.G. Cowen?

Ms. RICHARDS. S.G. Cowen compliance personnel were in the room when we interviewed Mr. Gruttadauria, and when we asked questions about the accounts and the exception reports. So they were very well aware of what we were focused on.

Mr. LATOURETTE. Would your investigative file have been available to Lehman Brothers when they were conducting their due diligence when they purchased the retail business of S.G. Cowen in the year 2000?

Ms. RICHARDS. No, because the examination didn't result in conclusive findings of violations. There was no deficiency letter sent to the firm.

Mr. LATOURETTE. Would your investigative file have been shared with Mr. Doherty in the Enforcement Division of the New York Stock Exchange?

Ms. RICHARDS. We share examination reports with the SROs whenever it's relevant for either party. But in this case, it wasn't.

Mr. LATOURETTE. And I was going to ask Mr. Doherty, before reading it in the newspaper, being advised during the course of these proceedings, any idea that Mr. Gruttadauria had been the subject of this anonymous complaint in 1993?

Was there any idea by you, Mr. Doherty, that Mr. Gruttadauria had been the subject of this 1993 complaint?

Mr. DOHERTY. Not to my knowledge, no.

Mr. LATOURETTE. Thank you very much, Madame Chairman.

Chairman KELLY. Thank you. Mr. Inslee, do you have questions?

Mr. INSLEE. If I may, Madame Chair, I'd like to yield to my colleague from Ohio my time in this regard. She's been doing excellent work on it.

Chairman KELLY. Thank you.

Ms. JONES. Thank you, Mr. Inslee. I want to start and continue the line of questioning from Mr. LaTourette, Ms. Richards.

In 1993, you got an anonymous complaint. You went and reviewed the record. Under all anonymous complaints, is it that you never talked to the customer?

Ms. RICHARDS. No, that certainly is not the policy. I think our policy currently—

Ms. JONES. Take me back to 1993, not currently.

Ms. RICHARDS. In 1993, our policy would have been to contact a customer if there were any loose ends, if there was any indication.

Ms. JONES. But who better than the customer than to tell you or to signal to you of some difficulty?

Ms. RICHARDS. Well, in fact, the examiner made the decision not to contact the customer because he was focused on the fact that the customer had never complained to the firm, the fact that the trades appeared to be directed by the customer and the fact that this customer appeared to be an experienced trader.

Ms. JONES. Appearances are deceptive. Would you agree with me on that, Ms. Richards?

Ms. RICHARDS. This was according to the new account form that the customer would have filled out with the brokerage firm. The

customer would have indicated to the brokerage firm his or her net worth, his or her investment experience, his or her investment—

Ms. JONES. Back up a minute. You said it appeared that the customer signed the form. What I'm trying to get to is appearances are deceptive. We're sitting here with people like Mr. Fazio, Mrs. Stout, Mr. Glazier. Under the appearances invested with Mr. Gruttadauria, you were the examination folk. It's incredible to me that—I'm a former prosecutor, you're an examiner. You go after the witnesses. The best witness would be the customer that you would talk with them to find out in any instance, would it not be?

Ms. RICHARDS. Sitting here now, I wish we would have called the customer, absolutely. I don't know what the customer would have said.

Ms. JONES. We never know what anybody is going to say.

Ms. RICHARDS. But sitting here now, I certainly wish we would have talked to the customer, yes.

Ms. JONES. So now the rules, seeing as we're now trying to get so instances like this don't happen again, you talk to the customer now?

Ms. RICHARDS. Yes, we have a much more liberal policy on when the government contacts the customer about a particular account, absolutely.

There's another change, if I could—

Ms. JONES. Please.

Ms. RICHARDS. There's another change in the law that I think will be helpful in preventing similar situations like this. Under new rules that were adopted by the Commission a couple of months ago. The information that I described on a new account form about the customers' name, address, investment objectives, net worth, that information now will have to be sent to the customer for verification, so that will prohibit a registered representative from falsifying information on the new account form and I think that's a terribly important—

Ms. JONES. It won't prohibit falsification.

Ms. RICHARDS. Well, the registered representative will be out of the picture. The firm will send that statement to the customer and the customer can look at it and say—

Ms. JONES. Where does the firm get the customer's address?

Ms. RICHARDS. The firm would get the customer's address from the customer.

Ms. JONES. So you're saying that every firm now will have a direct contact with a customer even though there is another representative involved in the process?

Ms. RICHARDS. Yes, the firm itself will communicate directly with the customer and the customer will then be able to verify yes, that's my name, that's my address or no, it's not or that's not my investment objective, that's not my net worth. It will make it much more difficult for registered reps to lie about those things—

Ms. JONES. And what caused you to make this rule change in the last two months?

Ms. RICHARDS. It had been in the works for some period of time. We worked very closely with the state securities regulators who suggested to us that this was a change that needed to be made to

prevent theft by brokers. The Commission agreed with it and made the change a couple of months ago.

Ms. JONES. What other changes have you made to assure an investing public that you are going to do your job?

Ms. RICHARDS. Well, there's another change imposed in the same books and records rule that I think Mr. Fazio alluded to and that is the protection against registered representatives opening post office boxes in their control. The new rule would require that brokerage firms send a change of address confirmation to the old address and the new address. That, I think, will go a long way towards preventing registered representatives from creating these fictitious post office boxes, because the customer will get a notice from the firm that says have you or have you not changed your address to a post office box? I think that's an important protection.

Ms. JONES. Did you see all of these events that are occurring and I look at them, oh wow, okay—I can finish that question or not? No, okay, I won't. I'll go back.

Chairman KELLY. Mr. Tiberi. We'll let you hold that thought and come back.

Mr. Tiberi.

Mr. TIBERI. Thank you. Thank you, Madame Chairwoman. Just a couple of questions. Ms. Richards, of your total investigative force meaning like attorneys, investigators, supervisor attorneys, senior trial counsels, how many are employed in the Northeast Region in New York?

Ms. RICHARDS. The Northeast Region is comprised of both enforcement attorneys as well as examiners and accountants who conduct examinations of broker dealers, investment advisers, and investment companies. I don't know offhand the total number of staff in the New York office, but I'm happy to provide that to you.

Mr. TIBERI. That would be great. My understanding is is that the bulk of the employees who do criminal investigations, the staff attorneys are located here in Washington, D.C. and they're sent out rather than having a stronger presence throughout the United States. And it would seem to me that maybe that has created a problem.

Ms. RICHARDS. We have 11 regions and districts in major metropolitan centers which are staffed by not only enforcement attorneys who bring enforcement cases, but also in my office, by examiners and accountants who conduct examinations of registered firms in their regions and districts.

Here in Washington in the examination program, we have a staff of about 100 accountants, examiners and attorneys who also conduct examinations and assist in the examinations conducted by the field offices.

Mr. TIBERI. You'll provide that information to us?

Ms. RICHARDS. Sure.

Mr. TIBERI. Thank you. Ms. Stout, you mentioned in your testimony that with respect to on-line services that Mr. Gruttadauria was dissuading you from, in your own words, accessing your on-line account. How did he do that? How did he dissuade you from doing that?

Ms. STOUT. He really had not persuaded me not to. I was still insistent on doing it, but when I called—he told me that he had

made up his mind when he went into business that he would never have any on-line. He would not be harassed by his clients and I said I have never harassed you, Frank. I would like to do it. It's a joy for me to learn new things and he said if you feel so strongly I will have to get you another broker. And I thought, well, I don't know. And I kind of led him on and he said I'll tell you what, Golda, I've know you for all these years. I will send you the symbols and I thought all right. But I didn't get the symbols. And then I was going to call and say forget it.

Mr. TIBERI. Over the years you received monthly statements, Ms. Stout?

Ms. STOUT. Yes.

Mr. TIBERI. I assumed you paid taxes on those statements?

Ms. STOUT. Oh, yes, I did.

Mr. TIBERI. How much tax do you believe you paid in the end on money that you didn't earn?

Ms. STOUT. Well, two years ago I almost went into hysterics. I ended up paying $32,000 to the government. I paid quite a little bit to the state, plus I had been paying quarterly for the estimated. Now that will give you an idea of what I did do.

Mr. TIBERI. Ms. Stout, did either Cowen or Lehman offer to take responsibility?

Ms. STOUT. No.

Mr. TIBERI. Okay. Has either company offered to make up the losses incurred?

Ms. STOUT. No.

Mr. TIBERI. Mr. Fazio, has either company offered to make up losses that you incurred?

Mr. FAZIO. No. They have not offered anything.

Mr. TIBERI. And neither Cowen or Lehman will take responsibility, Mr. Fazio?

Mr. FAZIO. No, they have not. I asked for some substance of some kind until we settle it. They didn't offer a dime, nothing.

Mr. TIBERI. Madam Chair, I'd like to yield the balance of my time to Mr. LaTourette.

Mr. LATOURETTE. Thank you very much, Mr. Tiberi, for the courtesy on the little less than a minute that you have remaining.

Mr. Fazio, I wanted to reference before we go into other matters, there was a rather obnoxious column in the Cleveland Plain Dealer a couple of months ago and it's unusual for the Cleveland Plain Dealer, it's a fine newspaper, but it suggested that those of you who lost money were either sloppy, greedy or inattentive and that perhaps participated in your own demise. And I would just like you, sir, to indicate for the purposes of the record, were you a sloppy, inattentive or a greedy investor?

Mr. FAZIO. Absolutely not. I kept track of everything I did and checked it against the statements and everything balanced. If it didn't, he would correct it. I was not a sloppy investor and this person, I was so mad when I read that article I wanted to cancel the Plain Dealer.

Mr. LATOURETTE. The statements that you received from Mr. Gruttadauria, did they mirror the notes and notations that you—

Mr. FAZIO. Yes, they mirrored my investments as I kept track in several notebooks of my trades. They did. I want to add one other

thing, that in answer to another question, the customer did not sign the form. When Lehman took over, I'm the client, it was forged. My name was forged. Customers had no way of knowing about the trades, the excessive trades or anything else. Signatures were forged.

Mr. LATOURETTE. Thank you very much and thank you again, Mr. Tiberi, for your courtesy.

Chairman KELLY. Thank you, Mr. LaTourette. Mr. Clay, have you questions?

Mr. CLAY. Thank you, Madame Chair. Let me thank you for conducting this hearing as well as I'd like to ask unanimous consent to submit my statement in the record.

Chairman KELLY. So moved.

Mr. CLAY. And yield the balance of my time to Ms. Jones.

Ms. JONES. Thank you, Mr. Clay. Ladies and gentlemen, I've been able to twist all of my colleagues' arms to tell them this is my jurisdiction, give me your time and I thank each of them for being willing to do so.

For the record, Madame Chairwoman, we had asked Mr. Samuel Glazier to come and testify and under advice of his counsel, he chose not to, but he is seated here in the room today and we do have a letter from Mr. Glazier's attorney that I'd like to submit for the record, so that everybody will understand why it was he chose not to testify.

[The following information was subsequently furnished by Hon. Stephanie Tubbs Jones for the hearing record.]

Chairman KELLY. So moved.

Ms. JONES. Great. Thank you. Let me see, where did I leave off.

Let me go back to you, Ms. Richards. Tell us how you perceive and Mr. Doherty, you can answer this question, that you, the Stock Exchange, and you the SEC, are going to collaborate to see that Mr. Glazier and Mr. Fazio and Ms. Stout and Mr. Stanton and others may be able to get some relief?

Ms. RICHARDS. Well, in our enforcement action that we filed against Mr. Gruttadauria, we asked for disgorgement of any and all ill-gotten gains. Any ill-gotten—

Ms. JONES. Just for the record, why don't you tell us what disgorgement is, okay?

Ms. RICHARDS. That's a request to the Court that Mr. Gruttadauria be ordered by the Court to turn over any monies or property that he may have obtained unlawfully.

Ms. JONES. And so has he been enjoined from disposing of those assets, have you corralled those assets for purposes of the possible victims?

Ms. RICHARDS. We asked for, at the time we filed the complaint, an asset freeze, a freeze of all of his accounts and the Court entered that order.

Ms. JONES. So who is it, if you can answer this question, responsible for corralling—you know, we generally set up someone who has oversight over such assets. Has someone been assigned to do that and are you able to tell us for the record what the value of those assets may be at this time?

Ms. RICHARDS. As far as the value of the assets, I think it's too early to know. The Commission's enforcement staff is still in the

midst of taking discovery and very actively investigating this matter, not only as to Mr. Gruttadauria, but also as to other individuals who may have assisted or participated in the fraud along with him.

Ms. JONES. In light of the fact that Mr. Gruttadauria was employed by Lehman Brothers had you corralled any of Lehman's assets in order to be able to satisfy the possible losses of these victims?

Ms. RICHARDS. Under the securities laws' framework, there is a remedy of arbitration. Each customer can arbitrate his or her dispute with a brokerage firm. In addition, I know that a number of customers are considering taking action in Federal Court and State Court.

Ms. JONES. Let me ask my question again, in light of the fact that Mr. Gruttadauria was employed by Lehman Brothers, have you corralled any of the assets of the Lehman Brothers or SG Cowen in order to satisfy the losses of the victims of this particular incident?

Ms. RICHARDS. The Commission doesn't have authority to obtain monies directly on behalf of investors. Typically, when we obtain disgorgement of ill-gotten gains, we would then seek the Court's approval to disperse those moneys back to investors who were defrauded.

Ms. JONES. Isn't it conceivable, Ms. Richards, that Mr. Gruttadauria had ill-gotten gains, Lehman Brothers also had ill-gotten gains, so in fact, their assets ought to be corralled? Let me cut if off. It's conceivable that if Gruttadauria got ill-gotten gains, so did Lehman Brothers, because it's based on a commission. Is that true?

Ms. RICHARDS. The Commission is continuing to investigate the conduct by the two brokerage firms that employed him.

Ms. JONES. So you're saying the SEC has no authority to deal with Lehman Brothers as they're dealing with Gruttadauria in term of assets?

Ms. RICHARDS. The Commission has the authority to bring enforcement actions against both of those firms and we are very actively investigating them. Both of these firms are still in business. Both of these firms are healthy. They have adequate net capital. They have adequate reserves. This is not a situation—

Ms. JONES. How long does it take to declare bankruptcy, Ms. Richards?

Ms. RICHARDS. I don't know. These firms have adequate capital to continue to do business.

Ms. JONES. I'm trying to get my staffer to find me a newspaper article where Lehman is, in fact, claiming the possibility that so many suits to cause them to be placed in financial difficulty. Have you seen that article?

Ms. RICHARDS. I saw an article where they disclosed that the firm was taking a reserve against the potential for lawsuits.

Ms. JONES. So what does that tell you?

Ms. RICHARDS. It tells me they're starting to set aside money for the possibility that they'll have to make some of the victims whole.

Ms. JONES. So you're saying to the world on behalf of the SEC that Lehman Brothers is going to be in a position to settle or pay up all these folks who have lost money. Help her out, come on.

Mr. DOHERTY. Could I add something? Since we're investigating this matter right now, I'd rather not comment on what we have in mind here. But I can tell you that when we get involved in an investigation and we see customers who have been damaged and have had money stolen, very much a high priority of our concern before we resolve that enforcement action is that those customers get taken care of and dealt with fairly by our member firms.

Ms. JONES. So are you saying that the stock exchange is going to have the back of Lehman Brothers for satisfying the claims of all these folks?

Mr. DOHERTY. What I'm saying is that since I can't comment on what we're going to do in this case, I'll tell you what we've always done and what has been our consistent practice where investors have had their money stolen by an employee of a member firm. We have made it very clear to our member firms that we expect them to deal fairly with their customers and reimburse their customers. They understand that and I cannot think of a case in the last 10 years where an employee of one of our member firms has stolen money and that that customer has not been taken care of by the member firm.

Ms. JONES. Thank you, Madame Chairwoman. I appreciate the time.

Chairman KELLY. Thank you. Ms. Richards and Mr. Doherty, I'd like an answer to this question. Do either of your institutions have any rules about the appropriateness of branch managers or brokers who supervise their compliance officers? Do either of you have any rule in existence now and did you back a couple of years ago? How long has this rule been in place?

Ms. Richards, do you want to answer that first and then we'll go to Mr Doherty?

Ms. RICHARDS. Yes, as I said, broker-dealers have a duty to reasonably supervise. We would not consider a reasonable supervisory system a structure in which supervision was had by a subordinate. That to us would not reflect a reasonable system of supervision. Supervision must be independent to be effective, so we would look to someone outside of the branch manager's chain of command to supervise that branch manager's activities.

I would note that that's something that was specifically set forth in my testimony as one of the practices that we intend to focus on very hard in our examinations.

Mr. LATOURETTE. Will you yield to me just for that, on that point?

Chairman KELLY. Of course.

Mr. LATOURETTE. In this situation where Mr. Semanek is the compliance officer on behalf of Lehman Brothers and he's a subordinate of Mr. Gruttadauria, are you indicating that that is a nonsatisfactory arrangement?

Ms. RICHARDS. I can't comment on the facts of this particular case because that very situation is under investigation by our enforcement staff, but a situation in which a subordinate of a branch

manager is supervising that branch manager's activity, in my view, doesn't reflect a reasonable system of independence.

Mr. LATOURETTE. With the Chairwoman's indulgence because I don't want to parse words or have anybody leave here and be confused, so you're not going to comment about Mr. Semanek and Mr. Gruttadauria, but if, for the purposes of a hypothetical there was a guy in Cleveland who was the branch manager and his compliance officer was his subordinate, would you find that to be an inappropriate supervisory structure?

Ms. RICHARDS. In Cleveland or wherever—

Mr. LATOURETTE. Anywhere in the world.

Ms. RICHARDS. Yes, we would be very critical of that.

Mr. LATOURETTE. Thank you.

Mr. DOHERTY. Could I add that in our view a producing branch office manager needs to be supervised with respect to his own production like any other salesman and so that I would completely agree with Ms. Richards that supervision by a subordinate, if that's the sole aspect of the supervision, would not be, in our view, reasonable and we have brought enforcement cases against firms and others where we felt that was a deficiency.

Chairman KELLY. Ms. Richards, it's my understanding that you put this oversight in place about 1998. Is that correct?

Ms. RICHARDS. Oversight?

Chairman KELLY. The oversight of the decision being that it was inappropriate for a branch manager or a broker to supervise their own compliance officer. Wasn't that in place in 1998?

Ms. RICHARDS. The duty to supervise has certainly been in place and is the framework, the linchpin of the federal securities laws—

Chairman KELLY. So it was not enough to stop Mr. Gruttadauria, is that correct? Must have been. Is that correct?

Ms. RICHARDS. Existing duties to supervise apparently failed with respect to Mr. Gruttadauria.

Chairman KELLY. Thank you very much. Does either the SEC or the New York Stock Exchange believe that they require greater authority to detect fraud similar to Mr. Gruttadauria's? Is there something here that we need to look at at the federal level that will not impinge on the trading that's occurring, will not impinge on the markets and yet do you need another tool in your toolbox?

Ms. RICHARDS. I would say that, on behalf of the Commission, that we have 250 examiners for a population of 8,000 registered broker dealers, some 90,000 branch offices and 678,000 registered representatives that we police, with the SROs, with 250 examiners. The Commission is now engaged in a top-to-bottom review of its resources to determine whether or not we need more—just simply need more people to do the job that we need to do. Chairman Pitt has spearheaded that effort and we're working closely with him to make those kinds of determinations.

Chairman KELLY. What about you, Mr. Doherty?

Mr. DOHERTY. My reaction is I don't think we need additional authority. I think we need to continue to gather information and adapt our program. We have under consideration some rules that would impose more specific requirements in this area that would hopefully go a long way toward enhancing investor protection in this area.

In the final analysis, however, responsibility has to be on the member firms to put in place the kind of procedures that the rules require and run their business in a way that's compliant with the rules. We oversight that. The SEC oversights that.

Overall, this system, has given us the best markets in the world, but that doesn't mean that we can't improve things and that's what we're trying to do.

Chairman KELLY. Well, I thank you all for your testimony. I want to note that some Members may have additional questions. I'm sure they do have additional questions for this panel and they may wish to submit them in writing. So without objection, the hearing record will remain open, as I had stated earlier, for 30 days for Members to submit written questions to these witnesses and to put their responses in the record.

I'd like to thank the first panel very much for appearing here. We appreciate your testimony and I want to especially say to you, Mr. Fazio, and Ms. Stout, you are excellent spokespeople for those people who were damaged by Mr. Gruttadauria's actions and we thank you for traveling so far to be with us today.

With that, I'm going to excuse this first panel with our great appreciation. Thank you so much.

Ms. JONES. Madame Chairwoman, just for the record, I found that newspaper article that I was talking about with Lehman Brothers with the reserves and not having enough money to help out these folks and I would just like to submit it for the record.

Chairman KELLY. With unanimous consent, so ordered.

Ms. JONES. Thank you.

Chairman KELLY. This panel is excused. I'd like to have the second panel start taking their seats.

For our second panel we welcome Mark Kaplan, Managing Director and General Counsel, SG Cowen Securities; Mr. Thomas Hommel, Managing Director and Co-Head of Global Litigation for Lehman Brothers; Daniel Sibears, did I pronounce that correct? Mr. Sibears, did I pronounce that correctly?

Mr. SIBEARS. It's pronounced Sibears.

Chairman KELLY. Sibears, thank you very much. Mr. Sibears, Senior Vice President and Deputy for Member Regulation for the National Association of Securities Dealers; Mr. Bradley Skolnik, Indiana Securities Commissioner and Chairman of the Enforcement Section of the North American Securities Administrators Association; and Marc Lackritz, President of the Securities Industry Association. And we thank all of you for being here. I appreciate your testimony before us today and I welcome you on behalf of the full committee. Without objection, your full written statements and any attachments that you have will be made part of the record and you'll each now be recognized for a 5-minute summary of your testimony.

I'd like to begin with you, Mr. Kaplan.

## STATEMENT OF MARK E. KAPLAN, MANAGING DIRECTOR AND GENERAL COUNSEL, SG COWEN SECURITIES

Mr. KAPLAN. Thank you. Madame Chair, Members of the Subcommittee, I thank you for the opportunity to come before this Panel for this important hearing. On behalf of SG Cowen, I pledge

our company's full support for your efforts. We applaud the Subcommittee for its leadership in working to protect investors from fraud and other abuses.

SG Cowen is committed to doing everything possible to get to the bottom of this scheme and to do what's right for our former clients by making every effort to reach a fair and equitable resolution of their claims.

I want to begin by briefly reviewing SG Cowen's short involvement in the retail brokerage business and where Frank Gruttadauria fit into that business. In July 1998, SG Securities purchased most of the assets of Cowen & Company, a wholly unrelated firm. Frank Gruttadauria had worked for Cowen & Company for over eight years.

SG Securities did not have a retail brokerage business until this acquisition. With the purchase, SG Cowen was formed as a full-service investment banking and retail brokerage firm in the United States.

In October 2000, a little over two years later, SG Cowen's retail brokerage business, including Frank Gruttadauria and his accounts, were sold to Lehman Brothers. Our firm has been out of the retail brokerage business since that time.

Because we sold that business, we are faced with a unique and significant challenge in piecing together what happened in the Gruttadauria scheme. First, practically everyone involved in SG Cowen's retail brokerage business no longer works at the firm. As a result, we lack the institutional memory that would help us resurrect and reconstruct what happened during the time that Mr. Gruttadauria worked at the firm.

Second, the files that we are researching are stored on vast amounts of paper and microfiche, not electronically. That requires us to manually review more than 11,000 boxes of documents relating to hundreds of thousands of transactions and, to unravel this scheme, we must analyze every transaction in every account.

Lastly, we are attempting to unravel a scheme that escaped detection, notwithstanding the due diligence, compliance procedures and independent reviews of several distinct companies and outside entities—which points to the sophistication and the complexity of this scheme. Even so, speaking for SG Cowen, we wish our efforts had uncovered it sooner and we're doing everything we can to ferret out what really happened.

To do that, and from the very first day we learned of this problem, SG Cowen has dedicated substantial company resources to the complex task of reconstructing client records. This includes well over 100 people working on a nearly around-the-clock basis. We estimate that more than 30,000 person-hours have been expended in this effort and we are far from finished.

While this is very much a work in progress, we have learned some things that I would like to share with the panel. However, and as I am sure you understand, we simply cannot comment on matters that bear on the on-going investigations of the SEC and the New York Stock Exchange and that are the subject of private litigation.

What I can say is that some clients did receive false statements with inflated account balances from Mr. Gruttadauria. When they

sought to withdraw funds, based on these artificially high levels, Mr. Gruttadauria had to get the money from somewhere else and that turned out to be the accounts of other clients. That appeared to require him in turn to provide false statements to those other clients and so the scheme grew. Thus, at its root, this was a scheme in which Frank Gruttadauria appears to have been robbing Peter to pay Paul. Many questions still remain. Did some people lose substantial sums? Did some people wind up with substantially more money than their investments would have earned? Were the compliance procedures and supervision at the various firms inadequate? Or was Frank Gruttadauria's scheme unusually sophisticated in evading detection?

Because of the nature of this scheme, we need to understand what happened with all transactions and all affected accounts before we can determine how to address any individual client's claim. Again, we are pursuing this task with great urgency, but it will take time.

Members of the Subcommittee, we offer our sincere apology to the former clients of SG Cowen for the harm that Frank Gruttadauria's conduct has caused them. His conduct is anathema to us. That is not the way we do business and that is not who we are. We are proud of our hard-earned reputation for integrity in the marketplace and for what we do for our clients. That is why SG Cowen will continue to work tirelessly to determine exactly what happened and to make every effort to reach a fair and equitable resolution of our former clients' claims. We know that that can't happen fast enough for them and they are absolutely right.

With that, I thank you very much for the opportunity and welcome the chance to answer any questions you may have.

[The prepared statement of Mr. Mark Kaplan can be found on page 96 in the appendix.]

Chairman KELLY. Thank you very much, Mr. Kaplan.

Mr. Hommel.

**STATEMENT OF THOMAS E. HOMMEL MANAGING DIRECTOR AND CO-HEAD OF GLOBAL LITIGATION, LEHMAN BROTHERS**

Mr. HOMMEL. Thank you, Madame Chairwoman. My name is Thomas Hommel. I'm a Managing Director with Lehman Brothers in New York. I have a few remarks that I'd like to read into the record, after which I'd be happy to answer any questions that the Committee may have for me.

In January of this year, Frank Gruttadauria reportedly sent a letter to the FBI admitting that he had defrauded his clients for a period of 15 years. Mr. Gruttadauria worked for Lehman Brothers for only 15 months at the very end of this 15-year period. His employment resulted solely from Lehman's acquisition of certain retail customer accounts and branch offices from SG Cowen & Company in October of 2000. Prior to Lehman's acquisition of the Cowen branches, we performed due diligence with respect to Cowen's personnel and operations. Our due diligence disclosed that Mr. Gruttadauria had a spotless compliance record with not even a single customer complaint against him, nor were there any significant number of customer complaints in the entire Cleveland Office.

Lehman acquired over 60,000 accounts from Cowen, including 4,900 in the Cleveland Branch Office. Approximately 470 of those accounts were handled by Frank Gruttadauria. It now appears that Mr. Gruttadauria was indeed deceiving a relatively small number of those clients, as well as his employers. He did so by diverting account statements generated by the brokerage firms for which he worked and preparing and sending to these clients false statements reflecting nonexistent trades and false account balances. These activities took place for a 15-month period at Lehman Brothers for two basic reasons. First, the addresses received by Lehman for 40 of Mr. Gruttadauria's 470 accounts were incorrect. These were the diverted statements. Second, the assets delivered over to Lehman from Cowen in those accounts were relatively small and the account activity, both trading activity and transfers of funds, was virtually nonexistent outside of a handful of accounts. Since a brokerage firm is charged with safeguarding a client's securities and funds, compliance systems are designed to do just that and a lack of activity in these accounts at Lehman meant that they were not singled out for scrutiny.

At the cornerstone of supervisory procedures for every broker-dealer is the ability independently to send to all of its customers confirmations and monthly statements reflecting all activity in their accounts. In the tape to tape or computer transfer of account information from Cowen to Lehman in October of 2000, the incorrect addresses that Mr. Gruttadauria had put in place at Cowen were transferred to Lehman. Thus, a fundamental supervisory tool had been taken away from Lehman without its knowledge as a result of purchasing accounts that had defective addresses.

Moreover, nothing about the addresses that were on these accounts appeared suspicious in any way. In virtually all instances, the addresses appeared to be accounting firms or law firms which presumably had been employed by the high net worth client, or otherwise contained street addresses. Indeed, there is nothing extraordinary about a high net worth client directing his broker to send account statements to his accountant or to a lawyer. One of the accounting firms listed had a post office box included in the address, while another was, in fact, an actual accounting firm with its actual street address listed. Thirty of the 40 accounts transferred from Cowen to Lehman that had incorrect addresses were directed to one or the other of these accounting firms. The 40 accounts that were transferred to Lehman that had bad addresses contained assets of less than $5 millon. The false account statements for those same accounts reflected equity of over $250 million. From these hard facts, it is clear that to the extent that the assets reflected in the false account statements ever existed, they had been dissipated long before they reached Lehman Brothers. Because there were relatively modest amounts in the Lehman accounts, there was little or no trading in these accounts. There were few transfers of funds as well, again, putting aside a small handful of accounts.

On January 17, 2002, the very same day Lehman learned about the alleged misappropriation, it sent a new management team to Cleveland, as well as various other personnel to immediately meet with clients. Lehman also immediately notified its regulators and

has fully cooperated with the numerous inquiries it has received from those regulators and other governmental entities. The complete former management team of the office was replaced. All of Mr. Gruttadauria's clients were immediately contacted to ensure that they knew precisely what was in their accounts and meetings were conducted with the affected customers to fully share with them what information the firm had regarding their accounts. Indeed, within 3 weeks of Mr. Gruttadauria's disappearance, Lehman Brothers had contacted substantially all of Mr. Gruttadauria's 470 clients and we personally have met with representatives, either family members or counsel, of 24 of the families involved in Mr. Gruttadauria's scheme, accounting for all but a few of the 60 accounts, which includes the fictitious accounts, for which false statements were prepared.

Moreover, Lehman has already paid substantial sums to certain customers, including the customers whose accounts served as the bank for Mr. Gruttadauria's scheme at Lehman Brothers, to reimburse them for funds misappropriated from their accounts while at Lehman, without requiring those people to sign releases. Lehman believes that the amounts already paid represent a substantial portion of any funds that may have been misappropriated while Mr. Gruttadauria was employed by Lehman, and is continuing its efforts to identify and reimburse any remaining customers for any such misappropriation that may have occurred at Lehman. Lehman Brothers, unfortunately, was in the unenviable position of having to tell these customers that they were not worth what they thought they were. However, substantially all of the alleged inflation in the account value and substantially all of the alleged misappropriation took place prior to these people ever become customers of Lehman Brothers. Lehman Brothers, as part of its 150 year tradition, places an enormous premium on earning the trust and confidence of its clients. We regret deeply that these events took place, but also firmly believe that our systems of supervisory procedures are more than reasonably designed to prevent and/or detect this type of activity.

Indeed, Lehman's compliance record since 1994, when the new Lehman Brothers re-emerged, is an enviable one, with not a single regulatory sanction associated with our private client services business. We will continue to work with the affected clients, with their counsel, with the regulators and the Courts, to resolve the claims that have been raised in the most fair and efficient manner possible.

Thank you.

[The prepared statement of Mr. Thomas E. Hommel can be found on page 104 in the appendix.]

Chairman KELLY. We thank you.

We next go to Mr. Sibears.

**STATEMENT OF DANIEL M. SIBEARS, SENIOR VICE PRESIDENT AND DEPUTY FOR MEMBER REGULATION, NATIONAL ASSOCIATION OF SECURITIES DEALERS**

Mr. SIBEARS. Chairman Kelly, Members of the Committee, thank you for the opportunity to testify on behalf of the NASD. First, let me briefly describe the NASD. The National Association of Securi-

ties Dealers is the world's largest self-regulatory organization or SRO. Under federal law, the roughly 5500 brokerage firms and almost 700,000 registered representatives in the U.S. securities industry, comes under our jurisdiction. Employing industry expertise and resources, we license industry participants, write rules to govern the conduct of brokerage firms, educate our members on legal and ethical standards, examine them for compliance with NASD and federal rules, investigate infractions and discipline those who fail to comply. We have a staff of 2,000 with headquarters in Washington, D.C. and 15 district offices throughout the country. We are governed by an independent Board of Governors, at least half of whom are unaffiliated with the securities industry.

I'm the Senior Vice President and Deputy for the Member Regulation Department which has over 800 dedicated employees. My testimony today will focus on the exam program which is the largest function carried out by member regulation. I recognize that the Committee has a significant interest in the Gruttadauria case. For the reasons set forth in my written statement, however, I am not in the position to comment specifically on that matter which is under investigation by the New York Stock Exchange and the Securities and Exchange Commission.

On an annual basis, the NASD examines approximately 2600 brokerage firms' headquarters and over 200 branch offices. The yearly schedule of exams is prepared in conjunction with other SROs, including the New York Stock Exchange, pursuant to an agreement to maximize cooperation and to minimize duplication among regulators.

The exam process has advanced with technology. In the mid-1990s, the NASD developed automated exam modules, essentially taking the paper modules procedures and schedules of the past and placing them on a computer. With the NASD's recent development of INSITE which stands for Integrated National Surveillance and Information Technology Enhancements, we use sophisticated data mining techniques to detect signals of change in member firm activities. This includes statistical analysis of customer complaints, transactional and trading information, registration information and financial information.

All this technology is helpful in identifying problems, but our goal is to have the systems that encourage firms to identify and stop problems before they happen. We use all the tools at our disposal, automated, manual and intellectual, to anticipate problems. The tools used to conduct the exams have changed and although the scope has grown, what we examine for has not changed radically. During our on-site visits to the firm's office, the examiners review the firm's books and records such as financial computation work papers and subsidiary ledgers, order tickets and confirmations, complaint and correspondence file and many other records. Examiners check that the firm's records support the regulatory filings that the firm has made to the NASD in the case of trade reporting, financial filings, complaint filings and advertising filings, for instance. Examiners prepare independent financial calculations to determine the financial condition of the firm, including such measures as net capital and customer reserve. Examiners also interview the firm's compliance officers and management to learn

about its supervision in operational practices. The front line of our system of preventive compliance is at the securities firm itself. All securities firms are required to have supervisory systems and internal controls. NASD takes our members' supervisory obligations very seriously. Effective evolving supervisory systems form the foundation of a firm's ability to ensure that its associated persons are appropriately dealing with customers and the customers are protected. Appropriate supervision safeguards the firm and increases investor confidence, thereby ultimately ensuring the fair and efficient functioning of our markets.

However, ordinary supervisory procedures may be insufficient to ensure compliance in certain circumstances, circumstances that may warrant heightened supervisory controls include registered representatives who have been the subject of numerous customer complaints, disciplinary actions or arbitrations, registered representatives terminated from association with prior firms for regulatory reasons or concerns, registered representatives who have frequently changed their employment and registered representatives whose trading practices or customers appear on certain exception reports generated by the firm to monitor customer accounts.

Firms that ignore such signals or red flags of sales practice violations or that never put in heightened supervision of problem brokers may themselves be the subjects of disciplinary action for failure to supervise the brokers. While today's hearing is focused on one bad actor, the overwhelming majority of NASD members materially comply with the letter and the spirit of the rules and the law. They view their own reputation for fair dealing and high standards as a competitive asset in a competitive industry.

The NASD's job is to protect investors by setting high standards of conduct and by disciplining those that fail to live up to those standards, sometimes by barring them from the industry for life.

I'd be pleased to take any questions that you may have.

[The prepared statement of Mr. Daniel Sibears can be found on page 109 in the appendix.]

Chairman KELLY. Next we go to Mr. Skolnik.

**STATEMENT OF BRADLEY W. SKOLNIK, INDIANA SECURITIES COMMISSIONER AND CHAIRMAN, ENFORCEMENT SECTION, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION**

Mr. SKOLNIK. Chairwoman Kelly and Members of the Subcommittee, I'm Brad Skolnik, Indiana Securities Commissioner and Chairman of the Enforcement Section of the North American Securities Administrators' Association. I commend you for holding this hearing and thank you for the opportunity to appear today.

The Securities Administrator in your state is responsible for the licensing of investment professionals and securities offerings, investor education and most importantly the enforcement of state securities laws. We've been called the local cops on the beat and I believe that is an accurate characterization.

Today, our focus is on the case of Frank Gruttadauria. My testimony will focus on two questions. What should be done to prevent another Gruttadauria from cheating investors out of their money

and what steps can investors take to better protect themselves from these criminals?

I believe our securities laws and regulations are fundamentally sound. One lesson from this case might be that compliance departments need to toughen their enforcement of the rules already on the books. Compliance departments must have reasonably designed standards and systems in place to prevent and detect fraud. For example, it's important that firms implement an effective, centralized compliance system to approve the opening of accounts and to monitor associated name and address changes.

In addition, I encourage brokerage firms of a reasonable size to provide on-line access to their customers' account statements. Investors will then be able to check their mailed account statements against the information provided directly by the firm's website which is not subject to manipulation by a crooked broker.

Another useful tool would be more resources for regulators. I applaud recent House action to raise the SEC budget. We need to make sure that both state and federal regulators have the resources they need to do their jobs. There's also another way to fight these criminal fraudsters. Securities regulators must work with prosecutors to obtain more criminal convictions. The prospect of serious jail time is the only way to deter these calculating cold-blooded recidivist criminals. Anything less is viewed as just the cost of doing business.

Think about it. Someone steals your car, they go to prison. A con artist steals the money your parents saved for retirement and all too often, only gets fined. That's just not right.

Make no mistake about it. Frank Gruttadauria stands accused of being an unscrupulous scam artist and his alleged criminal activities will be addressed in a court of law. However, as a State Securities Commissioner, I've encountered too many fraudsters who have swindled hard-working Americans out of their life savings.

Indeed, over the past few years, in my home state of Indiana, we've encountered at least two high profile incidents where stock brokers employed some of the same tactics such as the issuance of fictitious account statements to plunder their clients.

The question is how can we better protect investors from being victimized by the next Gruttadauria? We need to realize that no matter what we do, there will be always be diabolical con artists. That's why stiff penalties and long prison sentences are so important.

In addition, NASAA has some tips for how investors might better protect themselves from these sophisticated scams. First, periodically check mailed account statements against on-line information from the firm's website or by calling the firm's headquarters. Secondly, we've all heard the saying, don't put all your eggs in one basket. Investors should consider spreading their investments possibly among two or three firms. Third, contact your State Securities Regulator to check out a broker before doing business with them. We can tell you if the company or individuals offering investment advice are licensed or if they have any disciplinary history. Fourth, use common sense. If written account statements show you're making lots of money at a time when the stock market is in decline, maybe you should double check your accounts with the firm's com-

pliance office. Fifth, with the advent of desktop publishing and technology, it's not difficult to create bogus account statements. I encourage investors to carefully check for typographical errors that sometimes appear on falsified statements. Sixth, many investment professionals use either custodians or clearing brokers to hold their clients' funds and securities. Investors should periodically compare statements received from their broker with these independent third parties for confirmation and accuracy. And finally, investors should make sure their account statements are issued by the brokerage firm or mutual fund complex and not from some other assumed business name used by the investment professional.

I applaud you for holding these hearings in an effort to shed light on the criminal abuses in the securities markets. The problems in this area are serious, but can be successfully addressed if securities regulators and policy makers work together on solutions and if investors are properly educated so they can protect themselves. Thank you very much.

[The prepared statement of Mr. Bradley Skolnik can be found on page 116 in the appendix.]

Chairman KELLY. Thank you very much, Mr. Skolnik. I hope that anyone who receives a transcript or has any indication of what you've just said who is an investor will listen and act upon those seven suggestions. Thank you for putting them into the record.

We go now to Mr. Lackritz.

**STATEMENT OF MARC E. LACKRITZ, PRESIDENT, SECURITIES INDUSTRY ASSOCIATION**

Mr. LACKRITZ. Thank you, Madame Chairwoman, and Members of the Subcommittee. Thank you very much for the opportunity to testify today to describe the regulatory structure of the securities industry which I know you've already heard a little bit about, the efforts that we're making to continually improve compliance and prevent fraud, and a new investor education and information efforts underway to help empower investors and prevent this kind of incident.

The securities industry is profoundly concerned whenever an investor loses money through fraud and we share your Subcommittee's outrage over this particular incident. Indeed, we're embarrassed that this type of fraud has even occurred because although it happens only rarely, it simply should not occur at all. Our industry prides itself on our dedication to ensuring the highest ethical standards among our professionals and our deep commitment to earn the public's trust and confidence that the markets operate fairly with complete integrity. When that trust and confidence are undermined in any way, our reputations are diminished and investors become more reluctant to provide the capital that companies need to grow and flourish, employ more workers and provide financial returns that boost our nation's prosperity. That's why we have no tolerance for those who have broken the law and we believe that bad actors should be prosecuted to the full extent of the law.

Although this, episode of fraud is egregious and unacceptable, it is important to note how rare these incidents are. More than 99.99 percent of all transactions result in no complaints, a record that other industries and professions envy. Since 1995 the increases in

dollar volume in securities transactions dwarf the increase in complaints. Every single day nearly $700 billion in transactions clear and settle on the stock and debt markets based on a handshake, a nod, a hand signal, a keystroke or a phone call. This would not be possible without strong, fair regulatory scheme that protects investors and ensures the integrity of the markets.

The securities industry multi-tiered regulatory structure makes them amongst the most highly regulated industries. The first layer of investor protection occurs within the brokerage firm itself. Broker dealers are responsible for complying with every law and regulation pertaining to their business, including the strict supervision of all personnel. They must also comply with mandatory continuing education programs.

SROs, the second tier of regulation, verify that brokerage firms have systems and procedures in place to manage themselves properly and to comply with securities regulations, review firm's books and records, and administer tests and supervise the industry's mandatory continuing education requirements. They also create a compliance system by which individuals and securities firms can police their own activities. For example, the NASD regulation maintains a public disclosure program on its website. I've give you that address in my written testimony, as well as a toll-free telephone number that provides disciplinary information on all licensed securities brokers. This resource which we believe is unique in any profession, enables investors to know instantly whether a broker with whom they are considering doing business has ever had disciplinary action taken against him or her.

As you know the SEC is charged with preserving the integrity, efficiency and fairness of the securities markets by administering and enforcing the federal securities laws. And it also oversees the SROs. They have a long and successful history of detecting fraud and punishing wrongdoers. This year already, the SEC brought more enforcement actions in the first quarter, 61 cases, than it did during the same period last year and in taking the helm of the SEC, Chairman Harvey Pitt is refocusing the agency's role on catching problems early rather than spending years developing a case and then imposing penalties. We support this effort and Chairman Pitt's request for more resources to expand the commission's legal and enforcement staff and we appreciate this Subcommittee's and Committee's full support of greater resources for the SEC because a fully-funded SEC is critical for both the securities industry and our customers.

As you know, Congress is the ultimate overseer and ensures that the SEC is fulfilling its responsibility to regulate the markets.

This regulatory structure has been extremely successful by fostering the broadest, deepest, most transparent markets in the world and now countries across the globe are trying to emulate our system. I think we've established a record the entire industry can be proud of, the public can rely on and other industries can only envy. Yet, once in a while a bad actor slips through the structure and defrauds our customers. When this happens, the industry works very, very hard to make customers whole and to improve our system by detecting and stopping fraud. Broker-dealers use sophisticated technology to detect abuses. For example, computers com-

pare clients' electronically-stored profile against the trades he or she is trying to undertake. If the two don't match, the broker-dealers' compliance officers will scrutinize the activity immediately. Market regulators also use advanced state-of-the-art software and computerized surveillance systems to detect and investigator signs of foul play.

In addition to our efforts to stop fraud before it happens, the broker-dealers in the industry are redoubling our investor education efforts so that investors will have the necessary tools and skills to invest responsibly and avoid being defrauded. We have published literally dozens of educational brochures and participated in investor town meetings across the country organized by the SEC. In addition, we fully support the Treasury Department's new campaign for financial literacy, a goal our industry has been committed to achieving for more than 25 years through our stock market gain. More than 600,000 students in fourth through twelfth grade participate in this 10-week program that combines basic economic education with an investment simulation exercise.

We also recently launched a new website, www.siainvestor.org which provides interactive on-line learning tools that addresses investors' different needs and it's free to anyone that accesses it.

The securities industry works in concernt with government, regulators and self-regulatory organizations to promote a culture of trust and confidence which are our most important assets. In such an environment, innovation soars, competition thrives and investor confidence flourishes. We will continue to work together to eliminate any and all incidents of wrong-doing through effective leadership, compliance, self-regulation and more investor education. These actions will help maintain and enhance the public's trust and confidence which is good for investors, good for our industry and good for our country.

Thank you very much.

[The prepared statement of Mr. Marc Lackritz can be found on page 122 in the appendix.]

Chairman KELLY. We thank you. I'd like to open the questioning with a question to Mr. Kaplan and Mr. Hommel. Have you contacted Mr. Fazio and Ms. Stout with regard to their accounts because they said here, today that you have not?

Mr. KAPLAN. I can begin. I did hear their testimony. I have not personally spoken to them. I have personally spoken to many of Mr. Gruttadauria's clients. The only thing that I can say, Chairperson Kelly, is that we are committed to reaching a resolution, a fair resolution with each of these clients. It is very difficult, we understand, for these clients to have gone through this. We are committed to that process. We understand that it has been a long one, but this is one that we are committed to and one we have devoted a tremendous amount of resources to.

Chairman KELLY. Mr. Kaplan, if I understand the testimony here this morning, Mr. Gruttadauria had less than 500 clients, is that correct?

Mr. KAPLAN. I believe that may be generally accurate, correct.

Chairman KELLY. And Mr. Kaplan, all of this happened, the problem became apparent as I understand it, in January. How long

do these people have to wait before they get some kind of contact from your company?

Mr. KAPLAN. I agree with the Chairperson that this process has not moved as quickly as we would like and I know the clients would like. As I indicated in our oral statement, the process for us of unraveling this scheme has been a very complex one and one that has required a lot of time and a lot of resources.

As I indicated, this for us, has not just meant reviewing the two years that he worked at SG Cowen, but we have gone back to look at all of the records while he worked at Cowen and Company and this has required us to piece together each of the individual transactions in each of the accounts which, because of the way records were kept, has required a manual review of all of those records. We have devoted at this time about $4 to $5 million to try to recreate these accounts. This has meant scores of lawyers, scores of accountants. We recognize the urgency. We appreciate your efforts and you have our pledge that we will work as quickly as possible to try and reach a fair and equitable resolution with those clients.

Chairman KELLY. Mr. Hommel, you have not answered these questions. Will you, please?

Mr. HOMMEL. Madame Chairwoman, within 30 days after Mr. Gruttadauria's disappearance, I personally met with Ms. Stout in her home in Elgin, Illinois, as well as with Mr. Fazio and his counsel, Mr. Kranz, in Mr. Kranz' office in Cleveland. We also met with representatives or the clients of 24 of the other families who were involved in Mr. Gruttadauria's scam. The purpose of the meeting was to make sure that these folks had the information that we had so that we were all dealing with the same set of facts, and in fact, many of the folks did not have their actual account statements. We brought them with us and gave them to them. We asked them to show us the false account statements that they were receiving so that we knew what they were receiving and from that point forward, we've engaged them, in some instances with greater success than in others, in discussions that are designed to ultimately lead to a resolution of this situation.

Chairman KELLY. Mr. Kaplan, you're aware, I know, of the New York Stock Exchange 1998 enforcement action against Cowen. Can you discuss with us the changes, if any, that the firm made to address the failure to reasonably supervise branch office managers acting in the capacity of registered representatives, that that terminology was in that report. Can you address that?

Mr. KAPLAN. Yes. Shortly before SG Securities acquired Cowen and Company, Cowen and Company did enter into a consent order with the New York Stock Exchange that related to a number of different issues. As a result of that consent order, SG Cowen implemented a number of changes. It hired a number of additional personnel in the compliance department, including a new director of branch examination whose role was to go out and conduct audits of each of the branches. There was a compliance committee formed at the very top of the company to review both the progress with this order and to review generally the compliance procedures. There were personnel changes in the margin department and there were supervisory changes within the firm. I do know from looking back at this material that six months later, an outside independent

law firm came and reviewed the changes that were made. That law firm certified to the Exchange and certified to the executives at SG Cowen that changes, in fact, were made. The issue that you raise is an important one, which is whether those changes could have prevented this fraud from happening. That is an issue that we are looking at as well. That is an issue that we are cooperating on with the New York Stock Exchange.

Chairman KELLY. Thank you. I'm out of time and I'm going to go now to Ms. Jones.

Ms. JONES. Thank you, Chairwoman Kelly. Let me say at the outset to all the panelists I have 5 minutes. I'm going to ask short questions. I'd like short answers, if you could facilitate me, please.

Mr. Kaplan, during the period of time that Mr. Gruttadauria was employed with SG Cowen, how much money did you make from his trades?

Mr. KAPLAN. I am not sure.

Ms. JONES. Could you get an answer for me, sir?

Mr. KAPLAN. Yes, I will.

Ms. JONES. It was more than $2 million, $3 million, $4 or $5 million that you could say that, could you not, sir?

Mr. KAPLAN. I can't speculate, but I will provide you with that exact information.

Ms. JONES. How much money did SG Cowen make in 1995?

Mr. KAPLAN. We did not acquire Cowen and Company and Mr. Gruttadauria until 1998.

Ms. JONES. How much did you make in 1998?

Mr. KAPLAN. Again, I apologize that I do not have those specific figures.

Ms. JONES. You understand why I'm asking these questions, do you not, Mr. Cowen

Mr. KAPLAN. You are right to focus on those issues. I apologize that I don't have the answers for you right now.

Ms. JONES. In fact, the people who lost dollars as a result of his conduct—strike that. You do understand that you are responsible for the conduct of Mr. Gruttadauria, do you not, sir?

Mr. KAPLAN. We understand our responsibility here.

Ms. JONES. That wasn't my question. My question is that you do understand that you are responsible for the conduct of Gruttadauria?

Mr. KAPLAN. We do understand that and, as I indicated, we are committed to reaching a fair and equitable resolution with his clients.

Ms. JONES. There may be a little question as to what is fair and equitable in light of the fact that Mr. Gruttadauria represented to these people and they relied upon his representation that they have a certain amount of money when you may now come and say well, the real thing you have was X, but I have a piece of paper that said I had 10 times that?

Mr. KAPLAN. Well, I think that is one of the issues that will go into the decision or the discussion as to what is a fair and equitable resolution. There are clients—

Ms. JONES. Thank you very much. I hate to cut you off. Let me go on now to Mr. Hommel. Pronounce it for me, sir?

Mr. HOMMEL. Hommel.

Ms. JONES. Hommel. How much did you make even though you only had Mr. Gruttadauria, at least that's your statement work for you for only 18 months, how much money did you make from his trading?

Mr. HOMMEL. I also do not have precise figures for you, but I would note that the trading activity during Mr. Gruttadauria's tenure at Lehman Brothers was very, very low.

Ms. JONES. That wasn't the question I asked you.

Mr. HOMMEL. I don't know, ma'am.

Ms. JONES. You can get that information for me, can you not, sir?

Mr. HOMMEL. I will.

[The following information was subsequently furnished by Mr. Thomas E. Hommel for the hearing record.]

[During the period of time Mr. Gruttadauria was employed by Lehman Brothers Inc. the gross revenue generated by transactions in the accounts serviced by him was $3,122,515. Mr. Gruttadauria's total compensation for salary and sales credit for that same time frame was approximately $1,007,000.]

Ms. JONES. Can you tell me who Mr. Steve Lessing is?

Mr. HOMMEL. Mr. lessing is the head of sales for our organization.

[From 1996 through April 2000, Stephen M. Lessing was Head of Global Sales and Research of Lehman Brothers Inc., responsible for the Firms's Fixed Income and Equity Sales and Research organizations, as well as the Private Client Services business. In April 2000, Mr. Lessing became the Senior client Relationship Manager for the Firm and Head of the Private Client Services Group.]

[The following information was subsequently furnished by Mr. Thomas E. Hommel for the hearing record.]

Ms. JONES. How long has he worked for Lehman Brothers?

Mr. HOMMEL. Mr. Lessing has been there for at least as long as I have which is 16 years, but I don't quite know the exact—

[Mr. Lessing has worked for Lehman Brothers for 22 years.]

Ms. JONES. Okay, and what was his supervisory authority, sir?

Mr. HOMMEL. He is basically the global head of sales.

[As head of Private Client Services, Mr. Lessing had general executive responsibility for the operation of that business, but was not the day-to-day business head.]

Ms. JONES. Then he had oversight over Mr. Gruttadauria?

Mr. HOMMEL. That would include institutional sales, retail sales, sales in many different forms.

[From October 2000 to January 22, 2002, Mr. Gruttadauria was employed in the Private Client Services business of Lehman Brothers.]

Ms. JONES. The answer is yes or no, sir.

Mr. HOMMEL. Yes ma'am.

Ms. JONES. Okay, thank you. And what was he paid, sir?

Mr. HOMMEL. I don't know, ma'am.

Ms. JONES. Can you get that information for me?

Mr. HOMMEL. I will do so.

[For the fiscal year 2001, Mr. Lessing was paid a salary of $450,000 and received a cash bonus of $2,050,000. He also received $2.5 million worth of restricted stock units which will vest over a period of five years in accordance with the terms of the plan pursuant to which they were issued. Mr. Lessing also received options for the purchase of 300,000 shares of Lehman Brothers Holdings Inc. stock.]

Ms. JONES. And you can also get for me the information as to how much money you made as a result of the sales by Mr. Gruttadauria.

Mr. HOMMEL. We will do that.

Ms. JONES. Let me go on a little bit. There's an article dated April 27th that says the SEC accuses Mr. Gruttadauria of stealing client money for himself and using some of it to shower Ms. English with $600,000 in cash and $100,000 worth of gifts. Let me take you to the NASD standards for discipline and somewhere it's either there or one of your other people who testified said that is a signal for a broker to not be giving gifts to other employees in the firm. I'm not quite saying it correctly, but you understand what I'm saying to you, don't you, sir?

Mr. HOMMEL. Yes, we have a policy which prohibits managers from making such gifts.

Ms. JONES. In fact, could you find out for me how much money was showered upon Ms. English as a result of the conduct of Mr. Gruttadauria and if, in fact, it was in violation of your standards, what you did about it?

Mr. HOMMEL. We will endeavor to do that. Of course, we may not have all the information necessary to get a complete picture. Ms. English would be in a better position to do that.

[We are not in possession of any records or information regarding the value or extent of any gifts allegedly given by Frank Gruttadauria to Laurie English. Lehman Brothers was unaware of any such gifts.]

Ms. JONES. Let me ask you. What is a Lehman Brothers policy with regard to a broker, a branch office manager supervising a compliance officer and then who supervises a branch office manager? All right, who didn't want me to talk? It's okay. I'm going to go anyway. Who supervises the branch office manager in his investment and trading?

Mr. HOMMEL. In this instance, Mr. Gruttadauria had a direct reporting line into the regional management office in Chicago, so he was supervised directly by the regional manager in Chicago and the regional office in Chicago.

Ms. JONES. And who was that person?

Mr. HOMMEL. The regional manager in Chicago's name is Michael Smith.

Ms. JONES. Was he the regional manager at the time that Mr. Gruttadauria was employed by your company?

Mr. HOMMEL. He was.

Ms. JONES. How much money did he make as a result of the trading of Mr. Gruttadauria?

Mr. HOMMEL. I do not know.

Ms. JONES. You can get that information for me as well?

Mr. HOMMEL. I'd be happy to get that for you.

Ms. JONES. Thank you very much.

[There was no direct relationship between revenues generated by Frank Gruttadauria and Michael Smith's compensation.]

Chairman KELLY. You're out of time.

Ms. JONES. I'll come back.

Chairman KELLY. Would you like to have those articles that you held entered into the record?

Ms. JONES. Yes ma'am, thank you very much.

Chairman KELLY. With unanimous consent, so moved. Mr. Tiberi.

Mr. TIBERI. Thank you, Madame Chair. To Mr. Kaplan and Mr. Hommel, did Lehman and Cowen have a policy requiring disclosure of a special fiduciary relationship and I'm speaking to the issue of Mrs. Cuneo who passed away in 1997 and the fact that Mr. Gruttadauria was named executor of her estate.

Mr. KAPLAN. On behalf of SG Cowen, I am not sure what the firm's policy was at that time as to individual brokers acting as trustees for client accounts.

Mr. TIBERI. Can you get us that information?

Mr. KAPLAN. I can.

Mr. TIBERI. And can you get us that information of what—well, it wouldn't apply to you. Mr. Hommel?

Mr. HOMMEL. Yes. I can tell you that if a firm employee were to accept responsibilities in that capacity, it would have to be disclosed. I will let you know whether or not there was a prohibition on that, but I can tell you that if there were an acceptance of those responsibilities it would have to be disclosed to the compliance department of the firm.

[S.G. Cowen approved of Mr. Gruttadauria acting as the broker for the Estate of Anne Cuneo with respect to which he acted as the Executor. Since that account was acquired by Lehman, the relationship remained in place. At Lehman, the decision whether to allow a broker to service an account where he or she may be acting in a fiduciary capacity is made on a case-by-case basis.]

Mr. TIBERI. Do you know, to your knowledge, did anyone check those disclosures in Mr. Gruttadauria's case?

Mr. HOMMEL. I don't know.

[There is no record of any inquiry with respect to Mr. Gruttadauria acting as Executor of the Estate of Anne Cuneo.]

Mr. TIBERI. You can find out?

Mr. HOMMEL. We will find out for you.

Mr. TIBERI. Thank you. Continuing, Mr. Hommel, are the press reports accurate that your firm gave Mr. Gruttadauria a $5 million bonus to remain in the Cleveland office and run it?

Mr. HOMMEL. We paid Mr. Gruttadauria a $5 million retention bonus as part of that acquisition, as we paid a retention bonus to the other brokers of Cowen who came over to Lehman Brothers. We believe that that is commonplace in these types of transactions. I personally don't know of any transaction involving the sale and purchase of retail assets that did not involve retention bonuses for the simple reason that ours is a very fluid industry from the em-

ployment perspective. Brokers are free to go to whomever they'd like to work with.

Mr. TIBERI. Thank you. With that purchase, did you also accept their liabilities and their assets?

Mr. HOMMEL. I'm sorry?

Mr. TIBERI. With that purchase, did you accept their liabilities and their assets?

Mr. HOMMEL. No, we didn't. We purchased accounts and the asset purchase agreement is very clear that we did not accept liabilities.

Mr. TIBERI. During the purchase, were you aware of the 1998 fine against that office from the New York Stock Exchange?

Mr. HOMMEL. Yes, we were.

Mr. TIBERI. You were. And Mr. Kaplan, just to follow up on Ms. Kelly's question earlier, you said you had met with victims or met with some of the victims. What efforts have been made by Cowen to fully make the victims whole?

Mr. KAPLAN. At this point our efforts have been focused on trying to understand what happened in each individual client's accounts. As I indicated in my oral testimony, this scheme was perpetrated by shifting monies from one account to another account. In order to understand what is a fair and equitable resolution with each client, we must understand how much a client put in and how much a client took out. That process has involved a tremendous amount of work and when we complete that process, we will meet with each of the clients to reach that resolution.

Mr. TIBERI. What's the time line, Mr. Kaplan, do you have any idea?

Mr. KAPLAN. I hope to complete that process within the next several months.

Mr. TIBERI. I yield the balance of my time to Mr. LaTourette.

Mr. LATOURETTE. Thank you very much, Mr. Tiberi. Mr. Kaplan, on October 15 of 1997, the New York Stock Exchange sat down with counsel for Cowen, I believe they're Wilke, Farr and Gallagher, and during the course of that and that had to do with the allegation of violation of New York Stock Exchange Rule 342, failure to supervise in accordance with those procedures. And then in the response document, do you have your response document from that time with you?

Mr. KAPLAN. I do not have it, sir, although I have some familiarity with it.

Mr. LATOURETTE. Okay, and Madam Chairwoman, I'd ask unanimous consent that this response document be made part of the record and I'd ask that the document be supplied to Mr. Kaplan so that he can refer to it. But the salient points are that Cowen promised a sea of changes relative to the investigation by the New York Stock Exchange and in pertinent part on page 76 indicates Cowen recognizes the concern that arises from a situation in which the operations manager is placed in a position of supervising to even a limited extent the individual to whom he or she reports. Does that comport with your response to the New York Stock Exchange's inquiry?

Mr. KAPLAN. Well, again, SG Cowen or SG Securities, when it purchased Cowen and Company in 1998, was made aware of this

consent order and, as I indicated, implemented a number of changes in conjunction with the Exchange. In order to address these very problems raised by the Exchange, it is clear that that is one of the issues that we are looking into as to whether those changes could have caught someone like Mr. Gruttadauria who perpetrated this scheme.

Mr. LATOURETTE. When Mr. Doherty met with me the other day, he indicated that the $385,000 fine levied by the New York Stock Exchange, only 12 fines have been larger in the history of the Exchange. I don't ask you to comment on that, but the question is if the statements in that pleading were true, when SG Cowen acquired the business in 1998, it's my understanding, even though you couldn't answer Ms. Tubbs-Jones' question that Mr. Gruttadauria generated for SG Cowen $5 million in 1998 and $5 million in 1999 as commission. Now I'll ask you to go back and check that out. And my question is, if that's true, and I'm going to ask you to assume that that's true, how, by examining the accounts that you took possession of in 1998, could there ever be a justification for fees or commissions of $5 million produced by this man? The amount of equity in the accounts versus what the commissions were, if you accept my statement that he earned $5 million for your firm, they don't match and why didn't that do something to you guys? Why didn't that raise a red flag? Why didn't that come to anybody's attention?

Mr. KAPLAN. Mr. Gruttadauria, as we have heard all of this morning, put together a very complex and sophisticated scheme. You heard how he gained the trust of his clients. He betrayed the trust of these clients. One of the things that we're looking into is whether this was a matter of someone who put together a very complex and sophisticated scheme that evaded detection by all of the firms he worked for, firms that conducted due diligence, and by their compliance departments and their supervisors. That is one of the issues that we know we are obligated to address to this panel, his former clients and to the Exchange. That is a very important issue. I cannot at this point indicate how that took place.

Mr. LATOURETTE. Madam Chairwoman, I see Mr. Tiberi's time has expired. If I might continue on my own time?

Chairman KELLY. By all means, proceed.

Mr. LATOURETTE. Thank you very much. Mr. Hommel, that raises a question of you and I'll ask you to assume for the purposes of my question that, in fact, Mr. Gruttadauria did earn commissions for SG Cowen of $5 million in 1998 and 1999, but regardless of what the number is, during the course of the due diligence conducted by Lehman, you would be aware of what his potential was or what he had generated for Cowen or no?

Mr. HOMMEL. We would know what his production statistics were, yes.

Mr. LATOURETTE. For 1998 and 1999?

Mr. HOMMEL. Yes.

Mr. LATOURETTE. If I'm correct that for both years it was $5 million or there abouts and if you are correct that most of the thefts that occurred prior to the transfer of these accounts from SG Cowen to Lehman Brothers, does that not raise some question in your mind how accounts that you say have a diminished value, by

the time you receive them, have produced $5 million in commissions for SG Cowen in the two previous years?

Mr. HOMMEL. Certainly in retrospect, as we look at it now. As we looked at it then, looking at the New York Stock Exchange investigation and the results of it and Mr. Gruttadauria's statistics, there was nothing to indicate to us at that point that whatever commission level Mr. Gruttadauria earned in 1998 and 1999, was through the use of anything but trading on a legitimate basis with his accounts.

Mr. LATOURETTE. And Mr. Kaplan, back to you. We've heard talk about the 1993 anonymous complaint filed with the Securities and Exchange Commission and how that was resolved. Were you aware of that, sir?

Mr. KAPLAN. No. As I indicated, SG Securities did not acquire the firm until five years later. We first learned of this anonymous complaint as it hit the press yesterday. We have checked our records and we have seen no evidence of that in any of the due diligence or in his files.

Mr. LATOURETTE. And Mr. Hommel, the same question to you. Before it was reported in the press, yesterday, did you have any indication of this 1993 complaint?

Mr. HOMMEL. No, none whatsoever.

Mr. LATOURETTE. Mr. Kaplan talked about perhaps this was a fellow who was engaged in a rather elaborate scheme, sort of indicating a uniqueness to it, but what Mr. Gruttadauria was up to was not unique at all. This has happened before, has it not, this same pattern of behavior, Mr. Hommel?

Mr. HOMMEL. I don't see this as a pattern of behavior that we have experienced before.

Mr. LATOURETTE. You do not see it?

Mr. HOMMEL. No, if you're referring to—

Mr. LATOURETTE. Let me get to that. I think that Mr. Daouk and when you were in my office, you indicated that Mr. Daouk is different because he was a referring broker, as opposed to someone who is an employee and I guess that I became surprised then when I read the District Court decision from 1998 that indicated that Lehman effectively made WIS, Mr. Daouk's company its de facto branch office. And as I understand the facts in the Daouk case which is currently—is it resolved yet?

Mr. HOMMEL. No, it's still pending.

Mr. LATOURETTE. Then it was pending at the time that you were doing your due diligence in an attempt to purchase SG Cowen's retail business, was it not?

Mr. HOMMEL. It was.

Mr. LATOURETTE. It's my understanding that in the Daouk matter, Mr. Daouk had created new signatures for clients to allow them to authorize future transactions, that he had prepared and distributed forged monthly account statements, that he had used a personal off-network computer and that he had established post office boxes where he intercepted the client information sent from Lehman and that he churned accounts in order to generate excess commissions which were shared by both he and Lehman Brothers.

Is it your observation that that pattern of conduct that Mr. Daouk is accused of engaging in is significantly different from Mr. Gruttadauria's behavior?

Mr. HOMMEL. I do.

Mr. LATOURETTE. And can you explain to me why you think that is so?

Mr. HOMMEL. I think that because first, Mr. Daouk was never an employee of Lehman Brothers. He was never an employee of Shearson Lehman Brothers. He was an employee of E.F. Hutton back in the mid-1980s in its Beirut office. E.F. Hutton closed its Beirut office in 1986 and the office was taken over by a firm called World Investor Services which never had any direct affiliation with Shearson Lehman Brothers or Lehman Brothers. I think the passage you're referring to is the court's recitation of an allegation in the complaint.

However, the fact is that World Investor Services entered into an introducing broker relationship with E.F. Hutton to which Shearson Lehman Brothers succeeded when Shearson bought Hutton in late 1987 or early 1988. That contractual relationship persisted through 1992 when the business left us. Mr. Daouk worked for an introducing broker that referred accounts to E.F. Hutton and later to Shearson Lehman Brothers. They were the primary point of contact with those clients. The clients were predominantly Lebanese nationals with some Saudi nationals. The accounts were largely opened in the mid-1980s when there was a civil war in Lebanon. Mail service was sporadic, if existent at all, and post office boxes to my understanding, were in wide use. In any event, we never had direct contact with these clients. Mr. Daouk, as the referring broker, did. He also took discretion on the accounts so that Shearson Lehman Brothers and Hutton before them, essentially acted as a clearing broker for these trades.

Mr. LATOURETTE. The two accountant firms, accountancy firms that Mr. Gruttadauria established, I'll find my notes, but basically where these statements were going, WJS and DH—

Mr. HOMMEL. One is an actual accounting firm.

Mr. LATOURETTE. Which one is an actual accounting firm?

Mr. HOMMEL. I believe it's DeGrandis and DeGrandis.

Mr. LATOURETTE. Okay. And then how many of the fraudulent statements were going to—the real statements were going to that accounting firm.

Mr. HOMMEL. There's a universe of 40 accounts that were transferred over. There were 60 accounts for which false accounts were created, but a number of them had—they were fictitious in their entirety, that is, there was no corresponding Lehman Brothers account. For the 40 accounts that came over from Cowen for which fictitious account statements were created, but for which real accounts did exist, 30 of those account statements were diverted to one or the other of the accounting firms. Seventeen, I believe, went to JYM Accounting. JYM had a post office box. Those 17 were—17 of the 18 of the accounts that had post office boxes. The other one happened to be a legitimate account so that the customer was actually getting the fake statement and the real statement with the same number at the same address. However, 30 of the 40 went to

the accounting firms. Seventeen of them went to the post office boxes in the name of JYM.

Mr. LATOURETTE. Were you in the room when the first panel testified?

Mr. HOMMEL. I was.

Mr. LATOURETTE. You had the opportunity to listen to those folks. The exhibits that we put up relative to the activity, just based upon your experience and how you guys run your firms, the activity of Mr. Fazio's account in 1990 that we had on the chart, is there anything that in your experience would have triggered perhaps an inquiry by members of your firm had you been aware of it?

Mr. HOMMEL. I think that those numbers may have triggered some type of response from compliance supervisory systems, but to say out of context right now what our reaction would have been back then had it been us instead of some other firm, I don't think that I can speak to that.

Mr. LATOURETTE. How about you, Mr. Kaplan?

Mr. KAPLAN. I have the same response. Without knowing Mr. Fazio and what his intentions are and investment philosophy, it is hard for me to speculate as to what actions would have been taken at the time.

Mr. LATOURETTE. Do you think, when we were talking to Ms. Richards from the SEC, that perhaps it would at least cause you to make an inquiry of the investor? Were they sort of this hyperactive investor that wanted to turn over their account 18 times in six months?

Mr. KAPLAN. It is traditional in our industry that our compliance officers, when they see an account with an unusual activity, that they will make contacts with the client to ensure that that trading is consistent with what they want.

Mr. LATOURETTE. How about you, Mr. Hommel?

Mr. HOMMEL. I would agree with Mr. Kaplan's statement on that point.

Mr. LATOURETTE. Thank you very much. Thank you, Madam Chairman.

Chairman KELLY. Thank you very much. The questions here, I know that they seem difficult, but on the other hand, they're very, very important to us in terms of understanding what has gone on here and what our need is to respond to this.

I'd like to address a question to you, Mr. Sibears. Since we know that the SEC had a clear indication of churning in 1993, and the stock exchange performed some review of the Gruttadauria accounts in 1994 which might have caught him, I have to ask you, did the NASD ever review specific customer account statements of Gruttadauria clients?

Mr. SIBEARS. Chairman Kelly, we have gone back and done an exhaustive review of the records of the exams that we've conducted of firms that Mr. Gruttadauria was associated with and we've not been able to detect any accounts that we have reviewed in the course of examination program that were accounts of Mr. Gruttadauria's clients.

Chairman KELLY. Mr. Sibears, I find that a very interesting statement since there was obviously some question here in 1993.

Again, 1998, there were some flags raised and yet there's no record of your looking back at what happened here, is that correct?

Mr. SIBEARS. Well, we certainly have a record of what examinations that we conducted that related to the firms in question, but as Mr. Doherty testified to, the New York Stock Exchange has a number of firms that are members of the New York Stock Exchange. I don't believe, at least his oral testimony, mentioned the fact that some of those firms, in fact, virtually all of those firms, not everyone, are dual members of the New York Stock Exchange and the NASD. And we have a very highly cooperative program between the New York Stock Exchange and the NASD that is designed to ensure that firms do not receive any kind of regulatory overlap or unnecessary duplication.

So, for example, in a firm like these that we've been talking about, when we did our reviews of Cowen and Lehman, our focus tended to be not on financial issues or operational issues, but on things that were unique to our jurisdiction such as municipal underwritings, private securities transactions, trading of market making rules that are unique to our authority as a regulator so as to avoid the overlap. So in this kind of instance, it wouldn't be particularly unusual.

Chairman KELLY. On page 5 of your testimony, sir, you go into great detail about the number of scams that the NASD has found that are carried out through the use of bogus post offices or bogus addresses. You mentioned that you sent a member alert highlighting that concern to your member firms. Can you tell me when you sent that member alert?

Mr. SIBEARS. Yes. We sent that on January 28th and what we did was—

Chairman KELLY. January 28th of this year?

Mr. SIBEARS. 2002 and it was posted to our website which we—is our standing operation procedure now, to get the broadest attention and audience.

Chairman KELLY. You also mentioned that you revised your examination procedures with this regard. Can you tell me when you made those revisions?

Mr. SIBEARS. That was earlier in this year and the revisions that we talk about in that testimony were directly related to the Gruttadauria matter. We did have certainly a number of very extensive supervisory procedure examination steps, but those procedures in that exam protocol was refined as a result of this matter.

Chairman KELLY. All right, thank you very much. I have one question for all of the witnesses and that is do you think that the regulators need any new authority to enable them to specifically detect this type of fraud, the type of fraud that was demonstrated by Mr. Gruttadauria and I'm asking all of you.

Mr. Lackritz, why don't we start with you?

Mr. LACKRITZ. Thank you, Madame Chairwoman. We would strongly support increased resources for enforcement of the SEC as I mentioned in my testimony. We strongly appreciated and supported your Committee's action to increase the authorization of the SEC, specifically for enforcement activity and I think that's the main area that we would recommend changing.

Chairman KELLY. Mr. Skolnik, have you a comment?

Mr. SKOLNIK. Madame Chairwoman, I believe that the securities laws presently in place and the authority that state regulators, as well as federal regulators and SROs have is adequate. I do concur, I think that regulators at all levels probably need more resources to deal with the demands that have been created by just the vast increase in the number of investors who have entered our capital markets in the last couple of decades.

Chairman KELLY. Mr. Sibears?

Mr. SIBEARS. With the caveat, Madame Chairman, that hopefully we can supplement the record after we talk about this a little bit more back at the NASD because I've been thinking of your question since you asked Mr. Doherty and Ms. Richards. I think it's an incredibly important question, but it strikes me that we have very good and very broad authority and the important thing is the ability to both try to be very proactive and catch these problems through our processes before they occur and have the flexibility to very quickly amend our procedures and refocus our examination and enforcement programs once something is brought to our attention which, for example, in this case, we were able to do. But I would hope to be able to possibly even respond to this while the record is open more fully.

Chairman KELLY. Mr. Hommel, Mr. Kaplan, would either one of you like to respond?

Mr. HOMMEL. We believe that the current regulatory scheme is adequate to protect the interest of investors. We firmly believe that actually our compliance systems were the reason that Mr. Gruttadauria's scheme came to an end.

Chairman KELLY. Mr. Kaplan?

Mr. KAPLAN. I would agree that increased resources is critical for the SEC and its audit function. However, these regulators cannot be everywhere. They cannot look at every account and I think each member firm, has an obligation to make sure that we maintain a review of our clients, a review of our employees. That obligation is on us as well.

Chairman KELLY. Thank you. Thank you very much. Ms. Tubbs-Jones, do you have any more questions for this panel?

Ms. JONES. Lots. I only have 5 minutes. Mr. Hommel, did you say that you believe it was your compliance system that brought to light the conduct of Mr. Gruttadauria?

Mr. HOMMEL. We think that our compliance systems contributed to the fact that he went underground when he did.

Ms. JONES. Now there's a difference in contributing and bringing to light. You do understand the distinction between the words?

Mr. HOMMEL. I didn't mean to say anything other than that our compliance systems contributed to the fact that he did.

Ms. JONES. I accept that change in your statement, sir. Did you also say that you had an asset agreement that when the—the accounts transferred from SG Cowen or whatever the name of the company—

Mr. HOMMEL. We purchased assets from SG Cowen. The assets were the accounts.

Ms. JONES. And did you say that your agreement, in the agreement you did not accept any liabilities?

Mr. HOMMEL. No, the agreement we feel is quite clear that any liabilities that arise from the operation of that business prior to the closing date of the transaction remained with SG Cowen.

Ms. JONES. But any liabilities that result from any conduct after the date of that transaction, you are responsible for?

Mr. HOMMEL. That's correct.

Ms. JONES. Is that a fair statement?

Mr. HOMMEL. That is a fair statement.

Ms. JONES. Making that statement then, can you tell me when you will respond to all these folks seated in the audience for that liability?

Mr. HOMMEL. Well, we have responded to some of them, as I said in my opening statement. We have reached interim resolutions with some of the clients where we've identified misappropriated funds. We have credited those clients. If I may, with respect to the folks in here and many other folks, we're in a difficult position in that the assets that came over were pretty much static when they hit Lehman Brothers. That is, there was no change in their actual financial situation. That is a generalism, but largely true throughout the 40 accounts for which false statements were produced.

Ms. JONES. That's your allegation. According to all these people in the room the accounts have changed significantly since the time they came from Cowen to Lehman.

Mr. HOMMEL. I don't know that that's what they say because when they came in, the false account statements carried very large balances which over time have not tremendously declined.

Ms. JONES. So you're saying that most of the people in this room were not damaged by the conduct of Mr. Gruttadauria?

Mr. HOMMEL. No, I'm not saying that at all.

Ms. JONES. I don't want to press words with you. Let me move on, okay?

Mr. Lackritz, in your statement, you say that there are three levels of regulation or supervision in your industry. The first level is investor protection from the brokerage firm. The second is the self-regulatory organizations and the third is the Securities and Exchange Commission.

Mr. LACKRITZ. Yes.

Ms. JONES. If you were called as an expert witness in the lawsuit, all of these good folks against Lehman Brothers, what level and I will ask you in your opinion, based on your background and experience, sir, at what layer was there a breakdown? What layer would that be, 1, 2 or 3? A breakdown in the supervision to avoid what we have in place, the losses we have in place today, sir.

Mr. LACKRITZ. That's a very tough question to answer, Congresswoman.

Ms. JONES. I know I ask tough questions. So give me a tough answer, sir.

Mr. LACKRITZ. I'll do my best.

Ms. JONES. Okay.

Mr. LACKRITZ. I think that's what the litigation and the enforcement actions are in the process of uncovering right now. There are facts in each of these circumstances with respect to each of these firms. Obviously, there was a breakdown in the system and obviously, this was an incident that—I'm embarrassed to be here. I'm

apologizing on behalf of the industry to the victims. In terms of—it was a breakdown throughout the process.

Ms. JONES. So you would assess blame at every level of supervision? Or responsibility?

Mr. LACKRITZ. Yes, responsibility certainly.

Ms. JONES. So what would you do to improve, improve every level?

Mr. LACKRITZ. I think that we have continually place emphasis on improving compliance systems and technology in the firms which we're doing. We have to continue to increase investor education which we're doing and improve compliance programs.

Ms. JONES. Thanks. I've got one last round of questions.

Mr. Skolnik, let me back up, real quick. Mr. Hommel, did you say you didn't learn until very recently about the 1993 case, sir?

Mr. HOMMEL. That's correct.

Ms. JONES. And Mr. Kaplan, you said the same thing. Is that correct?

Mr. KAPLAN. That is correct.

Ms. JONES. Then Mr. Skolnik, how could every day Joe and Stephanie call the NASSA or their state security regulator to find out about Frank Gruttadauria if neither of these companies who specialize in hiring brokers knew about the 1993 conduct, sir?

Mr. SKOLNIK. Congresswoman, it's very clear here that these investors were vigilant. As we heard today from the testimony that I think touched us all, they did carefully scrutinize account statements and did ask, I think Mrs. Stout talked about how she challenged Mr. Gruttadauria and did ask questions.

One thing investors can do is to contact their state securities regulator to inquire whether the investment professional, the stock broker or investment advisor they're dealing with is properly licensed to be conducting business and to determine if they have any disciplinary history.

In this case, unfortunately, it would not have necessarily have detected any wrongdoing on behalf of Mr. Gruttadauria because he did not have a disciplinary record. However, in a lot of cases, a lot of enforcement cases and investigations that we initiate, we see situations where if investors had taken the opportunity to contact a state securities regulator, they would have learned that the investment professional they are dealing with may have had a disciplinary record or worse yet, maybe was not even properly licensed to conduct business.

Chairman KELLY. Thank you, Ms. Tubbs-Jones.

Ms. JONES. Thank you, Madame Chairwoman.

Chairman KELLY. Mr. LaTourette.

Mr. LATOURETTE. Thank you, Madame Chairwoman. I'd like to throw this open to anyone on the panel because it's a question that comes up from time to time. Is there a recognized rule of thumb for what the measure of damages should be in the situation that we find ourselves in today?

Mr. Hommel?

Mr. HOMMEL. Given the pendency of litigation, I'm a bit restrained in what I can talk about. There are several theories of recovery that have been advanced by the plaintiffs.

Mr. LATOURETTE. I'm not interested in their theories. I guess I'm wondering in cases that you've encountered during the course of your career is there sort of a rule of thumb that this is what this kind of theft is worth?

Mr. HOMMEL. I've not encountered a case specifically like this in my career, but I would imagine that in approaching the situation, what we try to do is define common ground with the complaining customers' rooted in the actual cash flows. That has been something that has prevented us from moving along in the negotiations with some of these folks because, as I said, the cash flows at Lehman Brothers simply did not exist in many of these accounts.

Mr. LATOURETTE. Anyone else have an observation about how these things are normally taken care of?

Mr. LACKRITZ. I think that in almost all of these situations, it's the responsibility of the firm to make their clients whole or to treat their clients fairly and in almost all of these situations when they occur and it's very rare that they occur. I think it's important and I want to stress, the system actually works very effectively. Unfortunately, there are these rare instances when this kind of behavior occurs and when it does, the firms take responsibility to treat their customers fairly and make them whole in the circumstance.

Mr. LATOURETTE. And I think as I understood Mr. Hommel, we can have different definitions of what making them whole means, but is there any notion in this type of litigation relative to punitive damages as opposed to negligence or not paying attention or when someone actually goes out and steals, it's under your supervision as appears to be the case here, is there any notion of punitive damages in any of the cases that you're aware of? If you know. If you don't that's fine. I'm talking to you, Mr. Lackritz, I'm sorry.

Mr. LACKRITZ. I'm only aware of punitive damages in very rare and unusual instances where there's gross and willful negligence as opposed to failure to supervise or something like that.

Mr. LATOURETTE. But in essence, if gross negligence gives you punitive, I suppose intentional actions are even higher than gross negligence and the other observation I would make is that Mr. Hommel has never seen the situation, I guess, I would describe this as unique, based upon the breadth of his experience.

Mr. Hommel, let me—you talked about due diligence when Lehman bought the business from SG Cowen. Can you describe in a little detail for us what that means and specifically does due diligence include going into each and every one of Mr. Gruttadauria's accounts and physically looking at them or not?

Mr. HOMMEL. No, there would be no reason to go into Mr. Gruttadauria's accounts at that point. There were almost 100 brokers who came over with accounts that numbered in excess of 60,000, so it would require going into 60,000 accounts which is fairly impractical. What we did was we reviewed the compliance records of every one of the brokers who were coming over and for each broker who had one or more entries on his compliance record, complaints on his compliance record, we gave them special scrutiny. We also did an analysis of the customer complaints throughout the Cowen system and we checked all the arbitrations and litigations that were pending against any of the registered representatives in the system.

We looked at the Cowen audits going back several years to see what was turned up, all of which is, I would submit, somewhat standard, but in this instance we also took a look at the New York Stock Exchange report and the New York Stock Exchange report had several issues that needed to be dealt with. As we look back, it appeared that a prominent New York law firm had come in, had assisted Cowen, in addressing those problems, had made recommendations that were subsequently adopted and as we looked at that incident as a whole it appeared to us, not as a red flag, but as an indication that Cowen had been inspected and corrected.

Mr. LATOURETTE. When you say that you looked at any complaints filed against the brokers that came over, we know today that a complaint was filed against Mr. Gruttadauria in 1993. Are you saying that the only complaints that you looked at were those that resulted in a finding, some sort of adverse finding?

Mr. HOMMEL. No, we looked at complaints that were on the CRD, the Central Registration Depository. There are certain requirements that a broker must report, complaints to the CRD, so we get the broker's registration file, which is the CRD file, and we see any complaints that have been registered against that broker. For reasons that were explained before, apparently, this 1993 incident did not make it on to Mr. Gruttadauria's compliance record.

Mr. LATOURETTE. Okay. I thank you. I don't think I have anything else.

Chairman KELLY. Thank you very much. The Chair notes that some Members may have additional questions for this Panel and they may wish to submit them in writing, so without objection the hearing record is going to remain open for 30 days for Members to submit written questions and for these witnesses to place their responses in the record.

The Chair also notes that Mr. Fazio and Ms. Stout have stayed for this Panel's testimony and let me say that I sincerely hope for both of them that this hearing and that their testimony will result in better protections for all investors. We appreciate the fact that they came such a distance and took so much time and I think it's incumbent of all of the agencies that have been here, giving testimony today that they understand that this is not—it cannot be business as it has been in the past. We must have better regulatory oversight so this kind of thing and these kinds of people are never again damaged. We must have a change. If you need this to come from the federal government in the form of a law, then we will do it. We need to do whatever we can to help the people of this nation feel that they cannot lose their entire savings when they put their savings in the trust of someone like Mr. Gruttadauria.

I will excuse the second Panel with our great appreciation for your time. I want to briefly thank all of the Members and their staffs, but also I want to thank my counsel, Mr. Andy Cochran, for his terrific work on this panel and the other staff here on this Financial Services Committee. They've worked very hard on this hearing and I thank them for their assistance in making the hearing possible.

This hearing is now adjourned.

[Whereupon, at 1:00 p.m., the hearing was concluded.]

# A P P E N D I X

May 23, 2002

# Opening Statement of Chairwoman Sue Kelly Oversight and Investigations Subcommittee Hearing on "One Broker Gone Bad: Punishing the Criminal, Making Victims Whole"

**Thursday May 23, 2002; 9:30 am; 2128 Rayburn**

On January 11, 2002 Frank Gruttadauria, a Cleveland branch manager and broker, mailed a letter to the FBI admitting to fifteen years of willful fraud and theft of his clients' savings and disappeared. In the aftermath of this revelation, law enforcement, the regulators, the successive owners of that branch, and Gruttadauria's clients began to uncover the extent of this one broker's deceitfulness and the intricate web of lies he employed to perpetrate his fraud. We do know that Mr. Gruttadauria is accused of stealing at least $40 million of his clients' savings while sending his clients fake statements stating that their savings had grown to an estimated combined total of $260 million.

Today Mr. Gruttadauria is in federal custody after less than a month of being on the run. It appears that his efforts to evade detection by the firms and regulators were much better than his ability to evade the law. One issue is clear: Mr. Gruttadauria and any who assisted him will be punished for their crimes. From my initial review of this case Mr. Gruttadauria had the ability to perpetrate this fraud because of his position in the Cleveland branch as both the manager and a broker. This put him in the position of supervising himself -- a key point of this case.

Another key point is the lack of complaints in regard to Mr. Gruttadauria's actions. The majority of investigations against problem brokers appear to be triggered by five or more complaints. Since Mr. Gruttadauria was able to send false statements to his clients and forged any authorization he needed, he appears to have avoided scrutiny incurred through traditional warning signs.

The purpose of this hearing is to examine this case in an effort to determine what steps are warranted to ensure that similar fraud and theft is prevented. Our responsibility is to ensure that scams such as this will not go undetected again. In order to do this, we must take a step back from the particulars of this case and examine the systems that firms and regulators have in place to detect such fraud by manager-brokers. We know that the securities industry is full of very intelligent individuals who, if they put their mind to it, could potentially inflict a great deal of harm on the savings of many families and investors. To preserve and bolster investor confidence, we must gain an understanding of how the current systems were defeated so consistently by Mr. Gruttadauria.

I want to thank all of our distinguished witnesses for taking the time out of their busy schedules to join us here today. The committee understands the constraints that some of our witnesses are under and their inability to discuss some of the specifics of the case due to ongoing nature of the Gruttadauria investigation. The last thing we want to do is inadvertently harm the prosecution of Mr. Gruttadauria or any of his accomplices. We appreciate your willingness to come here today to discuss the issues to the best of your ability.

**Opening Statement**

# Chairman Michael G. Oxley

## Committee on Financial Services

**Subcommittee on Oversight and Investigations**
**"One Broker Gone Bad: Punishing the Criminal, Making Victims Whole"**
**May 23, 2002**

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Good Morning. I want to take this opportunity to thank the Chairwoman of the Subcommittee on Oversight and Investigations, Congresswoman Sue Kelly for this important hearing.

The subject of today's hearing, stock broker Frank Gruttadauria, had as many as 470 clients during the height of his success, earning more than $6 million in commissions in a good year.

For some unknown reason, that was apparently not enough. It appears that over 15 years, Mr. Gruttadauria sent false statements to two dozen or more of his clients. It is further alleged that over that same 15-year period he misappropriated possibly hundreds of millions of dollars (somewhere between $125 million and $700 million) from those clients, several of whom treated him as warmly as they would members of their own families. One client even made him the executor of his estate.

He was never caught. Apparently feeling that he was on the verge of being found out, he called his activities to the attention of the Federal Bureau of Investigation (FBI), fleeing to Colorado where he eventually surrendered to authorities.

State and Federal authorities as well as the brokerage firms which employed Mr. Gruttadauria are continuing their months long efforts to uncover the extent of his activities and we can only hope that those efforts will bring a sense of closure to his many victims and their families.

It is my sincere hope that our efforts today will be of help in this ongoing investigation. We will have the opportunity to hear directly from several of Mr. Gruttadauria's victims and we will learn first-hand from them how he concocted a scheme whereby he misdirected their brokerage-account statements to post office boxes which he rented and personally controlled. Mr. Gruttadauria then created false statements in order to mislead his clients about the real value of their investments.

Although some may feel that outrages of the sort inflicted by Mr. Gruttadauria upon his trusting clients are systemic, the efforts being undertaken by the law enforcement, prosecutors, SEC, NYSE, Lehman Brothers, and SG Cowen Securities would certainly indicate that this is not the case. Hindsight is always perfect, yet our examination revealed that there were missed opportunities for the various authorities to stop Mr. Gruttadauria's criminal activity.

The presence of representatives today from the Securities and Exchange Commission (SEC), the New York Stock Exchange (NYSE), the Securities Industry Association (SIA), the National Association of Securities Dealers (NASD) and the North American Securities Administrators underscores their commitment to ensure that violations of securities law such as this particularly egregious case do not occur in the future. I look forward to hearing from them today about those efforts.

Let me also note that the Financial Services Committee was pleased to work with the SEC in order to provide it with a significant increase in its budget to allow for a much-needed escalation of its enforcement abilities. Apparently, the SEC also had some information years ago on Gruttadauria. I also look forward to hearing from the SEC about how it will improve its processes.

Thank you again, Madame Chairwoman. I have every confidence that individual investors will benefit from your serious review of this case.

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# OPENING STATEMENT

One Broker Gone Bad: Punishing the Criminal, Making Victims Whole

Subcommittee on Oversight and Investigations

5/23/02

**Rep. Stephanie Tubbs Jones**

Good Morning, Chairwoman Kelly, Vice Chairman Paul, Ranking Member Gutierrez and Members of this Subcommittee. Madame Chairwoman, I ask unanimous consent that my full statement be included in the Record.

This subcommittee often finds itself in the unenviable yet vitally important position of reviewing incidents of financial fraud, theft and general corruption. As is the case today, this committee often listens to testimony of witnesses or victims whose trust and kindness have been exploited for the benefit of a few misguided and unethical individuals. This testimony is often the most powerful because it is genuine and real. It is our job as Members of Congress to sit and listen intently; constantly trying to keep our heartfelt sympathies for the victims of these crimes from clouding the objectivity that we must maintain. Today this testimony will be amplified because many of the stories that we hear today took place in the district that I represent, the 11th District of Ohio.

The story of Frank Gruttadauria is, frankly, shocking. It has been alleged that Mr. Gruttadauria stole tens of millions of dollars from dozens of clients from all over including primarily my home state of Ohio. This fact in and of itself is not what is shocking; what is shocking, is that he stole this money over a period of 15 years and did so while heading the Cleveland, Ohio branch of a major brokerage firm. How can this be?

How was Mr. Gruttadauria able to gain the trust of so many prominent Ohio families in so little time? Why wasn't his falsified resume was not more carefully scrutinized before he ascended to the ranks of Branch Manager of a major metropolis brokerage operation? Additionally, why weren't the regulatory agencies responsible for the oversight of such activities able to pick up on the fact that Mr. Gruttadauria was stealing millions of dollars from his clients over a period of 15 years, even after the NYSE had fined SG Cowan for violations regarding oversight of its brokers while Mr. Gruttadauria was employed with them? Finally, I wonder how after 15 years of lying and stealing Mr. Gruttadauria was brought into custody only after overwhelming guilt apparently forced him to turn himself in?

Although the answer to the question 'Why?' can only be addressed by Mr. Gruttadauria, we must also look to the oversight practice and polices of corporate and regulatory bodies for the more important answer of 'How?' A letter to the FBI written by Mr. Gruttadauria himself sheds some light on this question and in fact exemplifies our purpose here today. The letter reads, "The various firms' greed and lack of attention [to him] on a senior level contributed greatly" presumably to his ability to steal the funds. "I can hardly believe that I could have done this without detection for so long."

I look forward to the insight that this hearing may bring regarding how this scam was able to succeed. Hopefully as a result, we can look forward to the Gruttadauria's of the world spending their time wondering how they got caught, instead of how they didn't.

Madame Chairwoman, I thank you for my time.

Opening Statement of Mr. Steven C. LaTourette

I would first like to thank Mrs. Kelly and the chairman of the full committee, Mr. Oxley, for convening this hearing, and also for the staff on the committee for doing yeoman's work in preparation of today's discussion.

Madam Chairman, many of us in the Cleveland area were startled when we read that a broker for Lehman Brothers, Frank Gruttadaria, had fled town leaving a note and computer disk for authorities admitting to bilking the firm's clients out of an estimated $300 Million.

His victims ranged from some very wealthy folks to moderate income people who were investing for their retirement years. By maintaining a desktop computer, setting up a phony post office box, mailing fraudulent statements, and juggling funds, it appears that Mr. Gruttadaria was able to craft a ponzi scheme that lasted for 15 years and only collapsed because of a cash call on a large account and the persistence of Golda Stout of Elgin, Illinois, who we will hear from today.

Some will come before the subcommittee today and say that this was one very crooked broker gone bad and while it's unfortunate, there are no systemic difficulties or problems that require attention by this or any other committee. That might be the case if there were not some historical context and warning signals marking Mr. Gruttadaria's career with S.G. Cowen and Lehman:

1. In 1993 in response to a complaint, the SEC discovered that Gruttadaria was churning an account of another Illinois woman- turning a $90k account over 18 times, with losses of $80k but commissions of $39k. No action was taken.

2. In 1998, Cowen was fined by the NYSE $380,000 for activity on accounts in Boston and Cleveland, including activity by Gruttadaria, but apparently no red flags were raised.

3. At the same time Lehman was negotiating the purchase of Cowen's retail business, Lehman was aware of a scheme by one its brokers, Ahmed Daouk, who maintained a desktop computer, set up phony post office boxes, mailed fraudulent statements and juggled funds to steal from many clients, yet, their due diligence in examining the Cowen business failed to find the exact same conduct by Mr. Gruttadaria.

4. Mr. Gruttadaria's supervising partner at Lehman, I understand, earned a base salary of $450k, received bonuses of $8M and stock options of $29M during the supervision of Mr. Gruttadaria's operation, and I do think, with all due respect to our friends from Wall Street, that we need to examine if the Alfred E. Neuman motto of 'What me worry?" prevailed.

**TESTIMONY OF**

**LORI A. RICHARDS, DIRECTOR**
**OFFICE OF COMPLIANCE**
**INSPECTIONS AND EXAMINATIONS**

**U.S. SECURITIES AND EXCHANGE COMMISSION**

**CONCERNING**
**ISSUES RAISED BY THE FRANK D. GRUTTADAURIA MATTER**

**BEFORE THE SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS**

**COMMITTEE ON FINANCIAL SERVICES**

**U.S. HOUSE OF REPRESENTATIVES**

**MAY 23, 2002**

U. S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Testimony of

Lori A. Richards, Director

Office of Compliance Inspections and Examinations

United States Securities and Exchange Commission

Before the Subcommittee on Oversight and Investigations,

Financial Services Committee

U.S. House of Representatives

Concerning Issues Raised by the Frank D. Gruttadauria Matter

May 23, 2002

Chairwoman Kelly, Ranking Member Gutierrez, and members of the Subcommittee:

I appreciate the opportunity to appear before the Subcommittee today on behalf of the Securities and Exchange Commission ("Commission") to discuss the Frank Gruttadauria matter, the system of regulation and oversight of broker-dealers, and potential measures to prevent future losses. As evidenced by the Commission's recent enforcement action, the Commission is extremely concerned about the alleged fraudulent activity by Gruttadauria and has taken action to address it. As the Subcommittee has requested, I will first provide you with an overview of the Commission's enforcement action against Gruttadauria.[1] I will discuss how broker-dealers are regulated, their own supervisory responsibilities over their registered representatives, and certain compliance practices they can follow to prevent the misappropriation of customer funds. Finally, I will describe some of the steps that investors can take to protect themselves against unscrupulous brokers.

## I. SEC v. Frank Gruttadauria

On February 21, 2002, the Commission filed an action in Federal District Court[2] in Cleveland, Ohio against Gruttadauria alleging that he stole at least $40 million from

[1] Testimony concerning Gruttadauria's conduct is confined to allegations contained in the Commission's complaint.

[2] SEC v. Frank D. Gruttadauria, et al. No. 1:02CV324, (N.D.Ohio, February 21, 2002).

more than fifty clients while employed as a registered representative with several broker-dealers.[3] The Commission's complaint charges Gruttadauria with violating the anti-fraud provisions of the federal securities laws. On February 26, 2002, the Court entered a temporary restraining order against Gruttadauria and froze his assets. Then, on March 11, 2002, the Court granted a preliminary injunction against Gruttadauria and continued the freeze on his assets.

The Commission's complaint alleges that over a 15-year period Gruttadauria misappropriated customer funds for his own purposes, directing the funds to other customers' accounts either as purported returns or to satisfy withdrawal requests. He forged client signatures on withdrawals, made unauthorized transfers of funds, and took customer funds, purportedly to open accounts, but never actually opened those accounts.

According to the Commission's complaint, Gruttadauria was able to perpetrate this fraud, in part, by creating and sending false account statements to customers that greatly overstated the value of the customers' accounts. These statements also reflected holdings that did not exist and securities transactions that had never occurred. He also failed to disclose unauthorized withdrawals from the accounts. To further conceal his fraud, Gruttadauria then caused the clients' actual account statements to be sent to entities or post office boxes under his control.

The Commission's complaint also accuses Gruttadauria of materially misrepresenting the value of the positions held in customer accounts, often falsely telling customers that their accounts contained a wide variety of holdings worth millions of dollars. According to the Commission's complaint, the most recent false statements for the accounts of at least 50 of Gruttadauria's customers reflected an aggregate value of about $278 million, whereas the actual value of accounts held for these customers at Lehman was about $1.8 million.

The Commission's complaint also charges two entities controlled by Gruttadauria, DH Strategic Partners, Inc., and JYM Trading Trust, which the Commission alleges were used by Gruttadauria to misappropriate funds from his clients. The Commission's action names three relief defendants, Laurene English, Sarah Emamy, and Charlie Whiskey, LLC., alleging that they were unjustly enriched by Gruttadauria's fraudulent conduct. Specifically, the complaint alleges that Gruttadauria transferred funds, real property and automobiles to these relief defendants.

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[3] In December 1980, Gruttadauria became a registered representative with L.F. Rothschild & Co., Inc. In November 1987, Gruttadauria moved to Hambrecht & Quist, Inc. In May 1989, Gruttadauria joined the Cleveland, Ohio office of Cowen & Co.("Cowen"), and in 1991, he became the manager of that office. In July 1998, Societe Generale purchased Cowen and changed the name from Cowen to SG Cowen Securities Corporation ("SG Cowen"). In October 2000, Lehman Brothers, Inc. ("Lehman") purchased the Private Client Group division of SG Cowen, which included the Cleveland office where Gruttadauria worked. According to Lehman, the group, which serviced high net worth clients, was comprised of 92 registered representatives and approximately 60,000 accounts.

The Commission's enforcement staff is continuing to investigate this matter, including whether any other persons or entities may have violated the federal securities laws.

## II. The Regulatory Framework for Broker-Dealers

Self-regulation is the linchpin of the federal regulatory system for broker-dealers. At the most basic level, firms are responsible for their internal supervisory and compliance systems. Second, these efforts are supervised by the self-regulatory organizations ("SROs"). Finally, the Commission oversees the efforts of the firms as well as the SROs. In addition, the state securities regulators also regulate the activities of broker-dealers within their states. As a result of this system of self-regulation, the Commission is able to oversee a large and diverse population of broker-dealers with a small examination staff. At present, there are approximately 8,100 broker-dealers with 90,169 branch offices, employing 677,748 registered representatives. At the same time, the Commission deploys an examination staff of approximately 650, with 250 devoted to broker-dealer examinations.

### A. The Duty to Supervise

A broker-dealer's "duty to supervise" is a key aspect of the federal securities regulatory scheme. Under SRO rules, broker-dealers have an obligation to establish a system of supervision reasonably designed to ensure that their employees' conduct complies with the federal securities laws and SRO rules. There is no single supervisory or compliance system appropriate for all broker-dealers. The rules of the various SROs, as well as the Securities Exchange Act of 1934 ("Exchange Act"), anticipate that each firm will develop its own system of supervision to promote effective compliance with the federal laws and SRO rules based on the nature of the firm's business.

Specifically, broker-dealers' supervisory structure, policies, and procedures must meet the requirements of SRO rules governing supervision, including NASD Rule 3010 and NYSE Rule 342. These rules generally require that SRO member firms establish, maintain, and enforce written procedures to supervise the activities of the firm and its registered personnel, and to prevent violations of various securities laws and rules. Broker-dealers are required to designate qualified personnel, including registered principals, to carry out the firm's supervisory obligations, to have adequate controls in place to identify weaknesses and sales practice abuses, and to conduct a review of firm activities on a periodic basis through the internal inspection of its various office locations. In addition, broker-dealers' compliance departments also serve an important function in helping to ensure that firm employees are in compliance with securities laws. They review exception reports, investigate indications of irregular activity, and investigate customer complaints.

The Commission is authorized to sanction firms whose supervision falls below a reasonable minimum. Specifically, Section 15(b)(4)(E) of the Exchange Act provides for the imposition of a sanction against a broker or dealer who has failed reasonably to

supervise, with a view to preventing violations of the securities laws and regulations, another person who commits such a violation and is, subject to their supervision. The Commission has emphasized that senior management must ensure that adequate procedures are in place, that sufficient resources are devoted to their implementation, and that supervisory responsibilities be reassessed in light of changes in a firm's business operations.

B. Self-Regulatory Organizations

The SROs act as front line regulators of their member broker-dealers. As such, they adopt rules with respect to the conduct of their member firms, conduct surveillance and periodic examinations of their members to evaluate compliance, and bring disciplinary actions when their rules are violated.[4] The SROs examine every broker and dealer on a periodic cycle, varying from annually to once every four years, depending upon the type of firm and various risk factors.

C. The Commission's Oversight

The self-regulatory framework operates under the oversight of the Commission. While SROs have front line responsibility to oversee the conduct of their members, the Commission also regulates broker-dealers, conducts examinations of broker-dealers, and brings enforcement actions to enforce the federal securities laws and rules.

The Commission conducts three types of broker-dealer examinations: 1) oversight examinations; 2) cause examinations; and 3) surveillance examinations. Oversight examinations are conducted of firms that have been recently examined by an SRO, such as the NASD or NYSE, to evaluate the quality of the SRO's examination. Cause examinations are conducted when the Commission has a concern or an indication that a broker-dealer has engaged in or is engaging in violative activity. The focus of a cause exam is on those areas precipitating the examination. Surveillance exams focus on a particular practice or area.

In 1993, the Commission conducted a cause examination of the Chicago, Illinois office of Cowen, where Gruttadauria serviced some of his accounts, after receiving an anonymous oral complaint alleging churning in one of Gruttadauria's customer accounts. Based on this anonymous complaint, the Commission staff initiated an examination to review the account in which churning was alleged. While the examination noted significant trading in the customer's account, it appeared to be isolated to a few months in 1990, which was over three years prior to the examination. The account documents provided by the firm indicated that the customer was an experienced investor -- with an

[4] During this period, the NYSE examined Cowen and noted a number of supervisory deficiencies. As a result, the NYSE brought a disciplinary action charging Cowen with failure to supervise by failing to implement adequate systems and procedures to ensure supervision. These actions resulted in a censure, a fine of $380,000, and an undertaking to make a review of the firm's compliance system to determine the adequacy of the firm's systems and procedures.

estimated net worth of $5 million, and ten years experience trading options and a greater number of years experience trading equities and commodities. According to the registrant and Gruttadauria, the trades in the customer's account were largely unsolicited, meaning they were directed by the customer and not recommended by Gruttadauria. The examiner also reviewed a number of Gruttadauria's other accounts maintained at this branch office, to assess whether any pattern of churning existed, but found no such pattern. In addition, the firm represented that the customer never complained about the handling of her account. Due to these factors, the examination was unable to establish any indications of sales practice abuse in connection with the account sufficient to warrant further action.

The Commission conducted other examinations of Cowen, though not at the Cleveland office where Gruttadauria was employed. In examinations in 1990, 1994 and 1997, Commission staff reviewed a sample of customer accounts and customer complaints, in part to detect any sales practice problems.[5] These examinations resulted in deficiency letters.[6] To our knowledge, none of Gruttadauria's customer's accounts were reviewed in these examinations.

## III. Firm Practices That Can Serve to Detect and Prevent Misappropriation of Customer Funds or Securities

Many firms have in place procedures to help them prevent and detect theft by brokers. There are a variety of procedures firms are using to prevent theft by brokers, including the following:

- Verify Changes of Address With the Customer.
  Firms verify any changes of address by sending notices of the change to both the customer's old and new addresses. Additionally, a supervisor or firm compliance employee telephones the customer to verify the change of address.

- Review Changes of Address and Changes to Customer Account Information.
  Firms ensure that employees do not independently change customers' addresses and new account information without review by supervisors or compliance staff. Registered representatives do not have the ability to alter account statements on-line.

- Special Attention to P.O. Boxes and Addresses Other than Home Addresses.
  Firms closely scrutinize customers' use of any address other than their home address. Use of P.O. boxes, "in care of" addresses, and other than home addresses are prohibited, or verified by telephone and in writing directly with

[5] Commission staff also conducted discrete "cause examinations" of individual offices of Cowen for particular issues during this period, none of which involved the Cleveland office.

[6] A deficiency letter is a non-public document that delineates the results from a staff examination. Deficiency letters are sent after more than two-thirds of the OCIE staff's examinations.

the customer by a supervisor or firm compliance employee.[7] Duplicate confirmations and account statements are sent to the customer's home address, whenever possible.

- Confirm Customer Authorization to Transfer Funds.
  All transfers, withdrawals, or wires from the customer's account are confirmed in writing to the customer. Additionally, a supervisor or firm compliance employee verifies the transfer or withdrawal (the amount and the recipient, including the account number the funds are to be transferred to, if applicable) directly with the customer by telephone, at least on a sample basis and for any unusual transfers or withdrawals. Because pre-signed letters of authorization do not provide adequate assurance of authorization from the customer, they are prohibited. Customer signatures are verified. Furthermore, firms have procedures for supervision of third party wire transfers and checks, and particularly scrutinize transfers to accounts serviced by the registered representative or branch manager.

- Review for Unusual Activity.
  Firms focus on the possibility of abuse, and periodically and systematically review for indications of problems, such as: a registered representative that has a number of customers with non-home mailing addresses; any customer account that shows the same address as the registered representative; multiple changes of address by a customer or among customers of a registered representative; the use of the same address for multiple customers; or correspondence returned as undeliverable by the post office. Computer-generated exception reports are very effective in isolating indications of unusual activity.

- Investigate Unusual Activity.
  Firms carefully investigate unusual activity. Firm compliance employees or supervisors contact the registered representative and contact the customer directly to follow up on and investigate unusual activity.

- Independent Supervision and Review of Activity by Producing Managers.
  Firms have supervisory procedures in place to ensure that trading and other account activity in all managers' customer accounts is independently reviewed on a routine basis (by a firm employee who is not supervised by the manager and whose compensation is not controlled by the manager).

- Control Over Account Statements, Letterhead and Mail Facilities.
  Firms maintain control over their account statements, letterhead and mail facilities to prevent unauthorized use. Firms use watermarks, distinctive

[7] Some firms have obtained software from vendors that identifies non-home addresses, so that firms can carefully scrutinize these addresses and verify each address with the customer.

logos, holograms or colors that make duplicates of firm documents more detectable.

- Provide Customers with Account Information On-line.
  Firms provide customers with access to their account statements on a secure firm website so that customers can easily verify activity in their accounts. Firms apprise customers that on-line access to their account information is available. Account statements also include the phone number of the registered representative's supervisor, in case of any questions or problems with the account.

- Supervise Employees' Use of Personal Electronic Devices.
  Firms prohibit either employees' use of personal electronic devices (personal computers, blackberries) to conduct firm business or carefully monitor their use. Firms require that use of personal electronic devices be pre-approved and that they be linked with the firm's system to allow for supervisory review, or that data be periodically downloaded to the firm's system for review, or that a manager periodically review the contents of the electronic device.

- Firms Routinely Review Compliance with Policies and Procedures.
  Compliance with policies and procedures designed to prevent theft by employees is reviewed regularly during the branch compliance audit, including during unannounced compliance audits. In addition, firms' internal audit staff periodically review controls in this area.

This case highlights the importance of firm procedures to prevent and detect theft by employees. Securities regulators are paying particular attention in all sales practice examinations to determine whether firms maintain adequate procedures to prevent theft.

## IV. Investors Should Also Take Steps to Protect Themselves From Unscrupulous Brokers

While investors certainly do not bear responsibility for the fraudulent acts of others, investors can help to protect themselves. The Commission has an aggressive investor education program aimed at providing investors with information they may use to invest wisely. Investors can help to protect themselves by taking the following steps:

- Investigate Any Broker or Investment Adviser Before You Open an Account.
  You can verify your broker's disciplinary history by obtaining information from the Central Registration Depository ("CRD"). Either your state securities regulator or NASD Regulation, Inc. ("NASDR") can provide you with CRD information. You can find out how to get in touch with your state securities regulator through the North American Securities Administrators Association, Inc.'s website, www.nasaa.org. To contact NASDR, visit its website, www.nasdr.com, or call them toll-free at (800) 289-9999. The SEC publishes a brochure for investors called *"Invest Wisely: Advice From Your*

*Securities Industry Regulators."* It is available on the Commission's website at www.sec.gov.

- Read and Understand the New Account Form.
  Ask to see any account documentation prepared for you by the sales representative. Do not sign the new account form or margin agreement unless you understand it and agree to its conditions. Do not rely on any verbal representations from a sales representative unless they are contained in the agreement. Be careful about giving your sales representative "discretionary" authority to conduct transactions without your approval.

- Ask Questions.
  Make sure that you understand the risks, costs, and fees associated with any investment. Understand how the sales representative is paid. A good broker or investment adviser will welcome your questions, no matter how basic. Financial professionals know that an educated client is an asset, not a liability. The Commission publishes a brochure for investors called "*Ask Questions: Questions You Should Ask About Your Investments... And What To Do If You Run Into Problems.*" It is available on the SEC's website at www.sec.gov

- Read, Understand and Verify Account Statements.
  Never allow your account statements to be delivered or mailed to your sales representative as a substitute for receiving them yourself. Read all of your account statements. Make sure that you understand all the activity in your account. Compare confirmations of account activity with routine account statements. You can verify your account statements by accessing your account information on the firm's website, or by telephoning the firm's main office. Monitor your investments' value.

- Be Careful in Forwarding and Withdrawing Funds.
  Never provide your broker with cash or a check made out to a sales representative; make checks payable to the brokerage firm or an investment fund. Never send checks to an address different from the business address of the brokerage firm or a designated address listed in the prospectus. Do not provide your sales associate with pre-signed authorizations to transfer or withdraw funds from your account. Any transfers or withdrawals should be authorized by you in writing at the time you wish to transfer or withdraw funds.

- Be Alert to Any Signs of Irregularity.
  Be alert to irregularities including any unauthorized withdrawals or transfers, failing to receive confirmations or account statements, or delays in receiving funds withdrawn. Also, be wary of assurances from your sales representative that an error in your account is due solely to computer or clerical error. Insist that the branch manager or compliance officer promptly send you a written explanation. Verify that the problem has been corrected on your next account

statement. Other examples of irregular activity that you should be alert to are listed in the Commission's brochure *"Invest Wisely: Advice From Your Securities Regulator,"* at www.sec.gov.

- Address Any Problems Promptly.
  If you have a problem with your sales representative or your account, promptly talk with the sales representative's supervisor or a compliance manager. Confirm your complaint to the firm in writing, and ask for written explanations. If the problem is not resolved to your satisfaction, contact securities regulators and consider using arbitration to resolve your dispute.

* * *

As we vigorously prosecute Gruttadauria for the fraud we allege he committed on his customers, securities regulators are taking action to prevent unscrupulous brokers from engaging in fraud and theft. We are promoting strong compliance practices by broker-dealers that are designed to prevent fraud and theft by their employees. Securities regulators are paying special attention in examinations to determine whether firms have adopted and maintain adequate supervisory and compliance procedures to prevent theft. Further, we must continue to educate investors about steps they can take to invest wisely.

Thank you for inviting me to participate in this hearing. I am pleased to answer any questions that the Subcommittee members may have.

# Testimony

New York Stock Exchange, Inc. 11 Wall Street New York, NY 10005 www.nyse.com

**David P. Doherty**

**Executive Vice President, Enforcement**

**on**
**Regulation of Broker-Dealers**
**and the Matter of Frank Gruttadauria**

**Subcommittee on Oversight and Investigations**
**Committee on Financial Services**

**United States House of Representatives**
**Washington, D.C.**

**May 23, 2002**

**TESTIMONY OF DAVID P. DOHERTY**
**EXECUTIVE VICE PRESIDENT, ENFORCEMENT**
**NEW YORK STOCK EXCHANGE, INC.**

**before the**
**Subcommittee on Oversight and Investigations**
**of the**
**House Financial Services Committee**

**"Regulation of Broker-Dealers**
**and the Matter of Frank Gruttadauria"**

**May 23, 2002**

Good morning, Chairwoman Kelly and members of the Subcommittee. My name is David Doherty and I am Executive Vice President for Enforcement at the New York Stock Exchange. I appreciate the opportunity to talk to you this morning about how the New York Stock Exchange regulates our member firms, and to provide some information about actions we have taken concerning Cleveland broker Frank Gruttadauria and others associated with him.

The New York Stock Exchange is committed to strong and effective regulation of our member firms to protect investors, the health of the financial system, and the integrity of the capital formation process.

The Exchange is proud of our regulatory program. We believe our program has proven to be an effective way to promote investor protection and ensure the financial, operational and sales practice integrity of our member firms.

Regulation of the securities industry in the United States depends upon self-regulation. While self-regulatory responsibility begins with the broker-dealer, the Exchange plays a critical role by maintaining an extensive system for monitoring and regulating the activities of its membership. The Securities and Exchange Commission (SEC) oversees these activities, and we work closely with the staff in the SEC Divisions of Enforcement and Market Regulation and the Office of Compliance Inspections and Examinations.

The Regulatory Group of the Exchange consists of three divisions: The Division of Member Firm Regulation (MFR) -- responsible for the financial, operational and sales practice regulation of member organizations; the Division of Market Surveillance -- responsible for surveillance of all trading activities on the Floor of the Exchange; and the Division of Enforcement -- responsible for investigating and prosecuting violators of Exchange rules and the Securities Exchange Act of 1934 and the rules thereunder. Currently there are approximately 560 people in the Regulatory Group representing approximately one-third of the Exchange's staff, with an operating budget of approximately $142 million.

**EXAMINATION AND SUPERVISION OF BROKER-DEALERS**

The Division of Member Firm Regulation (MFR), with a staff of approximately 265, among other activities, oversees approximately 260 member organizations that deal with the public. These organizations service nearly 93 million customer accounts, operating from over 21,000 branch offices around the world and employ approximately 157,000

registered personnel. The firms that we regulate account for more than 85% of the public customer accounts carried by broker-dealers in the United States.

Member firms that do business with the public are required to file annual audited financial reports with the Exchange. Additionally, monthly reports, known in the industry as FOCUS Reports, provide detailed financial and operational information. These are filed electronically with the Exchange and are analyzed by an Exchange automated financial surveillance system to identify any emerging financial or operational problems. MFR also receives detailed complaint information through required filings that is used to identify significant sales practice trends. Through these reports, periodic surveys, and discussions with our member firms, MFR surveillance staff remains knowledgeable about the firms to which they are assigned responsibility.

The surveillance staff is responsible for monitoring their assigned firms' financial, operational and sales practice conditions and for alerting Exchange management of any adverse changes. At the first sign of a problem, meetings are held with firm management in order to assess the extent of the problem. Depending on the circumstances, management may be required to provide a corrective action plan. Additionally, firms may be subjected to special examinations, intensified surveillance and/or monitoring for the corrective action of prior problems. Special problems or those meeting the alert or early warning criteria are reported to the Financial and Operational Surveillance Committee of the Exchange's Board of Directors, as well as to the SEC, Securities Investor Protection Corporation (SIPC) and other SROs.

MFR conducts two types of on-site examinations of firms with retail accounts. To carry out these exams, MFR uses a range of techniques that include comprehensive computer analysis as well as field examination visits.

The Financial and Operational Unit (Fin/Op) conducts annual on-site financial exams of every firm that deals with the public. The primary objectives of these exams are to address the safety of customers' assets, the firm's financial and operational viability, and its sales practice compliance.

The Sales Practice Review Unit (SPRU) examines firms on a cyclical basis to determine compliance with Exchange rules and federal securities laws governing the handling of customer accounts. Each year SPRU examines the eight largest member firms based on the number of customer accounts, as well as any member firm identified as a particular risk that year. The next six largest member firms are examined on a biennial basis, and any firm referred by Fin/Op for sales practice concerns, as well as all other member firms are examined on a four-year cycle. Additionally, in years in which the SPRU examiners are not conducting an examination of a particular firm, Fin/Op examiners include a less detailed sales practice review in their examination scope. Thus, sales practices are reviewed every year at firms that deal with the public.

In preparation for each examination, MFR uses a risk-based approach to determine the particulars of the examination scope for each firm. However, given the different focus of Fin/Op and SPRU exams, they use different criteria as part of this risk-based approach.

For example, at the time of a Fin/Op examination, MFR surveillance staff processes the firm's most current FOCUS Report through our Examination Scope Selector System. This automated system subjects the report to 156 financial calculations to identify potential examination risks. The surveillance staff and examination staff assigned to the firm meet, together with their management, to develop a final examination scope for the firm.

Similarly, SPRU uses a risk-based approach to select which member firms to examine in a given year. The SPRU risk criteria are designed to identify areas of sales practice concern and risk in an effort to select a meaningful sample of member firms to visit. This approach assigns different weights to the various risk criteria. This has enabled SPRU to examine more frequently those firms that pose a greater risk and sales practice concern.

Moreover, in addition to visiting the main office of a firm, SPRU examiners visit some of the firm's branch offices each year. During each of the last three years, SPRU examiners have visited, on average, 200 branch locations across the United States. These branch offices are selected from among those meeting certain predetermined criteria. They are also chosen based on an analysis of such items as customer complaints, number of high profile registered representatives, commissions generated over a specific period, number

of active accounts during a specific period, number of restricted accounts in the office, number of account designation changes and/or order error and other factors that may be indicative of problems.

Visits to branch offices to detect problem registered representatives or violative conduct are an integral part of our sales practice program and we believe they also act as an incentive to maintain strong supervision over the sales activities of our members.

SPRU examiners also use a risk-based approach to determine which particular accounts and brokers to review. Account reviews conducted at the main office encompass accounts serviced by registered representatives throughout the firm; those reviewed during branch office visits are specific to that branch. Accounts also may be selected for review based on the examiner's analysis of several factors, including customer complaints, margin extensions, account designation changes and order errors. Specific brokers are selected for review based on the number of customer complaints against them and/or other criteria.

This risk-based approach to regulation means that, while all aspects of a firm's business operations or its branches and accounts are not subject to detailed inspection during every exam, MFR is able to concentrate on areas of greater potential risk to investors and to examine more frequently those firms or area within firms that present these risks.

The Exchange's examination program has greatly evolved over the past several years with regard to automation, which has led to a more efficient and effective program. Member organizations now file electronically required notices regarding customer complaints. We keep track of and analyze these complaints via an internal database. Technology has also enhanced the examination planning process by enabling us to perform a more meaningful and efficient review of data prior to the start of an examination.

In addition, both Fin/Op and SPRU examiners currently use laptops to assist in their on-site exams. The laptop has the final examination scope, as well as the relevant rules, regulations, corresponding interpretations and the general procedures to be followed in examining each area. The examiner has the authority to add additional questions or objectives to the exam while in the field, but needs supervisory approval to delete any planned work.

In 1999 an Electronic Communications Review was added to the SPRU examinations scope, which addresses, among other items, e-mail correspondence of registered representatives, use of personal computers, and unauthorized Internet communications.

Every examination includes an opening meeting with the firm's management concerning the firm's business in order to provide the staff with an understanding of the firm's procedures and controls, the types of records maintained and management reports produced. Through questioning, observation, and testing, the examiners assess

compliance with the rules governing the particular area under review. In addition, they seek to identify any material risk.

Examinations conclude with an exit review in which any findings and observations are discussed with the firm's management. Written examination reports are generally issued within 35 calendar days from the exit review. The reports cite any findings the examination team has made as well as the corrective actions indicated by the firm's management. Firms are required to respond in writing to confirm such corrective actions.

After each examination, serious or repeated violations are referred to the Exchange's Enforcement Division to consider possible disciplinary action. Any formal disciplinary action is made public in order to caution other firms to avoid similar problems.

**ENFORCEMENT AT THE EXCHANGE**

The Division of Enforcement, with a staff of 136, the majority of whom are attorneys, has a mandate to investigate and prosecute violations of the Securities Exchange Act of 1934, the SEC Rules promulgated under that Act, the Exchange Constitution, and the Exchange Rules by persons and entities within the member firm community. Within this regulatory framework, Enforcement focuses on certain types of conduct, including sales practice violations, financial and operational violations by members and member organizations and trading and Floor-related violations.

Enforcement receives information about possible violations from various sources, including investor complaints made directly to the Exchange and certain required filings by member firms. Member firms are required to report to the Exchange, among other things, when an internal investigation reveals violative activity, when the firm enters into a settlement of a customer complaint in excess of a specified amount[1], and certain types of disciplinary action taken by a firm against an employee. Enforcement currently receives over 10,000 such filings a year and reviews each one of them. A large majority of these filings relate to sales practice matters.

Enforcement may also commence an investigation as a result of referrals from our other regulatory divisions including Member Firm Regulation and Market Surveillance, as well as from the SEC. On certain matters, from the inception of the investigation, Enforcement works hand in hand with MFR or Market Surveillance or with the SEC. Enforcement typically carries a caseload of approximately 700 matters and initiates over 200 enforcement actions a year.

When we bring an enforcement action, the consequences are likely to be significant. Fines imposed on our member firms of $250,000 or more are no longer unusual. Also, as part of a settlement, we often require an undertaking by the firm to conduct internal reviews and adopt new procedures designed to prevent a recurrence of violative activity.

[1] The specified amount for an individual is $15,000; for a member firm it is $25,000.

Sanctions against individuals are significant as well. More than half of the individuals that we suspend or bar each year are put out of the business for at least one year or more. Also, member firm and management responsibility for misconduct within a firm is very high on our priority list. We look closely at this issue in virtually all of our cases. In a typical year, more than 25% of the enforcement actions we bring are against firms or management officials at those firms.

The purpose of an investigation by Enforcement is to ascertain the relevant facts in order to determine whether violative activity has occurred and, if so, what action should be taken. In conducting its investigations, which are all non-public, Enforcement may request documents from member firms, employees of member firms, and other persons having information relevant to Enforcement's inquiry. Enforcement also typically interviews customers who may have been harmed by violative activity and takes the formal testimony of firm employees or other individuals with relevant information.

Following the completion of its investigation, Enforcement reviews the facts and determines whether any violative activity has occurred, and if so, decides whether to recommend enforcement action.

After enforcement action is authorized, we can proceed to file charges before an Exchange Hearing Panel, which may result in a contested hearing, or we may reach a settlement of the action with the respondent in lieu of a contested matter. Enforcement

actions result in a written decision by a Hearing Panel, which is published by the Exchange.

The short-term objective of an effective enforcement program is to catch the people who break the rules and sanction them. The long-term objective is to deter other violative activity, induce compliance, and ultimately enhance investor confidence in the integrity of the market.

**THE GRUTTADAURIA MATTER**

On Tuesday, January 22, 2002 Lehman Brothers officials advised the Exchange of a matter involving a producing branch office manager at Lehman Brothers' Cleveland Branch office who may have stolen a significant amount of customer funds. The Exchange was advised that Gruttadauria had mailed a letter to the Federal Bureau of Investigations, postmarked January 14, 2002 which arrived on January 17, 2002, indicating that for 15 years he had misappropriated funds through various methods from his customers at Lehman and his prior employers, including S.G. Cowen and Cowen.

The Exchange immediately put together a team including Enforcement attorneys and MFR examiners, and commenced an investigation of the matter. We asserted jurisdiction over Gruttadauria and required his appearance to provide testimony before the Exchange, and discussed the case with the Securities and Exchange Commission. By Thursday morning, January 24, the Exchange had staff on-site in the Cleveland Lehman branch office, in Lehman's main office in New York, and in S.G. Cowen Securities

Corporation's main New York office, gathering relevant information. Within two weeks we had taken the investigative testimony of over a dozen witnesses.

On February 5, 2002, when Gruttadauria did not appear to give investigative testimony as required, the Exchange issued charges against him for misappropriation of customer funds and failure to cooperate with the Exchange's investigation. On March 16, 2002, a hearing was held before an Exchange Hearing Board, which found that Gruttadauria had engaged in the misconduct alleged, and Gruttadauria was permanently barred from association with a member or member organization. [2]

We also issued charges on February 27, 2002, against William Kall, one of Gruttadauria's administrative and sales assistants in the Cleveland branch office, based on his refusal to answer certain questions during his sworn testimony before the Exchange. On May 14, 2002, a hearing was held before an Exchange Hearing Board, which found that Kall had engaged in the misconduct alleged, and Kall will be permanently barred from association with a member or member organization unless he complies with the Exchange's requests for testimony within 30 days. [3]

Also on April 23, 2002, Enforcement issued charges against Laurene English, Gruttadauria's long-time sales assistant, based upon her failure to comply with Enforcement's request for additional testimony. A hearing has been requested in this matter.

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[2] Exchange Hearing Panel Decision 02-59, dated March 19, 2002
[3] Exchange Hearing Panel Decision 02-103, dated May 15, 2002

It is worth noting that, originating with prior MFR examinations of Cowen, in 1998 Enforcement initiated enforcement action against Cowen & Company for violations of a number of Exchange rules and federal securities laws that involved a variety of both sales practice and financial/operational violations.[4] A major focus of the case was the improper preparation, entry and maintenance of order tickets, and the failure to comply with margin requirements (Regulation T). Other violations included the failure to reasonably supervise branch office managers acting in the capacity of registered representatives, failure to review outgoing correspondence, failure to comply with research rules, failure to comply with discretionary account rules, failure to adhere to obligations with respect to allocating new issues, and supervisory deficiencies. Although we visited Cowen's Cleveland, Ohio office during one of the exams which underlie the Exchange's 1998 enforcement action, the main problems disclosed by these exams emanated from Cowen's Financial Square, New York and Boston, Massachusetts offices. Because these New York and Boston offices accounted for the bulk of the significant deficiencies in these earlier exams, MFR returned to these offices in subsequent SPRU exams to follow-up on the deficiencies noted. The 1998 Enforcement action resulted in an Exchange decision, by consent, in which Cowen received the sanction of a censure, a $380,000 fine and a requirement to comply with an undertaking whereby Cowen committed to correcting certain procedural and supervisory deficiencies.[5]

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[4] At the time of Enforcement's action, Societe Generale had recently purchased Cowen's assets and the firm was then known as S.G. Cowen Securities Corp.
[5] Exchange Hearing Panel Decision number 98-64, dated July 10, 1998

Pursuant to that undertaking, outside counsel for Cowen conducted a review to determine whether the firm complied with its commitments to address these deficiencies, including Cowen's agreement to enhance its corporate compliance functions. In 1999, outside counsel concluded in its report to the Exchange that Cowen had satisfied its undertaking in all material respects and made significant efforts in addressing the areas of deficiencies. As required by the Exchange, Cowen's Board of Directors and Chief Executive Officer also provided written representation that all actions referred to in the report were completely implemented.

Our investigation into the Gruttadauria matter is ongoing. To date the Exchange has taken the investigative testimony of over 25 witnesses. Our interest continues with respect to, among other areas, the potential responsibility of the firms involved, including the adequacy of their supervisory systems and procedures. One issue in our current investigation, of course, is whether the procedures affirmed in the Cowen undertaking report were actually put into effect and implemented. We are closely coordinating our efforts with the Enforcement Division of the SEC and have been cooperating with the FBI, as well.

**INTERNAL CONTROLS SURVEY**

Since the beginning of this year, the Exchange has undertaken a number of initiatives focusing on compliance systems and procedures at retail brokerage firms. These initiatives were partly in response to the Gruttadauria matter, but also reflect our

commitment to continually review, expand and improve our regulatory program to adapt to new information and technological advances.

Among these new initiatives was the creation of an Internal Controls Committee in Member Firm Regulation to address issues relating to possible supervisory and other weaknesses at our member firms. Another initiative was the distribution on March 11, 2002 of a comprehensive survey to 30 broker/dealers representing a cross section of our retail client-based member firms. This survey sought information about a variety of firm procedures, including those relating to the supervision of producing branch office managers, customer account address changes, transfers of customer funds, the use of personal computers at the office and the issuance of certain reports and materials to customers.

A key task of the Internal Controls Committee has been to analyze the results of this survey and develop a plan to appropriately address its findings. Among the actions being considered by the Internal Controls Committee are the adoption of new rules and/or amendments to existing rules, adding clarifications to existing rule interpretations, and the issuance of information memoranda to educate the member firm community. In addition, special examinations are being considered for certain firms, based on the results of the survey. Further, additional examination objectives have been added to the SPRU examination scopes to augment our review of issues related to producing branch office managers, customer address changes and the use of post office box addresses. Based upon information being developed in our on-going investigation, other additions to the SPRU examination scopes, as well as scopes for Fin/Op exams will be considered.

Let me assure you of the Exchange's continuing commitment to our strong regulatory program, which is a vital ingredient to investor confidence in our market.

Thank you again for the opportunity to testify today.

**Testimony by Mark E. Kaplan**
**Managing Director and General Counsel**
**SG Cowen**

**House Financial Services Committee,**
**Subcommittee on Oversight and Investigations**

**May 23, 2002**

Madam Chair, Mr. Gutierrez, Members of the Subcommittee, I thank you for the opportunity for SG Cowen to participate in this important hearing.

On behalf of SG Cowen, at the outset I want to pledge our company's full support for your efforts. We applaud the committee for its leadership in working to protect investors from fraud or other abuses.

I also want to say at the outset that we were as shocked as anyone to learn of Frank Gruttadauria's fraud. SG Cowen is committed to doing everything possible to get to the bottom of this scheme, and to do what's right for our former customers.

I want to begin my testimony by briefly reviewing SG Cowen, our short involvement in the retail brokerage business, and where Frank Gruttadauria fit into that business.

SG Cowen today is an investment banking firm that serves a wide array of corporate clients and institutional investors. The firm has a specific focus on technology, health care and related high growth sectors and provides research, financing and a variety of investment solutions to our institutional customers. The firm has more than 600 employees based in a number of cities in the U.S. and around the world.

In July 1998, SG Securities purchased most of the assets of Cowen & Company, a wholly unrelated firm. Frank Gruttadauria worked for this other company for over eight years. He worked for us for just over 2 years.

SG Securities did not have a retail brokerage business until this acquisition. With the purchase, SG Cowen was formed as an investment banking and retail brokerage in the United States.

The acquisition took place after the customary due diligence and audit of Cowen & Company. SG Cowen made a number of changes in the former Cowen & Co. retail brokerage operations after acquiring it. These changes included several steps, some taken in response to a New York Stock Exchange consent order, designed to upgrade compliance and supervisory procedures at the retail unit.

Cowen & Company's retail brokerage business did not fit into our overall business strategy, so it was sold to Lehman Brothers in October 2000. Our firm has been out of the retail brokerage business since the time of that sale.

Because we sold that business, we are faced with a unique and difficult challenge in piecing together what has happened in the Gruttadauria scheme. We face some very significant challenges in our efforts to uncover how these acts were perpetrated and their precise financial impact on each of our former customers. It has turned out to be a painstaking and labor-intensive process peculiar to us.

First is the fact that virtually everyone involved in SG Cowen's retail brokerage business no longer works for our firm. In other words, all our institutional knowledge left for Lehman Brothers over one and one-half years ago. And the senior-most management of SG Cowen has changed completely since the retail brokerage was sold. The fact that none of us in current management -- including myself -- were present at the creation of this situation further complicates the investigation. But though we come to this task as virtual outsiders, we clearly recognize our obligation to do what's right for our former customers.

Second, the files we are researching are stored on vast amounts of paper and microfiche that we warehoused when we sold the retail business to Lehman. The electronic and computer systems of the retail brokerage went with the retail brokerage when Lehman acquired it -- along with the ability to perform swift research on client databases. This means that we must painstakingly review these paper and microfiche sources in order to reconstruct accurate records for each of SG Cowen's former retail customers. I believe at one point we had rented out all seven existing microfiche printers in New York, and were burning them out on a regular basis.

Third, we are faced with the task of reviewing literally hundreds of thousands of transactions over the years, and each one must be examined.

Lastly, we are attempting to unravel a scheme that escaped detection notwithstanding due diligence, compliance procedures and independent reviews by several distinct responsible companies, law firms and other outside entities. The fact that Gruttadauria was able to continue his various acts of misconduct for so long at so many different companies while evading detection underscores the complexity and sophistication of this fraud. Even so, speaking for SG Cowen, we sincerely wish our efforts had uncovered it earlier.

While we are faced with real challenges, we know where our responsibility lies. Our job is to ferret out what really happened, and to understand what it means for our former customers.

To that end, SG Cowen has dedicated substantial company resources to the complex task of reconstructing and analyzing customer records. Well over 100 people have been helping on this nearly round-the-clock effort, including, at any given time, approximately 35 lawyers, 15 paralegals, 42 accounting professionals and numerous other document reviewers and preparers who have been dedicated full time or more than full time for the past three and a half months to the intensive record re-creation process to

which we are committed. We estimate that more than 30,000 person-hours have been expended in this massive effort. And we are far from finished.

Through these efforts, we have provided actual account statements and other account information to all of our former customers who have requested it.

But providing these customers with accurate statements is by no means the same as understanding fully the flow of funds in, out and across accounts over the years. An account statement shows funds that came in and funds that came out. But until you look at the actual checks, wire transfers, deposit slips and other materials, there is no way of knowing whose money went where.

Since the Gruttadauria problem came to our attention, our team has searched for and reviewed more than twelve hundred boxes of company records, including account agreements, monthly statements, correspondence, and literally millions of securities transactions, cash deposits and withdrawals. We are continuing to review additional boxes of records, including another ten thousand boxes of banking records that will help us document the monies that were deposited into our customers' accounts. For every transaction in every account, we must locate manually the documentation that will enable us to determine what happened in that transaction. For example, for every check written against the account of one of Gruttadauria's customers, we must find the cancelled check in a huge collection of boxes of the firm's banking records, determine to whom the check was written, who endorsed it, and whether that person or company was connected to the

person whose account the funds came from or whether the check otherwise was authorized by the customer whose account the check was drawn against, or on the other hand, whether the payee was an unrelated party or other customer of Gruttadauria to whom the customer had not authorized the check to be sent. Similarly, for every wire transfer, we have to track down the wire transfer document, identify the account from which the funds came, attempt to determine to whom the funds were being transferred, and, again, whether the recipient was related to the person whose funds were being transferred. This process is going on day and night, including as you read this, for hundreds of thousands of transactions in hundreds of accounts over many years.

Nonetheless, we have learned some things in this process, which I would like to share with the committee. Before I do, I must say that, due to the existing SEC and New York Stock Exchange investigations of this matter and pending private litigation, I am not at liberty to discuss the specifics of any individual investor case or our preliminary findings.

What I can say is that we have found that Gruttadauria sent a significant number of customers bogus account statements that falsely represented to the customers that they were earning far more in their accounts than they actually were. When they sought to withdraw funds based on the inflated balances on their statements, Gruttadauria apparently concluded that, to keep the customers from complaining, he had to get the funds to pay them from somewhere -- and that somewhere turned out to be the accounts of other customers. That appeared to require him to provide false statements to the other customer, and so the scheme grew.

Thus, at its root, this was a scheme in which Frank Gruttadauria appears to have been robbing Peter to pay Paul. There are still many questions that remain: why did he start this? how many customer accounts did he victimize? how much did the customers lose? did some customers wind up with substantially more money than they invested? These are the questions we're trying to answer.

The net of Gruttadauria's actions had the effect of linking customer accounts together. Funds or securities went into one customer's account but were used to pay another customer who wanted to make a withdrawal. What happened in one account clearly has effects on several others . That means that we need to understand what happened with all transactions in all the affected accounts before we are in a position to determine what it would take to attempt to compensate each individual former customer who lost money.

Again, we are pursuing this task with great urgency – but it will take time.

Members of this committee, we offer our sincere apology for the harm that Frank Gruttadauria's conduct has caused the former clients of SG Cowen.

His conduct is anathema to us. That's not the way we do business and that's not who we are. We are proud of our hard-earned reputation for integrity in the marketplace and of the work we do for our clients.

That is why SG Cowen will continue to work tirelessly to determine exactly what happened and make every effort to do the right thing for our former customers. We know that can't happen fast enough for them; and they are absolutely right. That is why we are working so hard to reconstruct the past.

With that, I thank you very much, and welcome the chance to answer any questions you might have.

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**TESTIMONY OF**

**THOMAS E. HOMMEL, MANAGING DIRECTOR**
**LEHMAN BROTHERS INC.**

**"ONE BROKER GONE BAD:**
**PUNISHING THE CRIMINAL, MAKING VICTIMS WHOLE"**

**BEFORE THE SUBCOMMITTEE ON**
**OVERSIGHT AND INVESTIGATIONS,**
**COMMITTEE ON FINANCIAL SERVICES**

**UNITED STATES HOUSE OF REPRESENTATIVES**

**MAY 23, 2002**

Lehman Brothers Inc. ("Lehman") is an investment banking firm that has operated for over 150 years, and currently employs over 13,000 persons worldwide. Lehman principally serves institutional clients, with its limited activities for individual investors being focused on serving high-net worth individuals through approximately 475 investment representatives.

Frank Gruttadauria worked for Lehman for only fifteen months. His employment resulted solely from Lehman's acquisition of certain retail customer accounts and branch offices from S.G. Cowen & Co. ("Cowen") in October 2000. That acquisition included eight different branch offices employing approximately 90 investment representatives servicing over 60,000 customer accounts. Mr. Gruttadauria was an investment representative in the Cleveland, Ohio branch office at Cowen, and had also served as the manager of that office for about ten years. He serviced approximately 470 customer accounts.

The Cleveland branch also employed an Administrative Manager, who was fully licensed to serve as a branch manager and had supervisory responsibilities over all customer activity in the Cleveland branch, including for customers serviced by Mr. Gruttadauria. In addition, the branch employed an Operations Manager who was responsible for various cashiering functions, including the disbursement of funds from customer accounts. At the time of Lehman's acquisition of the Cowen branches in October 2000, the Administrative Manager and the Operations Manager of the Cleveland branch each had over ten years of experience in their respective positions at that branch.

Prior to Lehman's acquisition of the Cowen branches, it performed due diligence with respect to Cowen's personnel and operations. That due diligence disclosed with respect to Mr. Gruttadauria that he had a spotless compliance record with not even a single customer complaint against him. Nor were there any significant number of customer complaints in the entire Cleveland branch. Although a New York Stock Exchange audit in 1994 and 1995 of several Cowen branches, including Cleveland, had revealed certain deficiencies in certain procedures, Cowen had entered into a settlement with the New York Stock Exchange in July of 1998 whereby it agreed to correct those deficiencies, none of which was related to the specifics of Mr. Gruttadauria's scheme. As part of its due diligence, Lehman was provided a report that was prepared by a prominent New York law firm, as mandated by the New York Stock Exchange, which set forth the corrective actions taken and the law firm's opinion that such actions were reasonably designed to prevent the recurrence of the noted deficiencies. In fact, in a prior submission to the New York Stock Exchange by that same law firm it stated: "Mr. Gruttadauria manages an exemplary Branch...At no time has the Cleveland Branch been the subject of any disciplinary action by a regulatory authority while Mr. Gruttadauria has been at the helm." Thus, Lehman's due diligence prior to the acquisition of the Cowen branches did not reveal any facts which raised any issues with respect to Mr. Gruttadauria himself, and those issues that had been raised about Cowen had been certified as having been fully addressed and remedied.

As part of the acquisition, Lehman also provided extensive training to former Cowen personnel regarding Lehman's policies and procedures. With respect to the Cleveland branch, this training took place through personal meetings in New York, Chicago, and Cleveland, numerous conference calls and the dissemination of various written materials.

As part of that transition, all 4,900 Cowen accounts in the Cleveland branch were to be reopened as Lehman accounts, thereby bringing them within Lehman's system of supervisory procedures. What Lehman did not know at that time was that approximately 40 of these accounts that were serviced by Mr. Gruttadauria had what are now alleged to be fictitious addresses.

At the cornerstone of supervisory procedures for every broker dealer is the ability independently to send to all of its customers confirmations and monthly statements reflecting all activity in their accounts. Thus, this fundamental supervisory tool had been taken away from Lehman, without its knowledge, as a result of purchasing accounts that had defective addresses.

Moreover, nothing about the addresses that were on these accounts that are now at issue appeared suspicious in any way. In virtually all instances, the addresses appeared to be accounting firms or law firms, which presumably had been employed by the high-net worth client, or otherwise contained street addresses. Indeed, there is nothing unusual about high net worth individuals directing their brokers to send account statements to lawyers and/or accountants. One of the accounting firms listed had a post office box included in the address, while another one was in fact an actual accounting firm with its actual street address listed.

Customers for whom the actual statements were diverted received phony monthly statements and related tax information that were apparently prepared by or at the direction of Mr. Gruttadauria utilizing personal computers that he caused to be networked together and which were located at his office, his home and the home of his assistants. In addition, approximately 19 individuals received phony statements for accounts when there was no such actual account maintained at Lehman. A number of these customers who received phony statements also received actual statements that were different in appearance from other accounts that they maintained at the firm. Moreover, unlike any accounts which reflected the correct address, customers for whom the real statements had been diverted never received confirmations for any transaction conducted in that account, contrary to the custom and practice of the brokerage industry.

In January 2002, Mr. Gruttadauria fled and notified the FBI of his scheme, which he claimed had gone on for 15 years, long pre-dating any affiliation with Lehman in October 2000.

We believe that the supervisory policies and procedures at Lehman caused ever increasing difficulty for Mr. Gruttadauria to perpetuate his scheme during the short period of time he was there for the following reasons:

**1. Lehman's Supervisory Structure.**

Lehman's supervisory structure is designed to provide numerous independent checks and balances. The Administrative Manager of the Cleveland branch not only reported to Mr. Gruttadauria, but he also had a reporting line to the Regional Administrative Manager located in Chicago and would interact with the Compliance Department in New York on an ongoing basis. For example, each month he was required to certify in writing to the Compliance Department that he performed each of the supervisory functions that he was responsible for, as well as to confirm in writing the steps he had taken with respect to accounts noted on certain exception reports. Moreover, he met one-on-one with the Compliance Department auditor during inspection visits to the branch in order to review activity in the branch and to enhance procedures.

Similarly, the Operations Manager also had a direct reporting line to the Head of Branch Operations for the firm, and would regularly interact with her.

In order to ensure that a branch manager like Mr. Gruttadauria could not exercise any undue influence, any bonus compensation for the Administrative Manager and the Operations Manager was finally determined by upper management outside of the branch together with Human Resources, not by Mr. Gruttadauria, whose role was limited only to input. Moreover, under Lehman's policies, Mr. Gruttadauria was prohibited from making any significant gifts or loans to other employees, and he was required to certify each year that he was in compliance with that specific policy. He did so in February 2001.

Thus, under Lehman's policies and procedures both the Administrative Manager and Operations Manager of the Cleveland branch were thoroughly trained, and had separate and independent reporting lines outside of the branch.

**2. Procedures With Respect to Change of Addresses.**

Lehman's policies with respect to changes of addresses by customers require a signed authorization by the customer. However, in addition to that authorization, the firm's computer system automatically generates a notification that is sent by the firm out of New York to the customer's old address notifying him or her of the change in address. That additional procedure was not in place at Cowen.

Thus, Mr. Gruttadauria at Lehman was limited in his ability to obtain new funds to perpetuate his scheme since he was no longer able to change addresses for customer accounts without detection, even if he forged the letter of authorization.

**3. Enhanced Monitoring of Customer Activity.**

Lehman's system with respect to monitoring activity in customer accounts involves progressive levels of customer contact as activity increases.

For example, all customers should be receiving confirmations and account statements reflecting all activity in their accounts on a contemporaneous basis. As activity in an account reaches certain levels, the Compliance Department requires that a letter be sent to the customer to acknowledge that the transactions in his or her accounts are authorized and in accordance with their investment objectives. The letter is sent by the Administrative Manager and must be signed and returned by the customer. Moreover, additional activity by the customer may cause the Compliance Department to require the Administrative Manager to establish direct personal contact with customers to discuss their trading, and to confirm in writing to the Compliance Department the substance of that communication.

By March 2001, one of the accounts, wherein it is now known there was a significant level of alleged misappropriations, had triggered a request by the Compliance Department for a letter to be sent confirming the authorization of all transactions. By November 2001, the Compliance Department also requested the Administrative Manager to personally contact the client to discuss the activity in his account. The Administrative Manager certified to the Compliance Department in writing in May 2001 that he had received a signed letter from the customer confirming the transactions in his account, and then again on November 29, 2001 he certified in writing to the Compliance Department that he actually spoke to the customer about his account activity, including the withdrawal of funds. No irregularities were noted by the Administrative Manager at that time; however, the customer now claims he never received the actual statements for this account, which were sent to an actual law firm.

These types of direct customer contact on an ongoing basis would render it highly unlikely for Mr. Gruttadauria's scheme to be able to continue without detection, even though the confirmations and monthly statements had been diverted.

4. **Internet Access.**

During 2001, Lehman was providing more and more customers with Internet access to their accounts, so that they could instantaneously see the current status of that account. In fact, one of Mr. Gruttadauria's clients in late 2001, who was receiving phony statements, was attempting to establish such access and Mr. Gruttadauria was attempting to deflect him.

This Internet feature not only provides greater customer service, but also enhanced supervisory controls, which in this case also increased the likelihood of detection.

* * *

Perhaps the best evidence that all of these policies and procedures were putting enormous pressure on Mr. Gruttadauria is the fact that when the Administrative Manager mentioned to him in December 2001 the upcoming Compliance Audit in February or March of 2002, Mr. Gruttadauria reacted by stating that "he would probably be out of here by then."

On January 17, 2002, the very same day Lehman learned about the alleged misappropriations, it sent a new management team to Cleveland, as well as various other personnel to immediately meet with clients. Lehman also immediately notified its regulators and has fully cooperated with the numerous inquiries it has received from those regulators and other governmental entities. The complete former management team of the office was replaced, all of Mr. Gruttadauria's clients were immediately contacted to ensure that they knew precisely what was in their accounts, and meetings were conducted with the affected customers to fully share with them what information the firm had regarding their accounts.

Moreover, Lehman has already paid substantial sums to certain customers to reimburse them for funds misappropriated from their accounts while at Lehman, without even requiring a release from these customers. Lehman believes that the amounts already paid represent a substantial portion of any funds that may have been misappropriated while Mr. Gruttadauria was employed by Lehman, and is continuing in its efforts to identify and reimburse any remaining customers for any such misappropriations that may have occurred at Lehman.

Lehman unfortunately was in the unenviable position of having to tell these customers that they were not worth what they thought they were, but substantially all of the alleged inflation in their account value and substantially all of the alleged misappropriation took place prior to them ever becoming customers of Lehman. At the time that Lehman acquired the accounts from Cowen which had the fictitious addresses, there was only approximately $4.6 million in those accounts while the phony statements for those accounts at that time reflected a market value of over $260 million.

Lehman, as part of its 150-year tradition, places an enormous premium on earning the trust and confidence of its clients. It regrets deeply that these events took place, but also firmly believes that its systems of supervisory procedures are more than reasonably designed to prevent and/or detect this type of activity. What happened here was truly unique in that Lehman, by purchasing accounts with defective addresses, had taken away from it without its knowledge one of the principal supervisory tools utilized throughout the industry -- the ability to independently send to customers confirmations and monthly statements which reflect all activity in their accounts. Notwithstanding that fact, Lehman's overall systems of supervision continued to tighten the noose around Mr. Gruttadauria's activities so that what apparently had gone on for fifteen years was unable to continue for more than fifteen months at Lehman. Finally, Lehman's compliance record since 1994 – when the new Lehman Brothers emerged – is an enviable one with not a single regulatory action initiated relating to our Private Client Services business.

**Testimony**

**Of**

**Daniel M. Sibears**
**Senior Vice President and Deputy**
**Member Regulation**

**NASD, Inc.**

**Before the**
**U.S. House of Representatives**
**Committee on Financial Services**
**Subcommittee on Investigations and Oversight**

**May 23, 2002**

***Introduction***

On behalf of the National Association of Securities Dealers ("NASD"), I want to thank the Committee for this opportunity to testify. My name is Daniel M. Sibears and I am a Senior Vice President and Deputy for Member Regulation at NASD in Washington, D.C.

I am pleased to have the opportunity to appear before this special hearing to provide you with information about the regulation of the securities industry and the role of NASD in regulating broker dealers.

As the world's largest securities self-regulatory organization ("SRO"), NASD has been helping to bring integrity to the markets for more than 60 years. Market integrity and investor protection are at the core of NASD's mission and are the foundation of the success of U.S. financial markets.

Under federal law, virtually all securities firms doing business with the American public are members of the NASD, a private sector, not-for-profit SRO. Roughly 5,500 brokerage firms, and almost 700,000 registered securities representatives come under our jurisdiction.

NASD writes rules that govern the behavior of securities firms and their associated persons, examines firms for compliance with these rules, as well as the federal securities laws, the rules of the Securities and Exchange Commission ("SEC") and the Municipal Securities Rulemaking Board, and disciplines securities firms and their employees if they fail to comply.

Our market integrity responsibilities include regulation, professional training, licensing and registration, investigation and enforcement, dispute resolution, and investor and member education. We monitor all trading on The Nasdaq Stock Market -- the largest-volume market in the world – and in the over-the counter markets. We are staffed by 1600 professional regulators and governed by a Board of Governors – at least half of whom are unaffiliated with the securities industry.

The co-existence of strong self-regulation and investor participation in the markets is no mere coincidence. Self-regulation brings to bear a keen practical understanding of the industry. It taps resources and perspectives not readily available to governments. It fosters investor protection and member involvement by promoting high standards that go beyond simply obeying the law. And it has helped to make the U.S. markets the most successful in the world.

Self-regulation works because the brokerage industry understands that market integrity leads to investor confidence, which is good for business. The overwhelming majority of NASD members comply with the letter and spirit of the rules and the law. They view their own reputation for fair dealing and high standards as an asset in a competitive industry.

NASD plays a crucial role in investor protection, which, in turn, is critical to investor confidence. By preventing problems before they happen, education may be the best form of investor protection. Our *Investor Alerts* give investors timely information that they need to spot problems before they happen. Through our Web site, publications, and investor outreach, we provide investors with information, tools, and resources they need to make effective use of the products and services that the securities industry offers. Our initiatives range from interactive programs that introduce children to the concept of saving to initiatives dealing with margin, online trading, and investing and retirement planning for adults.

NASD, other SROs and governmental regulators are not, however, the only level of regulation in the securities industry. Regulation starts with the securities firms themselves. All securities firms are subject to rules that require them to have supervisory systems and internal controls. The firms have personnel whose main responsibility is monitoring compliance with these rules, other SRO regulations and the federal securities laws. The scope and detail of these internal compliance departments varies given the substantial diversity of firms. Depending on the size of the firms and the type of business they do, they have to have effective mechanisms to monitor themselves for compliance with a myriad of regulations.

Effective supervisory systems form the foundation of a firm's ability to ensure that its associated persons are appropriately dealing with customers and that customers are protected. Appropriate supervision safeguards the firm and its customers and increases investor confidence, thereby, ultimately, ensuring the fair and efficient functioning of our markets.

Effective supervision is not static. Firms must continually evaluate the effectiveness of their policies, procedures, supervisory systems and internal controls and make appropriate changes when necessary. The systems need to be reviewed and revised to, among other things, reflect different risks and challenges that may be created in the market place, by hiring new personnel or when the firm's associated persons become, as I will describe below, the subject of one or more actions that raise the proverbial "red flag."

In addition, ordinary supervisory procedures may be insufficient to ensure compliance with federal securities laws and NASD or New York Stock Exchange (NYSE) rules and regulations in certain circumstances. In such circumstances, we look to the firms to impose heightened supervisory systems. Circumstances that may warrant heightened supervisory controls include registered representatives, whether new hires or current representatives, who have been the subject of numerous customer complaints, disciplinary actions or arbitrations; registered representatives terminated from association with prior firms for regulatory reasons or concerns; registered representatives who have frequently changed their employment; and registered representatives whose trading practices or customers appear on certain exception reports generated by the firm to monitor customer accounts.

In situations such as those I have mentioned, firms employing these brokers should take necessary, extra steps to establish heightened supervision. Firms should develop and employ special supervisory procedures tailored to the areas that were the subject of the broker's previous complaints, arbitrations, or disciplinary actions. In developing appropriate heightened supervisory procedures, the firm should analyze the product, customer, or activity type that was involved in the broker's prior misconduct or questionable behavior. The firm should then determine what type of supervision might best control and limit this risk to the customer and the firm. The procedures should also recognize the nature of the firm's business and the size and structure of the firm.

The supervisor who oversees the activities of the broker should be adequately qualified, appropriately trained, and have the necessary experience to carry out the heightened supervisory obligations. Individuals charged with carrying out heightened supervision, and the supervisory procedures put into place, must be able to detect signals that may indicate the broker is continuing to engage in further sales practice violations. Firms that ignore these signals or red flags of further sales practice violations, or that never put in place heightened supervision of problem brokers, may themselves be the subjects of disciplinary action for failure to supervise the brokers.

Several of our regulatory requirements are especially important as we learned in the wake of September 11th - such as anti-money laundering rules and requirements mandating that firms have business continuity plans in place. Firms must also ensure that their brokers are meeting continuing education requirements. In the area of compliance, the systems and controls that firms utilize can range from highly automated to manual and from internally managed to outsourced. Firms however, cannot contract away the responsibility and in the end must have strong systems designed to protect investors.

I recognize that the committee has a significant interest in the Gruttadauria case. Unfortunately I am not in a position to comment on that matter, which is currently under investigation by the NYSE . With respect to a few specific areas, such as financial/operational and options compliance, SROs divide responsibility as the Designated Examining Authority (DEA). For example, the NYSE assumes DEA responsibility for financial/operational inspections for firms that are dual NASD/NYSE members. As soon as this matter came to light, Lehman Brothers notified both the NASD (through our Cleveland office) and the NYSE . Because the matter appeared to involve internal financial control issues, and the NYSE is the designated examining authority for that firm, the matter was deferred to the NYSE for investigation.

***Member Regulation***

From its headquarters in Washington, DC, and through each of its 15 District Office locations, the Department of Member Regulation conducts a variety of programs to fulfill NASD's self-regulatory functions. These programs include our national examination program, the membership application process, a statutory disqualification program and our preventive compliance program.

The examination program is the largest function carried out by Member Regulation. On an annual basis, we examine approximately 2,600 brokerage firms' headquarters and over 200 branch offices. The yearly schedule of exams is prepared in conjunction with other SROs pursuant to an agreement that fosters cooperation among regulators and minimizes duplication.

The amount of time and scope of routine exams vary greatly. Large, full-service firms generally consume the greatest amount of time (including many weeks on-site) because of the size and complexity of their operations. Exams for very small firms, especially those with limited product lines or a small number of customer accounts, are generally completed with examiners spending just a few days on the premises.

The scope of our exams is determined by a risk-based focusing mechanism in which our regulatory intelligence and other data is analyzed. This risk-based approach allows us to devote our examination resources to areas that constitute the greatest risk to investors. Therefore, all aspects of a firm's business or operations are not necessarily subject to detailed inspection during every exam.

We are in the midst of deploying a completely new regulatory model that will technologically enable the examination program and permit us to conduct ongoing surveillance of firms for indications of serious potential problems in need of immediate attention. With INSITE -- which stands for Integrated National Surveillance and Information Technology Enhancements – we use sophisticated data mining techniques to detect signals of change in member firm activities. This includes statistical analysis of customer complaints, transactional and trading information, registration information, and financial information.

Importantly, when we detect abusive practices occurring in the industry, we take immediate steps to apprise our members of the problem. For example, when we became aware of a number of scams that were being carried out through the use of bogus addresses or Post Office boxes for customer accounts, we issued a Member Alert highlighting the concern for our member firms and described seven specific approaches for firms to guard against their customers becoming the victim of a scam using this method of operation. In another instance, when we saw a prevalence of member firms experiencing losses when they accepted third party checks that were lost or stolen, we moved quickly and issued a Member Alert to inform all our member firms of the scams, how they worked and how they could protect themselves from suffering similar losses.

In addition to alerting our membership of the problem, we immediately reassessed our examination procedures to incorporate appropriate information to assist our examiners in reviewing for these practices. Regarding the use of bogus addresses and PO boxes to carry out investment scams, we revised our examination procedures so that our reviews will better detect potential fraudulent activities by brokers relative to: transfers of securities accounts; use of Post Office boxes; letters of authority to transfer accounts; and customers and brokers having the same mailing address. Ultimately, it is the firm's own

supervisory system and internal controls that, if appropriately designed, will likely detect and prevent this fraudulent activity. To that end, our examinations also may review the firm's supervisory system and internal controls relative to the firm processes I just described. Revising our examination procedures to capture new abusive practices that we encounter allows us to determine if our firms are meeting their regulatory obligations to have procedures that reasonably protect against the abusive practices being perpetrated against their customers.

Routine examinations seek to determine whether a firm is complying with Federal securities laws, rules, and regulations, and with NASD rules. Examinations begin with a detailed review of data that is available through NASD systems, such as securities industry registrations, firm financial data, and firm trading data.

Unless there is a regulatory reason for the examination to be unannounced, the examination staff contacts the firm in advance to request that the firm have specific records, based on the focus and scope of the examination, ready on the date specified. Most firm-wide examinations are conducted at the main office of the firm, although we have increasingly focused on examinations of branch office activities.

During the time at the firm's office, the examiners review the firm's books and records, such as financial computation workpapers and subsidiary ledgers, order tickets and confirmations, complaint and correspondence files, and many other such records. This review is leveraged by a recently released application that integrates questions, review steps, rule references, sampling schedules, and supporting information for examiner reference. Examiners check that the firm's records support the regulatory filings that the firm has made to the NASD in the case of trade reporting, financial filings, complaint filings, and advertising filings, for instance. Examiners prepare independent financial calculations to determine the financial condition of the firm (net capital and customer reserve). Most rules do not have regulatory reporting requirements, so the examiners use the firm's source records to ensure that applicable rules are being complied with; for example, that the firm's written supervisory procedures cover the business activities of the firm. Examiners also interview the firm's compliance officers and management to learn about its supervision and operational practices.

Upon completion of the fieldwork, examiners provide a summary of the initial findings of the examination, and the firm is asked to provide any additional information that should be considered in bringing resolution to the apparent violations noted. Examiners then write a report of the examination, including any apparent violations discovered, and provide it to NASD district office management for review. All apparent violations are supported by appropriate documentary evidence, which is made part of the examination file. Resolution of examinations can vary from an informal cautionary letter for minor deficiencies to referrals to the NASD Enforcement Department for further investigation of more serious violations. The Enforcement Department is authorized to initiate formal disciplinary action against members and their associated persons and to obtain sanctions including censures, fines, suspensions and even expulsions and permanent bars from the securities industry.

In addition to our routine exam program, we conduct approximately 15,000 "cause examinations" each year. Cause examinations generally are investigations of customer complaints (6,630 received in 2001) or cases in which brokers are terminated for cause. In 2001, we investigated approximately 5,504 terminations for cause and approximately 2,752 other matters that came to our attention.

These cause examinations are often conducted by telephone, e-mail, and mail. The examiners obtain an understanding of the problematic activity from the complaining customer or terminating firm. They then contact the appropriate broker or firm for their explanation of the facts surrounding the allegation. The examiner also requests all documentation necessary from the parties to verify the explanations of both sides.

NASD operates in cooperation with federal, state and other SROs to maximize its effectiveness and to fulfill its mission of ensuring market integrity and investor protection. Our in-house disciplinary efforts are supplemented by referrals to the SEC and, where appropriate, to federal and local criminal authorities.

In addition to the examination programs, Member Regulation also administers the NASD membership application process. In order to become an NASD member, a firm must complete a detailed application and demonstrate that it satisfies the criteria established for membership and the conduct of business. These criteria are designed to ensure that members are able to conduct business consistent with the requirements of the federal securities laws and in a manner that assures investor protection. NASD reviews approximately 400 applications for new membership annually. Firms are also required to submit information and seek approval for material changes to their business as well as ownership changes. Approximately 1,000 such applications are considered each year.

Finally, Member Regulation sponsors a variety of programs to assist member firms and their personnel in efforts to comply with the securities laws. Through seminars, publications, and our extensive web site (www.nasdr.com), NASD strives to provide timely guidance and information to help members keep abreast of new and changing regulatory obligations, assist firms in their self-policing efforts, and identify industry "best practices," all in an effort to facilitate investor protection. NASD and its District Offices hold approximately 100 outreach sessions annually.

In closing, I would be pleased to respond to any questions you may have or to address any specific areas in greater detail. Again, thank you for the opportunity to appear before you today.

NASAA

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**TESTIMONY OF BRADLEY W. SKOLNIK**

Indiana Securities Commissioner
Chairman, Enforcement Section
North American Securities Administrators Association, Inc.

Before the

House Financial Services Oversight and Investigations Subcommittee

U.S. House of Representatives

May 23, 2002

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Chairwoman Kelly, Ranking Member Gutierrez and Members of the Subcommittee,

I'm Brad Skolnik, Indiana Securities Commissioner and Chairman of the Enforcement Section for the North American Securities Administrators Association, Inc. (NASAA).[1] I commend you for holding this hearing, and thank you for the opportunity to appear today to present our views on how Congress can help investors avoid fraud.

The securities administrator in your state is responsible for the licensing of investment professionals and securities offerings, investor education and, most importantly, the enforcement of state and federal securities laws. We have been called the "local cops on the beat," and I believe that is an accurate characterization.

Today your focus is on the case of Frank Gruttadauria: He was a clever insider who avoided the detection of his firm's supervisors for many years. Sadly, it sometimes takes an incident like this to shed light on a potential problem and lead to consideration of changes and reforms. My testimony will focus on two questions: What should Congress, the industry, and securities regulators do to prevent another Gruttadauria from cheating investors out of their money? What steps should investors take to better protect themselves from these criminals?

I believe our securities laws and regulations are fundamentally sound. One lesson from this case might be that compliance departments need to toughen their enforcement of the laws already on the books by strengthening their oversight activities. In my view, compliance departments should have reasonably designed standards and systems in place to prevent and detect fraud. For example, it is important that firms implement an effective centralized compliance system to approve the opening of accounts, and monitor associated name and address changes.

In addition, I encourage brokerage firms of a reasonable size to provide on-line access to their customers' account statements. Investors will then be able to check their mailed account statements against the information provided directly by the firm's website, which is not subject to manipulation by a crooked broker. This service should be provided in an equitable manner to all clients, including those with moderate investments.

Another useful tool would be more resources for regulators to do their jobs. I applaud recent Congressional action to raise the SEC budget by more than half to $776 million. This is a good start and includes pay parity to allow the Commission to retain top staff and meet its charges to protect investors and maintain the integrity of our securities markets. We need to make sure that state and federal regulators have the resources they need to conduct regular and extensive exams and audits.

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[1] The oldest international organization devoted to investor protection, the North American Securities Administrators Association, Inc., was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico and Puerto Rico. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

There is another way to fight these criminal fraudsters. We need to change our collective mind-set about white-collar crime. Make no mistake: Securities fraud is not a victimless crime. It destroys lives just as surely as street crime does.

Securities regulators must work with prosecutors to obtain criminal convictions. The prospect of serious jail time is the only way to deter these calculating, cold-blooded, recidivist criminals. Anything less is viewed as just a cost of doing business.

Another reason starch collar criminals aren't getting the punishment they deserve: securities cases are complex, costly and time-consuming. The truth is some prosecutors shy away from them because the subject is complicated and difficult to understand, and explain to a jury. But from my perspective as a state securities regulator, white-collar criminals who commit securities fraud deserve prison time just like thieves, muggers and murderers.

Think about it: Someone steals your car…they go to prison. A con artist steals the money your parents saved for retirement and just gets fined. That's not right.

As a stockbroker, first at S.G. Cowen and then at Lehman Brothers, Frank Gruttadauria allegedly diverted his clients account statements to a post office box without their authorization. He then misappropriated client funds and issued fictitious account statements to cover up his misdeeds and make it appear the investments were secure.

Make no mistake about it. Frank Gruttadauria stands accused of being an unscrupulous scam artist and his alleged criminal activities will be addressed in a court of law. But, sadly to say, this is not an isolated case. While Gruttadauria has attracted national attention because of the magnitude of his crime, this case is in many ways all too typical. As a state securities commissioner, I have encountered many fraudsters who have swindled hardworking Americans out of their life savings.

Over the past few years in my home state of Indiana, we have encountered at least two incidents where stockbrokers employed some of the same tactics, such as the issuance of fictitious account statements to plunder their clients. These two cases bear a disturbing similarity to the Gruttadauria case. Like Gruttadauria, the two Indiana brokers had no history of disciplinary problems or complaints and were well regarded in their local communities. There was next to nothing that would have tipped off investigators or customers about their criminal proclivities. The only real difference that matters today is that, unlike Gruttadauria, who is in custody and awaiting trial, these two Indiana brokers who stole from their clients are still at-large and wanted by the law.

**Mary Louise Sanders**

In late December 2000, Mary Louise Sanders, the president of Spectrum Investment Services, Inc., a 40-person Mishawaka, Indiana-based broker-dealer, told her employees that she was going on a vacation over the holidays. She was supposed to return to the office on January 2, 2001. But she still hasn't appeared.

Shortly after New Year's, it was discovered that Sanders, then a 57-year old grandmother, disappeared with more than $2 million dollars in client funds that were supposed to be used for the purchase of mainstream investment products such as mutual funds. While Sanders purported to sell rather low-risk mutual funds, it was discovered that she never invested the funds as promised; instead, she misappropriated the client funds and issued fictitious account statements to investors that looked legitimate to the untrained eye. The scheme was uncovered when just after New Years in January 2001, one of Sanders' clients came to the office to liquidate some of his investments. When one of Sanders' co-workers sought to assist the investor in her absence, it was learned that the investment accounts did not even exist.

The Sanders case is remarkable in the sense that she is everything a con-artist is not supposed to be: Mary Louise Sanders was a devoted grandmother and refined businesswoman who was well respected in the community.

Sanders is still missing and is a fugitive. Fortunately, many of the losses sustained by investors have been covered by the Securities Investor Protection Corporation (SIPC). The Indiana Securities Division moved in January 2001 to summarily suspend the licenses of Spectrum Investment Services, Inc. and its president Mary Louise Sanders. Federal authorities are actively attempting to locate her on an outstanding arrest warrant for mail fraud.

**Phillip Ferguson**

Phillip Ferguson is a stockbroker and financial consultant who operated a financial services business in Marion, Indiana since the mid 1980's.

In the summer of 2000, it was discovered that Ferguson misappropriated millions of dollars of client funds that he purported to invest in a variety of different investment products, including certificates of deposit, bonds, mutual funds, variable annuities and a commodity pool.

Ferguson disappeared after a routine audit of an introducing broker in the summer of 2000 revealed suspicious activity in an account he controlled. In July 2000, the CFTC filed a civil suit in federal district court in Fort Wayne, IN. It was alleged that Ferguson was engaged in the unauthorized and unregistered operation of a commodity pool.

As an example of regulatory cooperation, the CFTC alerted the Indiana Securities Division that Ferguson was also apparently involved in securities activities and that the Division may want to follow up with its own investigation. The Securities Division investigation revealed that while Ferguson sold what he represented to be a variety of rather low-risk investment products, including bonds, mutual funds and variable annuities, to over 300 mostly elderly investors, he never invested the money. Rather than investing the monies as represented, Ferguson misappropriated the funds for his own use.

It is estimated that investors may have lost as much as $30 to 50 million in connection with the fictitious investments sold by Ferguson. It is one of the largest homegrown, locally based frauds in Indiana history.

Ferguson deceived investors by creating fictitious instruments, including phony bonds and variable annuities, as well as issuing bogus account statements.

As with the Sanders case, the Ferguson matter lacked many of the classic signals of securities fraud: high-pressure sales tactics, promises of sky-high returns and Ferguson had no history of complaints or disciplinary actions. He operated a massive criminal enterprise by selling investments that didn't exist. By issuing bogus account statements and other documents, he was able to cover up his scheme. Unfortunately, most of the warning signs that might have alerted investors to fraud were not present.

An intensive, month long Securities Division investigation resulted in the filing in September 2000 of a 90-count criminal complaint by the Grant County, Indiana prosecuting attorney against Ferguson. He has also been charged with unlawful flight to avoid prosecution by federal officials in the Northern District of Indiana. Ferguson is still missing and is among the FBI's most wanted fugitives.

**Recommendations**

How can we better protect investors from being victimized by the next Frank Gruttadauria, Mary Louise Sanders or Phillip Ferguson. We need to realize that no matter what we do there will always be clever con artists. That's why stiff penalties and long prison sentences are so important. While they sadly can't put money back in investors' pockets, they are ultimately the strongest deterrent to investment fraud.

In addition, NASAA does have some tips for how investors can better protect themselves from sophisticated scams.

1. Periodically check mailed account statements against online account statements from the firm's Web site, or against account information you obtain by calling the firm's headquarters.

2. You've all heard the saying, "Don't put all your eggs in one basket." Well, that applies here, too. Don't put all your investments with one broker. Spread your investments among two or three firms.

3. Contact your state securities regulator to check out a broker before doing business with them. We can tell you if the company or individuals offering investments or advice are licensed or have any disciplinary history. Our website, www.nasaa.org, provides contact for each state. Just click the "find regulator" link on the left side of our homepage.

4. Use common sense. If your written statements show you are making lots of money at a time when the stock market is in decline, you should double-check your accounts with the firm's compliance office.

5. With the advent of desktop publishing, it is not difficult to create bogus account statements. Investors should carefully check the spelling of certain offerings, names, etc. because typos can appear on falsified statements. Investors should also compare information with that found from independent sources such as newpapers and the Internet, and follow-up on discrepancies.

6. Many investment professionals use either custodians or clearing brokers to hold their clients' funds and securities. Investors should periodically compare statements received from their broker with these independent third-parties for confirmation and accuracy.

7. Investors should make sure their account statements are issued by the brokerage firm or mutual fund complex and not from some other business name (that sounds legitimate) used by the investment professional.

**Conclusion**

One component of the fight against fraud is investor education. Many state securities agencies have established an investor education department in their divisions. In 1999, NASAA created a section committee that is devoted to investor education to reflect its heightened importance to our members and their education efforts. Through NASAA, members have issued investor alerts and press releases to warn about investment scams; held town meetings and investor education seminars; and visited high schools to teach students about personal finance, our capital markets, investment choices and fraud.

I applaud you for holding these hearings in an effort to shed light on the criminal abuses in the securities markets. The problems in this area are serious and systemic, but can be successfully addressed if securities regulators and policy makers work together on solutions.

We've become a nation of investors. Over half of American households are invested in stocks, bonds, mutual funds and money markets. Because of this, there are few issues more urgent than stopping the securities frauds that cost investors billions per year.

I pledge the support of the entire NASAA membership to work with you and provide any additional information or assistance you may need. Thank you.

WRITTEN STATEMENT
OF MARC E. LACKRITZ
PRESIDENT
SECURITIES INDUSTRY ASSOCIATION

BEFORE THE
HOUSE OVERSIGHT & INVESTIGATIONS SUBCOMMITTEE
OF THE HOUSE FINANCIAL SERVICES COMMITTEE

MAY 23, 2002

Madam Chairman and Members of the Subcommittee:

I am Marc E. Lackritz, President of the Securities Industry Association (SIA).[1] Thank you for the opportunity to testify today to describe the regulatory structure of the securities industry, the efforts we're making to continually improve compliance and prevent fraud, and the new investor education and information efforts underway to help empower investors.

The securities industry is profoundly concerned whenever an investor loses money through fraud, and we share your Subcommittee's outrage over this particular incident. Indeed, we are embarrassed that this type of fraud has occurred because, although it happens only rarely, it simply should not occur at all. Our industry prides itself on our dedication to ensuring the highest ethical standards among our professionals and our deep commitment to earning the public's trust and confidence that the markets operate fairly with complete integrity. When that trust and confidence is undermined in any way, our reputations are diminished and investors become more reluctant to provide the capital that companies need to grow and flourish, employ more workers, and provide financial returns that boost our nation's prosperity. While these problems are extremely rare, when they do happen, they unfortunately tarnish the reputation of the industry and the hundreds of thousands of professionals who have worked so hard to ensure that their clients are well served. That is why we have no tolerance for those who have broken the law, and we believe bad actors should be prosecuted to the full extent of the law.

**The Securities Industry's Multi-Tiered Regulatory Structure**

Although this, or any, episode of fraud is egregious and unacceptable, it is important to note how rare, and even unique, incidents such as these are. In relation to the number of transactions, the percentage of complaints against brokers is very, very small. Customer complaints to the SEC in the first quarter 2001 show that only one out of 172,000

[1] SIA represents the shared interests of nearly 700 securities firms. SIA member-firms (including investment banks, broker-dealers and mutual fund companies) are active in all phases of corporate and public finance. The U.S. securities industry manages the accounts of nearly 93 million investors directly and indirectly through corporate, thrift, and pension plans. In the year 2001, the industry generated $198 billion in U.S. revenue and $358 billion in global revenues. Securities firms employ over 750,000 individuals in the U.S.

transactions even gives rise to a complaint. That means that more than 99.99 percent of all transactions result in no complaints, a record other industries and professions envy.

Since 1995, the increases in dollar volume and securities transactions (269 percent and 510 percent, respectively, between 1995 and first quarter 2001) dwarf the increase in complaints (44.3 percent). Indeed, every day, nearly $700 billion in transactions clear and settle on the stock and debt markets based on a handshake, a nod, a hand signal, a keystroke, or a phone call. This would not be possible without a strong and fair regulatory scheme that protects investors and ensures the integrity of the markets.

The first layer of investor protection occurs at the brokerage firm itself, which is responsible for complying with every law and regulation pertaining to its business, including the strict supervision of all personnel. Securities firms must also establish clear-cut financial controls that serve the best interest of their customers. All firms must have ongoing education programs to keep employees up-to-date on industry-, product-, and service-related subjects as part of a mandatory continuing education program. In addition, broker-dealers continue to promote even higher standards of professionalism by voluntarily adopting certain "best practices" developed by SIA.

Self-regulatory organizations (SROs) are the second level of regulation. SROs include the New York, American, and regional stock exchanges, NASD Regulation, and the Municipal Securities Rulemaking Board. SROs verify that brokerage firms have systems and procedures to manage themselves properly and to comply with securities regulations. Some of their activities include regularly reviewing the firms' books and records, administering tests, and supervising the industry's mandatory continuing education requirements. SROs create a compliance system by which individuals and securities firms can police their own activities. For example, NASD Regulation maintains a public disclosure program on its website (www.nasdr.com), as well as a toll-free telephone number (800-289-9999), that provides disciplinary information on all licensed securities brokers. This resource, which we believe is unique in any profession, enables investors to know instantly whether a broker with whom they are considering doing business has ever had disciplinary action taken against him or her. In addition, the SROs discipline their members for violations of securities laws and regulations. In most cases, SROs take the first steps in detecting infractions, and often handle the initial stages in the major civil and criminal proceedings against industry personnel.

The Securities and Exchange Commission (SEC) – the third layer of regulation – is charged with preserving the integrity, efficiency, and fairness of the securities markets by administering and enforcing federal securities laws. It also oversees the SROs. As we all know, the SEC has a long history of detecting fraud and punishing wrongdoers. In fact, this year, it brought more enforcement actions in the first quarter – 61 cases – than it did in the same period last year. In taking the helm of the SEC, Chairman Harvey Pitt is refocusing the agency's role on catching problems early rather than spending years developing a case and then imposing penalties. The new approach has an even greater "chilling effect" on any individual who may be contemplating a new Ponzi scheme. We support this effort and Chairman Pitt's request for more resources to expand the commission's legal and enforcement staffs, and we appreciate this committee's support of greater resources for the SEC. A fully funded SEC is critical for both the securities industry and our customers.

Congress is the ultimate overseer and ensures that the SEC is fulfilling its responsibility to regulate the securities markets. The four layers of federal regulation – as well as state securities laws that impose additional requirements on broker-dealers and their employees operating within their borders – make the securities industry among the most highly regulated. This regulatory structure has helped to foster the broadest, deepest, most transparent markets in the world, and countries across the globe are emulating our system. We have established a record the entire industry can be proud of, the public can rely on, and other industries can only envy.

Yet once in a while a bad actor slips through this structure and defrauds customers. When this happens, the industry works very hard to make customers whole and to improve our systems for stopping fraud. Broker-dealers have invested heavily in technology that enhances their ability to detect abuses while more effectively managing investors' money. For example, computers compare a client's electronically stored profile against the trades he or she is trying to undertake. If the two don't match, red flags fly. The broker-dealer's compliance officers will scrutinize the activity immediately. New technologies also help securities firms collect, retain, and transmit information to meet their supervisory obligations. In addition, market regulators use sophisticated, state-of-the-art software and computerized surveillance systems to detect and investigate any signs of foul play.

**Investor Education More Important Than Ever**

In addition to the industry's efforts to stop fraud before it happens, broker-dealers and the industry are redoubling our investor education efforts so that investors will have the necessary tools and skills to invest responsibly and avoid being defrauded. SIA's annual investor survey finds consistently that investors are overwhelmingly content with the service that their broker provides to them.[2] They value most the time that their broker spends with them, the education he or she provides, and his or her investment recommendations. Even so, a majority of investors still think the industry should do even more to educate the public about investing.

As a result, our industry spends a great deal of time and effort to educate investors about the risks and opportunities of investing. Over the last decade, we have published a broad range of brochures to address specific investment issues. When online trading grew quickly, we produced a brochure that outlined the issues that investors should keep in mind when investing online. Amid the bull market, we published two brochures – *Understanding Market Risks* and *Managing Your Expectations For Long-Term Success In The Stock Market* – that cautioned investors about potential risks and explained to them the historical performance of markets. We just released a third edition of our most popular publication – *Your Guide To Understanding Investing* – a plain English, fully illustrated resource for new and experienced investors.

[2] SIA commissioned Yankelovich Partners in 1995 (acquired by HarrisInteractive in 2001) to conduct an annual survey measuring investors' attitudes toward the securities industry. Percentage of investors "very satisfied" or "somewhat satisfied" with their broker's service: 96% (1995); 94% (1996); 94% (1997); 95% (1998); 95% (1999); 95% (2000); 91% (2001).

In publishing these materials, we have worked with the SROs and the North American Securities Administrators Association in the hope that together we can reach more investors rather than if we were each to publish individual brochures. Two examples of our collaboration stand out. The first, which we released only a few weeks ago, helps investors interpret their account statements. The brochure also includes a "frequently asked questions" section and an extensive glossary of investment terms that account holders may come across while reviewing their statements. The second warns about promissory notes.

We have also participated in investor town hall meetings across the country organized by the SEC. During these, we often hold a seminar outlining the ten steps of successful investing and explaining investment fundamentals such as how to read a statement and knowing that your brokerage firm must send you a confirmation of any transaction you conduct with that firm. These joint efforts have been very successful, and we look forward to doing even more with the SEC, the SROs, and NASAA. By working together, our impact is far greater than if we were to work alone. And we fully support the Treasury Department's new campaign for financial literacy – a goal our industry has been committed to achieving for many years through our Stock Market Game™.

Today, more than 600,000 students in the fourth through twelfth grades participate in the 10-week program, which has been run by our Securities Industry Foundation for Economic Education for more than 25 years. The SMG combines basic economic education with an investment simulation exercise. Students form teams and invest a hypothetical $100,000 in stocks. While they are choosing which stocks to buy or sell, economic and political events are shaping the markets, causing interest rates and stock prices to change. The program helps students to understand the relationships between economics and markets.

In April this year, we launched a new website, "SIA Investor: Your path to financial knowledge" (www.siainvestor.org). It is an interactive online learning tool that addresses investors' different needs, from the basics to more complicated questions, such as asset allocation. A unique site, it features five core financial topics: Investing Goals, Investing Essentials, Choosing Investments, Managing Your Portfolio, and How Markets Work. Industry experts offer their views on such topics as portfolio diversification and the 401(k) retirement program. The site is strictly educational, with no product endorsements or advertising, and there are no registration or password requirements. We recently set up computers in the Rayburn House Office Building to allow Members of Congress and their staffs to see how the site works, and the response was very positive.

**Conclusion**

The securities industry works in concert with government, regulators, and self-regulatory organizations to promote a culture of trust and confidence, which are our most important assets. In such an environment, innovation soars, competition thrives, and investor confidence flourishes. We all have to work together to continue to keep incidents of wrongdoing to a minimum through effective leadership, compliance, self-regulation, and more investor education. These actions will help maintain and enhance the public's trust and confidence, which is good for investors, good for our industry, and good for our country.

Thank you very much.

# STATEMENT OF CARL FAZIO
# BEFORE
# THE HOUSE FINANCIAL
# SERVICES OVERSIGHT AND
# INVESTIGATION SUBCOMMITTEE

## MAY 23, 2002

**Chairman KELLY, Members of the House Financial Services Oversight and Investigation Subcommittee:**

Thank you for inviting me to be with you today. I will share with you my family's story of betrayal by four of America's great institutions - Lehman Brothers, Cowen & Company, S. G. Cowen and Hambrecht & Quist. Caution shown by today's investors not only reflects the lack of confidence the public has in corporate accounting; it demonstrates that the public also understands that major investment banking firms only say the right thing, they do not do it, and more importantly, they apparently turn a blind eye when investors are hurt.

I am Carl Fazio. I came to this country at the age of three. Through great effort and energy, my family was able to build one fruit stand into Fisher-Fazio's, a major chain of supermarkets which ultimately became a New York Stock Exchange company. At the time of its sale, I was its chairman and we employed approximately 20,000 people. Today, as I stand before you, although I earned and invested a handsome amount of money, I have few liquid assets. I am unable, at the age of 85, to pay my bills as they become due and am forced to sell my home, all because of the greed of Lehman Brothers, Cowen & Company, S. G. Cowen and possibly, Hambrecht & Quist. While focusing on generating fees, they failed to police their own brokers and employees. We have only recently learned that the New York Stock Exchange, in a disciplinary proceeding against Cowen & Company dealing with 1994 and 1995, criticized it for having compliance people subordinate to branch office managers. Even though the Stock Exchange found this deficiency, it was never corrected. In Cleveland, Robert Semanek, the firm's compliance person, reported to Frank Gruttadauria. This is wrong. Neither Cowen & Company, S. G. Cowen nor Lehman Brothers changed their procedures. That's a key reason why Frank Gruttadauria could generate fraudulent statements on his personal computer which he had in his office. He had the computer even though, according to some newspaper reports, it was against company policy. My assets have been stolen from me, not just by Frank Gruttadauria, but by the collective efforts of the brokerage firms that lent him their credibility and resources and turned their backs on protecting me.

After the sale of my company, at the request of my first wife, through her close friend, I entrusted some of my funds to Frank Gruttadauria and his firm. Over the years he became as close to me as one of my own sons. I viewed him as a member of my family and proudly watched him receive accolades in the investment community and rise up the ladder becoming a senior director of S. G. Cowen and the Branch Office Manager for Lehman Brothers. His positions in the companies gave me confidence. Little did I know that at some time, from the little records I have been able to get since Frank Gruttadauria admitted his frauds and ran away, maybe as early as the 1980s, he took my money and misappropriated it in order to grow his commission income, all the while sending me false statements which reflected the trades I sought in the market. He did this while encouraging me to deposit more and more money. Ultimately, all of my liquid assets were put under the control of Frank Gruttadauria who stole them.

I believe I am a very knowledgeable investor. I told Mr. Gruttadauria what I wanted to buy and what I wanted to sell. I made my own trades - or so I thought. I was in constant contact with him and with his office. I reviewed what I believed to be confirmations as well as my statements. Little did I know that I was dealing with smoke and mirrors. The correct statements were kept from me. What I received were fictional statements tailored to the investments that I directed. I did not have a clue that Frank Gruttadauria took control of my account and traded the hell out of it! What I did know, and what I know today, is that my phony statements correctly reflect the trades that should have been made on my behalf. What Mr. Gruttadauria did, and I am still learning as the brokerage firms begrudgingly turn over a limited amount of information, was take my funds and generate mind numbing amounts of commission for the firm while losing money in the market hand over fist. For example, in statements I recently received from S. G. Cowen's lawyers, I learned that in 1990 alone in my real account, the one I never saw, I paid commissions equal to more than 50% of my average equity and that my account turned over more than 15 times. That trading caused great losses. These commissions, turnovers and losses should have set off alarms at every compliance level, but all I heard from them was the sound of silence.

Brokerage firms are required to control their brokers. They have compliance procedures which must have been totally ignored when it came to this star broker. When accounts were losing money, someone other than the broker is supposed to call you. Someone other than your broker is supposed to talk to you about your investment objectives and the losses you are suffering and advise you as to the risks. That is one method brokerage firms have to root out trading contrary to the investors' wishes. In all the years I had accounts at Hambrecht & Quist, Cowen, S. G. Cowen and Lehman, not one person other than Mr. Gruttadauria and his staff ever talked to me about my accounts. Where were the policemen? Where was compliance? Where were the people within the companies who were supposed to protect me? Obviously, as Mr. Gruttadauria stated in his letter to the FBI, "I can hardly believe that I could have done this without detection for so long, the various firms' greed and lack of attention at the senior level contributed greatly to that." Apparently, the economic incentive of the leadership at the various brokerage firms lead them to turn a blind eye to the reckless conduct.

When I was first told the following I could not believe it was true. In Cowen's response to the New York Stock Exchange disciplinary proceeding, Cowen's lawyer, as

part of a memorandum stated that, "Mr. Gruttadauria manages an exemplary branch." How could they say that? All they had to do was glance at the accounts or look at all of the mailings to the post office boxes in his home town and this massive fraud would have come unraveled. They clearly didn't bother to investigate and I would ask you to determine why.

Now their greed has devastated me. And if the brokerage firms' actions are not bad enough, S. G. Cowen, a brokerage firm I sued, is now attempting to manipulate the court system by removing my claim from the court to arbitration. As they said in their Motion, and I quote, "Plaintiffs must pursue their claims in arbitration before a Panel of an appropriate self-regulatory organization." I believe they want it there because arbitration, as I have been advised, is a brokerage industry drafted procedure. Apparently, they believe they will obtain some strategic advantage from being there or they wouldn't seek to take the case from the federal judge hearing it. Even though the acts were fraudulent and concealed from me, the self-regulatory organization says I can only go back six years. Frank Gruttadauria said in his note that he has been doing this for 15 years. In other words, by not doing their job for more than fifteen years, these brokers may benefit by their own rules. Obviously, S. G. Cowen does not care about what happened to me. They want to get into arbitration because, I believe, they feel that they will be better able to deprive me of what I am truly entitled to.

I am 85 years old. I need this money to live on now. On January 28, 2002, I met with Lehman Brothers and told them of my urgent need for money. Lehman Brothers and S. G. Cowen are two of the wealthiest investment firms in the world, yet they have not offered one dime to compensate us for our losses or help us with my current needs. I can no longer afford my home in Aurora, Ohio. Is it fair that I have to sell my home? Is it fair I have to liquidate my assets just to pay my bills? Is it fair that my life has come to this? I don't believe you would think it is.

I am not alone. There are many people who continue to suffer at the hands of S. G. Cowen and Lehman Brothers. Many of us are no longer young. I urge you to hold these firms accountable now. Please don't wait until we die to protect us.

I would like to close by reading you a portion of Lehman Brothers mission statement. I quote "We are One Firm, defined by our unwavering commitment to our clients...." End of quote. In my situation they not only waved, they punted and now they just don't care.

Thank you for your time.

**Testimony of Golda L. Stout**
Subcommittee on Oversight & Investigations
Committee on Financial Services
May 23, 2002

1. I am a citizen of the United States of America. I was born on 12 May 1915 on a small farm north of Madrid, Iowa and my age is 87. My birth name was Golda Sylvia Lewis. My friends know me simply as Judy Stout.
2. I am the eldest and only surviving child of my parents, Earl Russell Lewis and Sylvia Bryant Lewis. I had one sister, Zola Mae Lewis, who was born on 28 August 1916 and died on 1 May 1997. After she married Lawrence A. Cuneo, Sr., she legally changed her first name and became Ann L. Cuneo. My two brothers were Ernest R. Lewis and Larry G. Lewis
3. I married Hugh H. Stout on 30 August 1939. We lived together for over 56 years until his death on 18 April 1996. With his death I suffered the greatest loss in my life and I think of him everyday.
4. I live in Elgin, Illinois where I have resided for over 50 years.
5. I graduated from Roosevelt High School in Des Moines, Iowa in January 1933.
6. I graduated from Capital City Commercial College in Des Moines, Iowa in November, 1933
7. I attended Iowa State College for the full-term of 1934 and the fall of 1936. I was studying to be a Registered Dietitian but did not complete my undergraduate education for financial reasons.
8. Great Western Insurance employed me in 1937 at their office in Des Moines, Iowa. After the merger of Great Western with Washington National Insurance, I was transferred to their home office in Evanston, Illinois.
9. I have two children (sons), Duane E. Stout and Ronald L. Stout, who were born on 13 December 1946 and 30 November 1942, respectively, in Evanston, Illinois.
10. Duane E. Stout married Christine Matousek on 10 October 1981. They live in Riverside, Illinois. Duane has a B.S. in Chemistry from Iowa State University, a M.S. in Biochemistry from Northwestern University and a B.S. in Pharmacy from the University of Illinois. His is currently a staff pharmacist at the Hines VA Hospital. He is also a Lt. Commander in the U.S. Public Health Service Reserve.
11. Ronald L. Stout married Breda Hickey on 25 November 1965. They live in Elgin, Illinois and their home is located approximately 500 feet from my home. Ronald has a B.S. with distinction in Electrical Engineering from Iowa State University and a Ph.D. in Electrical Engineering from Northwestern University. Ronald recently retired from Lucent Technologies Inc.
12. I have one stepson, Donnell D. Stout, born on 2 August 1933. He is married to Virginia Stout and they live in San Antonio, Texas. He is retired from the U.S. Air Force.
13. Ronald and Breda Stout have provided me with a granddaughter, Keara Lynn (25) and a grandson, Kieran Andrew (28). Both have undergraduate college degrees.
14. Kieran is both a full-time firefighter on the Carpentersville Fire Department and a Captain on the Pingree Grove Volunteer Fire Department that protects my home. He is married to Tamara L. Stout and they have blessed me with a great-granddaughter, Kierstin A. Stout (4). Tamara is due to deliver her second child in May 2002.
15. Keara is the Director of Aquatics for Lifetime Fitness in Algonquin, Illinois.

16. My children and their wives, my granddaughter, grandson and his wife, and my great-granddaughter have been the joys of my life. Due to their close proximity to my home I am fortunate to have them visit me frequently and for Sunday dinners. My great-granddaughter's best treat is having a sleepover with me, her Grandmere. They all keep me feeling vibrant and alive.
17. My physicians are pleased with my general health for a person 87 years young. I have a heart condition that required quadruple by-pass surgery in September 1996. However, I intend to have a major celebration on my 90th birthday.
18. Throughout many ordeals in life and especially this most recent one involving Frank Dominic Gruttadauria, Lehman Bros. and SG Cowen, my own internal drive and the steadfast support and involvement of my family have given the strength to deal with these challenges.
19. Based upon encouragement of Breda in June 1982, I established my first brokerage account and began to invest in the stock market. I did not initially engage Frank D. Gruttadauria as my account executive but was familiar with him through Breda. Frank had initially contacted her in the early 1980's to solicit her investment business.
20. Throughout the 1980's I became more familiar with Frank, his wife and children on a social basis. However, my sister, Ann L. Cuneo, did engage Frank as her stockbroker before I did.
21. Based upon my sister's favorable comments regarding Frank, my husband and I opened a brokerage account with him as the designated broker at the Chicago, Illinois office of Cowen and Company in November 1991. We established the account with an initial deposit of $100,000.
22. Over the next few years I came to trust Frank and Cowen and Company and I ultimately transferred all my investment assets to them.
23. Over the period from 1991 through 1997 I deposited with Cowen and Company over $750,000 in cash, securities and bonds. I continue with Lehman Bros. after my account transferred from SG Cowen to Lehman with Frank. My most recent cash deposit was $100,000 in October 2001 to Lehman Bros.
24. I felt secure in investing with Cowen and Company, SG Cowen and Lehman Bros. because of their solid reputation in the securities industry.
25. For many years I have monitored my investments by recording the closing price of each stock I owned in my notebook(s). I did this daily except when I was ill, on vacation, or had some other unexpected event arise so that I could not do so. The statements I received from Cowen and Company, SG Cowen or Lehman Bros. were consistent with my personal records of the securities I thought I owned and the current prices for them.
26. From discussions with Frank and the November 2001 Lehman Bros account statement received, I believed my portfolio value to be slightly in excess of $2,500,000.
27. As a Christmas present in 1999 my family gave me a personal computer. Since receiving it, I have undertaken a self-education project to become computer literate. In the fall of 2001 my son, Ronald, introduced me to on-line banking.
28. My son also informed me that he could access his entire investment portfolio on-line through a website provided by his investment firm. My thoughts turned to on-line access of my brokerage information too. This would be of great value since I could not readily get daily information from CNBC on my bond prices and it would save me from logging the closing price of each equity.
29. In early January 2002, I asked Frank for Internet access to my Lehman Bros. brokerage account. He told me that Lehman Bros. did not offer its clients Internet access to their

accounts. After informing my son about this he checked the Lehman Bros. website. According to the website, Lehman Bros. did offer Internet account access at live.lehman.com. He contacted the 24-hour Help Desk using their toll free number for more information. As indicated on the website and reconfirmed by through the Help Desk, a User ID must be obtained from your Lehman Bros. representative.

30. I called Frank and told him what we had learned. He then acknowledged that Lehman Bros did offer Internet access but he said that he had a personal policy not to allow any of his clients Internet brokerage service. He said it was too much of a distraction for him. He stated that if I wanted Internet access he would have my account transferred to another broker but I would lose his investment counsel and services. Based upon my desire to retain his advice and our long relationship, I did not transfer elsewhere.
31. Either in that telephone conversation or in a return call shortly thereafter, Frank offered to provide me with a list of all the symbols for the securities in my account so that I could check on the daily closing prices using Microsoft Money, which I told him I had to monitor my banking account on-line.
32. By Monday, 21 January 2002, I had not received any list of stock symbols from Frank. I decided that I would have my account moved to another broker in order to gain Internet access to my account. However, on the morning of 22 January 2002 my son received information from his lawyer that attorneys for Frank had been unsuccessful in contacting him for over one week and that the next information about Frank would be in the newspapers.
33. Based upon this alarming information I attempted to contact Frank by telephone. The person answering asked me for some of my account information, informed me that Frank was being sought by the FBI and I would be contacted with information about my account shortly.
34. I heard nothing for the remainder of that day and on Wednesday my son contacted the Lehman Bros. office. He was given the name of an individual who would contact me soon. Shortly before noon CST, a Lehman Bros. employee informed me that the value of my account was estimated at about $86,000. I disputed that amount and requested they provide me with a current statement since I had not received a December 2001 statement.
35. When I received the December 2001 statement, it confirmed the value of my portfolio to be approximately $86,000 at the end of that month. To my surprise I noticed that this statement was mailed in my name to Joseph DeGrandis, Jr. at DeGrandis & DeGrandis in Cleveland, Ohio.
36. I saved all the information I received from Cowen and Company, SG Cowen and Lehman Bros over the past ten years. Upon comparing them with actual account statements provided by these firms it is clear that I was defrauded on a massive scale for years. My account was drained of its assets by unauthorized sales of equities, checks issued to unknown individuals without my personal authorization, equities delivered to undocumented destinations and the forgery of my signature to at least one Lehman Bros. client agreement.
37. Throughout the period that Frank served as the account executive managing my securities portfolio, he told me he was investing my money according to my instructions and that he had my best interests at heart. I believed him because I trusted him like many of the investment companies are stressing in their television advertisements.
38. Had I known that Frank was preparing and sending me false brokerage account statements, sending the official statements to DeGrandis & DeGrandis without my authorization or knowledge, or making payments or transfers without my knowledge and

permission, I would have not selected Frank as my account representative, and, upon discovery of any of these facts, I would have immediately terminated our relationship.

39. By his own admission Frank D. Gruttadauria defrauded his clients for over 15 years. While individual investors cannot see the whole picture, the investment firm has oversight capability and responsibility. During a period of economic growth in the market, the accounts of Frank's clients were declining. This occurred without detection or suspicion by any of his employers, Cowen and Company, SG Cowen or Lehman Bros. Equally troubling to these firms should have been the seeming lack of concern on the part of clients to the loss in portfolio value and strange activities transpiring month after month after month.
40. Given recent newspaper articles about these firms, it would appear this is not the first occurrence of this type of fraud. It thus raises a question as to whether these firms are unwilling to detect wrongdoing.
41. I lived through a Depression in this country that I hope we never experience again. While I suffered along with millions of other Americans from the ravages of the Depression, I made a commitment to work hard and save. As a result of my investment activities, I felt secure in knowing that the remaining years of my life would be spent without financial worry. I looked forward to passing on a valuable legacy to my children, grandchildren and great-grandchildren. Unlike myself who could not complete college because of financial limitations, I wanted to assure my great-grandchildren of their education. But all has changed since January 2002.
42. The project to recover my loses has just begun. Either road, litigation or arbitration, will require much time since this is not the normal case. The investment firms have large resources to devote. And their revenue stream continues but mine has stopped. My investment portfolio loss is monumental to me but represents just minute's worth of the revenue to these investment firms. But even with this mind they will battle me as though their very existence is at stake.
43. This brings me to my main point. As we all realize social security should not be the foundation of any retirement plan. IRA's, 401ks, saving and investing are the real foundation for retirement. In almost all cases these activities will involve investments using a brokerage firm. To the greatest extent possible stockbroker misdeeds must be prevented from occurring. The cost in time and money to recover losses is too great a burden.

## APPENDIX

Testimony of
Lori A. Richards, Director
Office of Compliance Inspections and Examinations
United States Securities and Exchange Commission

Concerning Issues Raised by the Frank D. Gruttadauria Matter

May 23, 2002

As described in the Commission's testimony, the Securities and Exchange Commission's examination of the Chicago branch office of Cowen & Company occurred in November 1993. This cause examination was commenced as a result of an anonymous tip received by the SEC's Midwest Regional Office regarding possible sales practice abuses in a particular customer's account, which was serviced by registered representative Frank D. Gruttadauria. The Commission granted permission to make this exam report accessible to Financial Services Committee Members and staff and to provide explanations as needed, and we are happy to continue in that manner.

A total of five days were spent in the field examination of this branch office, all of which were used to review sales practices in selected accounts. Interviews were conducted with the following Cowen branch office personnel: Chicago Branch manager, Compliance Director, and Registered Representative (Frank D. Gruttadauria).

Pursuant to the SEC's standard practice, the report of this examination was submitted by the examiner and reviewed and approved by SEC supervisory staff including the Branch chief, two Assistant Regional Directors and the Associate Regional Director.

November 1993 Broker-Dealer Examination
Cowen & Company, Chicago Branch Office

The examiner reviewed approximately 200 customer accounts for the ten-month period ending on October 29, 1993. Included in this sample were accounts with large debit or credit balances, accounts handled by the highest producing registered representatives, accounts of officers and employees, customer option accounts and accounts which generated numerous monthly trades and/or large commissions during any particular month. This review disclosed no unusual trading activities or sales practice abuses.

**The Review of the Customer's Account[1] and Other Accounts Serviced by Registered Representative Frank Gruttadauria**

[1] The Commission is mindful of the privacy interests of individuals whose personal financial information is obtained during the course of an examination. Accordingly, the person whose account was reviewed as part of this examination is referred to as the "customer."

As part of this examination the examiner reviewed the trading activity in the customer's account. Other accounts serviced by registered representative Frank Gruttadauria at both the Chicago and Cleveland branch offices were also reviewed.[2]

The customer's account was opened during July 1989 and contained trading activity for several months through September 1990. There has been no account activity since October 11, 1990. Most of the trading in this account occurred during the months of April 1990 through September 1990. During this time the customer's average account equity was $96,491 and she incurred trading losses of $88,000. Also, during this period, her account generated commissions of $39,032 and had a turnover rate of 18 times.

A review of the customer's account card disclosed that she had annual income of $500,000 and an estimated net worth of $5 million. The account card also stated that she had 10 years of experience in trading options and a greater number of years of experience trading equities and commodities.

According to the Registrant, the customer made no complaints, either verbal or in writing, regarding the trading activity in her account. In addition, Gruttadauria represented to the examiner that the trades in her account were predominately unsolicited. Gruttadauria also claims that he had contacted the customer regarding her account. According to Gruttadauria, the customer told him that if any complaints were made in connection with the trading in her account, they would probably be instigated by one of her children without her knowledge or approval.

The type of trading in the customer's account was not noted in the review of other accounts serviced by Gruttadauria. The exam report concluded that, based upon this isolated incident which occurred over three years ago, the lack of any complaint by this customer during this time, and her prior trading experience, there do not appear to be any significant sales practices exceptions.

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[2] In addition to servicing and maintaining customer accounts at the Chicago branch office, Gruttadauria also services and maintains customer accounts at the Registrant's Cleveland branch office, where he is a co-branch manager. Gruttadauria spends approximately 10% of his time at the Chicago branch office.

HPD98064 COWEN & CO.....

NEW YORK STOCK EXCHANGE, INC.

EXCHANGE HEARING PANEL DECISION 98-64 July 10, 1998
COWEN & CO.
MEMBER ORGANIZATION

* * *

**Violated sections 220.4(c)(3)(i), 220.4(d), 220.8(b)(1)(i)(A), 220.8(b)(4), and 220.8(c)(1) of Regulation T and Exchange Rules 431(f)(7), 431(f)(9), and 432 (a) and (b) in that it failed to obtain timely payment, failed to liquidate, failed to impose and enforce 90 day restrictions, permitted customers to make a practice of satisfying margin by liquidation and free-riding in cash accounts, violated Exchange Rules 405(1) and (3) in that it failed to be informed of the nature of accounts and to learn the essential facts of a conduit account, violated Exchange Rules 408(a) and (b) in that it failed to obtain prior written authorization, to properly mark order tickets, to identify, approve, designate and supervise discretionary accounts, violated Exchange Rule 410(a) in that it did not designate an account prior to execution, violated SEC Regulation 240.15c1-6 in that it failed to disclose a potential conflict of interest to discretionary customers, violated Exchange Rules 472(a), 472.30 and 472.40(2) in that it did not properly approve public communications, did not properly label opinion material, and make required disclosures, violated SEC Regulations 240.17a-3, 240.17a-4 and Exchange Rule 440 in that it failed to create and maintain certain business records, violated Exchange Rule 342.16 in that it failed to properly supervise outgoing correspondence, and violated Exchange Rules 342(a) and (b) in that it failed to provide for and implement adequate systems and procedures to ensure supervision -- Consent to censure, a fine of $380,000 and an undertaking to make a compliance review.**

**Appearances:**

For the Division of Enforcement
Robert A. Marchman, Esq.
Jeanne R. Elmadany, Esq.

For the Respondent
Philippe M. Salomon, Esq.

* * *

An Exchange Hearing Panel met to consider a Stipulation of Facts and Consent to Penalty entered into between the Exchange's Division of Enforcement and Cowen & Co, a member organization (the "Firm"). Without admitting or denying guilt the Firm consented to a finding by the Hearing Panel that it:

Violated Sections 220.4(c)(3)(i), 220.4(d), 220.8(b)(1)(i)(A), and 220.8(b)(4), and 220.8(c)(1) of Regulation T promulgated pursuant to the Act by the Board of Governors of the Federal Reserve System ("Reg. T") and Exchange Rules 431(f)(7), 431(f)(9) and 432(a) and (b) in that it:

failed to obtain timely payment for cash purchases and timely satisfaction of initial and maintenance margin calls;

failed to liquidate securities in customer accounts when cash payments and margin requirements were not timely received;

failed to impose and enforce 90 day restrictions on cash accounts in which positions were sold prior to full and timely payment therefor;

permitted customers to make a practice of delaying the satisfaction of initial and maintenance margin requirements and satisfying such requirements by liquidation; and

permitted customers to make a practice of free-riding in cash accounts.

Violated Exchange Rule 405(1) and (3) in that it:

failed to be informed of the nature of each of its accounts prior to approving their opening; and

failed to learn the essential facts relative to every beneficial owner of a conduit account.

Violated Exchange Rules 408(a) and (b) in that it:

failed to obtain prior written authorization from the customer for each discretionary account;

failed to mark order tickets for discretionary accounts to indicate whether discretion had been exercised;

failed to identify, approve and designate discretionary accounts as such; and

failed to frequently supervise discretionary accounts.

Violated Exchange Rule 410(a) in that it did not designate the account for which an order was to be executed prior to the execution of each order in an Exchange listed security.

Violated SEC Regulation 240.15c1-6 in that it failed to disclose to discretionary customers the potential conflict of interest with respect to any syndicate offering in which it participated as an underwriter.

Violated Exchange Rules 472(a), 472.30 and 472.40(2) in that:

a supervisory analyst did not approve in advance communications it made available to the public;

it did not clearly and distinctly label opinion material as such; and

in connection with recommendations it did not disclose:

market making, principal trading and/or underwriting activities,

the position of an employee involved in preparation of a research report; and

whether any employee was a director of an issuer.

Violated SEC Regulations 240.17a-3 and 240.17a-4 and Exchange Rule 440 in that it failed to create and maintain complete and accurate business records concerning:

each brokerage order for its own or customer accounts;

the daily calculation of customer margin requirements and the satisfaction of such requirements;

outgoing correspondence;

discretionary accounts; and

beneficial owners of conduit accounts.

Violated Exchange Rule 342.16 in that it failed to have supervisory approval and evidence of such approval of all outgoing correspondence.

Violated Exchange Rules 342(a) and (b) in that it failed to provide for and implement adequate systems and procedures to ensure the supervision of:

the preparation, entry and maintenance of order tickets, including the designation of customer accounts, identification of discretionary transactions and time stamping;

the daily calculation of margin requirements;

obtaining timely payment for cash purchases and satisfaction of margin requirements;

liquidating securities in customer accounts when payments were not timely received;

the imposition and enforcement of 90 day freezes on customer accounts;

the form and content of outgoing correspondence;

supervisory analyst approval of firm generated research;

the inclusion of disclosures and disclaimers on research purchased and generated by the Firm and disseminated to the public;

the obtaining of written discretionary authorizations;

the identification, approval, designation and frequent review of discretionary accounts;

the allocation of hot issues to conduit accounts without a determination of the eligibility of the beneficial owners of such accounts to participate in such offerings;

the disclosure of the potential conflict of interest to discretionary customers in connection with syndicate offerings in which the Firm participated as underwriter; and

BOMs acting in the capacity of registered representatives particularly with respect to correspondence and customer payments for purchases.

For the sole purpose of settling this disciplinary proceeding and without admitting or denying any of the facts or matters set forth in the Stipulation of Facts and Consent to Penalty, the Division of Enforcement and the Firm stipulate to certain facts, the substance of which follows:

**Background and Jurisdiction**

The Firm, a member organization of the Exchange since 1923, is headquartered in New York City at Financial Square. The Firm conducts a general brokerage business: it executes principal and agency securities transactions, performs underwriting and investment banking services, manages investment portfolios, and offers correspondent clearing and execution services for other broker-dealers. During the relevant period herein, the Firm: had five (5) international branch offices, (14) domestic branch offices and (5) domestic satellite offices; employed approximately 1350 persons including approximately 550 income producing persons; and carried and cleared approximately 93,000 accounts including approximately 15,000 for its 45 fully disclosed correspondents.

**Member Firm Regulation Examinations of the Firm**

On May 25, 1994, following an annual examination of the Firm, including visits to the Firm's Financial Square, NY, Cleveland, Ohio and Boston, Massachusetts (Retail) branch offices, the Sales

Practice Review Unit of the Division of Member Firm Regulation of the Exchange ("MFR") issued a report ("the 1994 Examination Report"), which identified certain deficiencies in the Firm's supervisory standards and sales practice procedures. The examiners concluded that the Firm hac violated various Exchange Rules and federal securities laws and regulations.

The Firm provided a written response to the 1994 Examination Report by letter dated July 5, 1994 (the "1994 Response"). In the 1994 Response, the Firm represented that certain deficiencies noted were being corrected.

On October 17, 1995, following an annual examination of the Firm, including visits to the Firm's Financial Square, NY, Madison Ave., NY and Boston, Massachusetts (Research) offices, MFR issued a report ("the 1995 Examination Report") which identified certain deficiencies in the Firm's supervisory standards and sales practice procedures including violations of various Exchange Rules and federal securities laws and regulations which had been noted in the 1994 Examination Report. The examiners concluded that the Firm had violated various Exchange Rules and federal securities laws and regulations.

The Firm provided a written response to the 1995 Examination Report by letter dated December 6, 1995 (the "1995 Response"). In its 1995 Response, the Firm again represented that certain deficiencies were being corrected.

Enforcement's investigation confirmed each of the 1994 Examination Report and 1995 Examination Report findings discussed below and made additional findings of violative conduct in these areas including areas in which the Firm had represented to the Exchange the violations had been corrected.

**Overview**

As set forth below, the Firm violated various Exchange Rules and federal securities laws and regulations in connection with the following areas: failure to make and preserve order tickets; failure to comply with Regulation T; failure to review outgoing correspondence; failure to comply with research rules; failure to comply with discretionary account rules; failure to adhere to obligations with respect to allocating new issues to conduit and discretionary accounts; and failure to supervise Branch Office Managers ("BOM") acting in the capacity of registered representative. The Firm also lacked appropriate procedures of supervision and control, including a separate system of follow-up and review, in these areas.

**Failure to Properly Make and Preserve Order Tickets**

SEC Regulations 240.17a-3(a)(6) and (a)(7) promulgated pursuant to the Securities and Exchange Act of 1934 (the "Act") require, in relevant part, that a memorandum of each brokerage order be made which includes the time of entry and the account for which entered. Regulations 240.17a-3(a)(6) and (a)(7), in pertinent part state that, with respect to brokerage orders: "The term 'time of entry' shall be deemed to mean the time when such member, broker or dealer transmits the order or instruction for execution or, if it is not so transmitted, the time when it is received." In addition, with respect to purchases and sales between a member, broker or dealer and a customer other than a broker or dealer, Regulations 240.17a-3(a)(6) and (a)(7) require a "memorandum of each order received, showing the time of receipt, the terms and conditions of the order, and the account in which it was entered."

SEC Regulation 240.17a-4(b)(1) requires, in pertinent part, that every member, broker and dealer shall preserve for a period of not less than three years all records required to be made pursuant to SEC Regulations 240.17a-3(a)(6) and (a)(7).

Exchange Rule 440 requires that member organizations make and preserve books and records as the Exchange may prescribe and as prescribed by SEC Regulations 240.17a-3 and 17a-4.

Exchange Rule 408(b) requires, among other things, that every order entered on a discretionary basis by a member, allied member or employee of a member organization must be identified as

discretionary on the order at the time of entry.

Exchange Rule 410(a) requires, in part, that a record be preserved of every order directly or indirectly transmitted or carried to the trading floor of the Exchange (the "Floor") which includes, among other things, the terms of the order, the time when it was so transmitted, the time at which a report of execution was received, and before execution, the name or designation of the account for which such order is to be executed.

The 1994 Examination Report and the 1995 Examination Report noted numerous instances of the following deficiencies in the Financial Square, Boston (Retail) and Cleveland branch offices with respect to the preparation, entry and maintenance of order tickets:

Bunched orders, for both Exchange listed and other securities, were entered without identification of the accounts participating in the bunched order, and allocated after the execution of the bunched order. In some instances bunched orders were not allocated until hours after the execution had been reported to the registered representative and in some instances not until after the close of the market. (A bunched order refers to a single order, entered by telephone to a Firm trading desk or through the Firm's wire system, to purchase or sell a total quantity of a security for multiple accounts.)

The personal accounts of registered representatives and/or of other Firm employees were included in the allocation of bunched order executions with customer accounts, including discretionary customer accounts.

Partial fills of bunched orders were allocated partially or entirely to the personal account of a registered representative.

Order tickets for discretionary accounts failed to indicate whether discretion had or had not been exercised in connection with the order.

Order tickets, including order tickets for discretionary accounts, lacked evidence of BOM approval.

Order tickets contained inaccurate and/or were missing time stamps.

Order tickets failed to indicate the terms and conditions of the order such as: market/limit, day/GTC, and/or solicited/unsolicited.

Sell order tickets failed to indicate: long/short, and/or the location of the security being sold.

An example of one bunched order evidencing a number of the above noted deficiencies is as follows: on trade date December 22, 1993, sometime prior to 3:22 p.m., a registered representative in the Financial Square office entered a bunched order by telephone to purchase 10,000 shares of an Exchange listed security at a limit of 41.

The following events occurred in connection with this bunched order:

8,000 shares were purchased at 41 at 3:22 p.m.

The bunched order ticket, an order ticket for the registered representative's personal IRA and order tickets for two discretionary customer accounts were time stamped at 3:25 p.m.

The bunched order wire was sent at 3:28 and inaccurately indicated the bunched order to be a market order.

400 shares were purchased at 41 at 3:47 p.m.

At the close, the quantity on the bunched order ticket was reduced to reflect the partial fill.

At 4:02 p.m., 4,400 shares were allocated to the registered representative's personal IRA account.

At 4:03 p.m., 2,000 shares were allocated to a discretionary customer account.

At 4:04 p.m., another 2000 shares were allocated to another discretionary customer account.

This partial fill of a bunched order evidences accounts not designated until after the close and those accounts including the registered representative's personal IRA and two discretionary customer accounts. Further, none of the order tickets bear time stamps accurately reflecting the time of receipt and/or entry of the orders and neither of the discretionary customer order tickets was marked to indicate if discretion had been exercised. Finally, there is no evidence of BOM supervisory review on any of the order tickets related to these transactions.

Accordingly, the delayed allocation of executed orders, sometimes by hours and/or until after the close of the market, and the failure of order tickets to accurately record the time of receipt, entry and/or execution of a customer order gave registered representatives the ability to place trades in their personal accounts and/or customer accounts with the benefit of having witnessed post execution market performance, including, in some instances, the price of the security at the close of the market.

As set forth above, the Firm lacked appropriate systems of supervision and control, including separate systems of follow-up and review, to ensure that: order tickets contained requisite account identification information, time stamps, and terms and conditions of transactions; bunched orders were allocated on a timely basis; order tickets for discretionary accounts were marked to indicate whether discretion had been exercised; customers were given preference over employee accounts; and all order tickets received and evidenced supervisory review.

**Failure to Comply with Regulation T and Related Exchange Rules**

Section 220.4(c)(3)(i) of Regulation T promulgated pursuant to the Act by the Board of Governors of the Federal Reserve System ("Reg. T") requires, in pertinent part, that "A margin call shall be satisfied within one payment period after the margin deficiency was created or increased."

Reg. T §220.4(d) requires, in pertinent part, that "If any margin call is not met in full within the required time, the creditor shall liquidate securities sufficient to meet

the margin call or to eliminate any margin deficiency existing on the day such liquidation is required...."

Reg. T §220.8(b)(1)(i)(A) requires that "A creditor shall obtain full cash payment for customer purchases within one payment period of the date any nonexempted security was purchased."

Reg. T §220.8(b)(4) requires that "A creditor shall promptly cancel or otherwise liquidate a transaction or any part of a transaction for which the customer has not made full cash payment within the required time."

Reg. T §220.8(c)(1) requires, in pertinent part, that "If a nonexempted security in the [cash] account is sold... without having been previously paid for in full by the customer, the privilege of delaying payment beyond the trade date shall be withdrawn for 90 calendar days following the date of sale of the security."

Exchange Rule 431(f)(7) provides, that "When a 'margin call'...is required in a customer's account, no member organization shall permit a customer to make a practice of either deferring the deposit of cash or securities beyond the time when such transactions would ordinarily be settled or cleared, or meeting the margin required by the liquidation of the same or other commitments in the account."

Exchange Rule 431(f)(9) provides, in pertinent part, "No member organization shall permit a customer...to make a practice...of effecting transactions in a cash account where the cost of securities purchased is met by the sale of the same securities."

Exchange Rule 432(a) provides, in pertinent part, "Each member organization...shall make a record each day of every case in which...initial or additional margin must be obtained in a customer's account. The record shall show, for each account, the amount of margin so required and the date when and manner in which cash or securities are deposited or the margin requirements were otherwise complied with."

Exchange Rule 432(b) provides, in pertinent part, "[N]o member organization shall permit a customer to make a practice of effecting transactions requiring initial margin and then meeting the margin required by liquidation of the same or other commitments...."

The 1994 Examination Report and the 1995 Examination Report noted multiple instances of the following deficiencies in the Madison Avenue and Cleveland branch offices with respect to both cash and margin customer accounts in that:

when customers did not satisfy margin calls within one payment period, the Firm failed to liquidate securities to meet the margin call;

when customers did not pay for cash transactions within one payment period, the Firm failed to liquidate the transaction in the customer account;

the Firm failed to impose "90 day freezes" on cash accounts in which securities were sold without having been previously paid for;

the Firm permitted accounts on which "90 day freezes" had been imposed to continue to trade in violation of the restriction and, in some instances, these accounts engaged in additional free-ride transactions during the period of the original 90 day restriction;

the Firm permitted customers to make a practice of meeting calls for additional margin by liquidation;

the Firm permitted customers to make a practice of free-riding in cash accounts;

the Firm permitted customers to make a practice of meeting initial margin requirements by selling the same security; and

the Firm failed to create a record each day of each call for initial and/or additional margin and the time and manner in which the margin call was met.

One cash account of a customer of the BOM of the Madison Avenue branch office evidencing a number of the above noted discrepancies:

had a free-ride on its initial transaction which was the purchase of a "hot issue" syndicate offering and was placed on 90 day restriction as a result;

traded in violation of the 90 day restriction by purchasing another syndicate offering a few days after the initial transaction;

engaged in a second free-ride by selling the second syndicate purchase prior to making payment in full; and

was thereafter permitted to continue trading including day-trading of syndicate offerings in hot issues.

The transactions and lack of required payment therefore evidence an account in which a customer was permitted to make a practice of free-riding. Further, as indicated the Firm failed to impose a required 90 day restriction and failed to enforce one which it had imposed.

A personal margin account of a registered representative in the Madison Avenue branch office, within a two week period, purchased 3,500 shares of a single stock, in four (4) separate transactions, in a

declining market, resulting in:

three initial margin requirements which were not satisfied;

maintenance margin requirements which were not satisfied; and

four (4) occasions when margin requirements were increased due to the payment of checks drawn against the account.

The transactions and lack of required payments therefore evidence an account in which the Firm permitted a customer to make a practice of not satisfying margin requirements and in which the Firm did not effect sell outs in connection therewith.

As set forth above, the Firm lacked appropriate systems of supervision and control, including a system of follow-up and review, to ensure: the daily calculation of initial and maintenance margin requirements; the creation and maintenance of records of these calculations and the satisfaction of the requirements; the timely receipt of payment for purchases in cash accounts; the timely satisfaction of margin requirements; the detection and prevention of customers making a practice of free-riding and meeting margin requirements by liquidation; that sell outs were effected in cash and margin accounts; and the imposition and enforcement of 90 day restrictions.

**Failure to Review Outgoing Correspondence**

Exchange Rule 342.16 provides that the duties of supervisors of registered representatives should ordinarily include review and approval of correspondence. The Rule further states that appropriate records should be maintained evidencing the carrying out of supervisory responsibilities such as initialing of correspondence reviewed in the supervisory process.

The 1994 Examination Report and the 1995 Examination Report noted numerous instances of the following deficiencies in the Financial Square, Boston (Retail) and Madison Avenue branch offices with respect to the supervisory review and approval of outgoing correspondence (including but not limited to facsimile transmissions) in that:

BOMs did not always review outgoing correspondence;

BOMs did not always evidence review of outgoing correspondence;

extracts of research reports, which extracts did not contain required disclosures and/or disclaimers, were sent to customers; and

not all copies of outgoing letters and enclosures were maintained.

For example, the Boston (Retail) branch office maintained a facsimile machine in a freely accessible location within the branch for the purpose of registered representatives disseminating research materials without prior supervisory approval. Significantly, the 1994 Examination Report disclosed that among the items disseminated via this machine was a partial supplemental preliminary prospectus bearing notations by a registered representative.

As set forth above, the Firm failed to maintain appropriate records evidencing supervisory review of correspondence and failed to conduct adequate follow-up and review to ensure that its BOMs discharged their responsibilities to review and maintain correspondence.

**Failure to Comply with Exchange Research Communications Rules**

Exchange Rule 472(a) requires, in pertinent part, that any communication made available by a member organization to customers or the public shall be approved in advance by a member, allied member or supervisory analyst.

Exchange Rule 472.30 and Interpretation Memoranda 90-5 and 92-5 require that opinion material be clearly and distinctly labeled as such.

Exchange Rule 472.40(2) provides that when a communication with a customer recommends the purchase or sale of a security, the communication must disclose: (i) the organization's market making and/or principal trading activities in the security; (ii) the organization's underwriting activities with respect to public offerings of securities by the issuer; (iii) if the organization or any of its employees involved in the preparation or the issuance of the communication may have positions in any securities or options of the issuer; and (iv) if a member, allied member or employee of the member organization is a director of the issuer.

The 1994 Examination Report and the 1995 Examination Report noted multiple instances of deficiencies with respect to the required disclosures and disclaimers for research communications disseminated to the public in that:

Research materials which the Firm purchased from other member organizations were disseminated by the Firm to the public without any of the required disclosures as to the Firm and/or its employees.

In one instance, a Firm-produced research report was disseminated which failed to disclose that an employee involved in its preparation had a position in the security of the issuer.

Draft versions of Firm-produced research materials which did not contain the required disclosures as to the Firm and/or its employees and which had not

been approved in advance by a member, allied member or supervisory analyst were disseminated to the public.

a "weekly newsletter" written by a registered representative in the Boston (Retail) office:

Failed to contain the required disclosures regarding securities positions and corporate directorates.

Failed to clearly and distinctly label opinion material as such.

During the period covered by the 1994 Examination Report and the 1995 Examination Report, the Firm purchased research materials from other member firm organizations for use and dissemination by Firm registered representatives. In response to a finding in the 1994 Examination Report, the Firm stated it would establish a procedure to affix the required disclosures to purchased research items prior to dissemination to Firm customers. However, the 1995 Examination Report determined that the Firm had not established a procedure for affixing the required disclosures to purchased research and Firm registered representatives continued to disseminate the purchased research without the required disclosures.

The required disclosures provide the investing public with material information regarding potential conflicts of interest between the member organization providing the research and the investor with respect to a recommendation to purchase or sell the security of a particular issuer.

As set forth above, the Firm lacked adequate systems of supervision and control, including a separate system of follow-up and review, to ensure that Firm purchased and generated research: contained the requisite disclosures and disclaimers; received supervisory analyst review and approval prior to dissemination to the public; and distinctly labeled opinion material as such.

**Failure to Comply with Discretionary Account Rules**

Exchange Rule 408(a) states that no member, allied member or employee of a member organization shall exercise any discretionary power in any customer's account or accept orders for an account from a person other than the customer without first obtaining written authorization of the customer.

Exchange Rule 408(b) provides, in pertinent part, that no member, allied member or employee of a member organization shall exercise any discretionary power in any customer's account, without first notifying and obtaining the approval of a designated supervisory person with authority to approve the handling of such accounts. Such discretionary accounts shall receive frequent appropriate supervisory

review by a person delegated such responsibility, who is not exercising the discretionary authority.

The 1994 Examination Report and the 1995 Examination Report noted multiple instances of deficiencies with respect to customer accounts in which registered representatives in the Financial Square and Boston (Retail) branch offices exercised discretion in that:

discretion was exercised without written authorization of the customer;

written authorization was obtained from the customer; however, the designated supervisory person was not notified and had not approved the discretionary handling of such account; and

written authorization was obtained and the designated supervisory person was notified and approved the discretionary handling of the account; however, the account was not designated as discretionary on the books and records of the Firm.

For example, the 1994 Examination Report cited a registered representative for exercising discretion in 18 customer accounts without the written authorization of the customers. In addition:

in conjunction with the Firm's annual branch inspection immediately preceding the 1994 Examination Report, this registered representative had declined to provide a list of the accounts in which he exercised discretion as required by Firm procedure;

discretionary authorizations obtained subsequent to the 1994 Examination Report for five (5) of the 18 cited accounts bore no evidence of supervisory approval; and

one year after the 1994 Examination Report, two (2) of the 18 accounts had still not been designated as discretionary by the Firm.

The Firm provided duplicate copies of discretionary account statements to branch managers on a monthly basis to provide for the required frequent supervisory review of such accounts. However, duplicate statements were only generated for accounts which had been identified, approved and designated as discretionary by the Firm. As noted above, a number of accounts were being traded on a discretionary basis but were not so identified and/or designated by the Firm and therefore did not receive the required frequent supervisory review.

The exercise of discretion in accounts which had not been identified and/or designated as discretionary by the Firm permitted the registered representative to effect transactions without appropriate review.

As set forth above, the Firm lacked appropriate systems of supervision and control, including a separate system of follow-up and review for: the identification of discretionary accounts; the receipt and maintenance of prior written discretionary authorization for each such account; supervisory approval of discretionary accounts; the designation of discretionary accounts on the Firm's books and records; and the frequent supervisory review of each discretionary account.

**Failure to Adhere to Obligations with Respect to Allocating New Issues to Conduit and Discretionary Accounts in Syndicate Transactions**

**Conduit Accounts**

Exchange Rule 405(1) states, in pertinent part, that every member organization is required to use due diligence to learn the essential facts relative to every customer, every order, and every account accepted or carried by such organization.

Exchange Rule 405(3) states, in pertinent part, that the member, general partner, officer or designated person approving the opening of an account shall, prior to giving his approval, be personally informed as to the essential facts relative to the customer and to the nature of the proposed account.

The 1994 Examination Report noted several instances of deficiencies with respect to the sale of new issues in syndicate transactions, the price of which immediately appreciated in secondary market trading ("hot issues"), in that:

accounts for the benefit of undisclosed principals ("conduit accounts") were allocated shares in syndicate offerings of hot issues; and

the Firm did not possess the requisite information regarding the nature and identity of the beneficial owners of such accounts in order to determine the accounts' eligibility to participate in hot issues.

For example, a registered representative in the Financial Square office serviced a conduit account the transactions in which were exclusively delivery versus payment purchases of syndicate issues, including hot issues. Prior to the 1994 MFR examination, neither the Firm nor the registered representative had made any inquiry as to the beneficial owners of the account in order to determine their qualification to participate in hot issues. When subsequently requested to provide such information the account refused to do so and therefore the information was never obtained by the Firm.

Moreover, the allocation of hot issues to conduit accounts, absent a determination of the eligibility of the beneficial owners of such accounts to participate in hot issue offerings, may have occasioned the improper allocation of hot issues.

In response to a finding in the 1994 Examination Report, the Firm stated that with one exception, the MFR examiners had been provided with the appropriate documentation to disclose the identities of the accounts which received hot issues and further, that none of the accounts involved individuals who would be restricted persons pursuant to the Free-Riding and Withholding Interpretation of the NASD (the " Interpretation"). However, Enforcement's investigation revealed that subsequent to the response neither the Firm nor the respective registered representatives possessed the information necessary to make a determination whether any beneficial owner of any of the aforementioned conduit accounts which received hot issues were restricted persons pursuant to the Interpretation.

**Discretionary Syndicate Accounts**

SEC Regulation 240.15c1-6 states, in pertinent part, that the term manipulative, deceptive, or other fraudulent device or contrivance is defined to include any act of a broker or dealer, who is acting for a customer, designed to effect with or for the account of such customer, any transaction in, or to induce the purchase or sale by such customer of, any security in the primary or secondary distribution of which such broker or dealer is participating or is otherwise financially interested unless such broker or dealer at or before the completion of each such transaction gives or sends to such customer written notification of the existence of such participation or interest.

Securities Act Release No. 5398, dated June 1, 1973, interprets, among other provisions, Section 15(c)(1) of the Act and SEC Regulation 240.15c1-6 and provides in pertinent part:

An underwriter of any offering has a self-interest in the success of that offering and in disposing of his commitment. The placement of a portion of that offering in discretionary accounts thus raises such a potential conflict of interest. It is a violation of the anti-fraud provisions of the Federal securities laws if such an underwriter fails to make a full and effective disclosure of this conflict to the customers involved. Full and effective disclosure, where the underwriter acts as a principal, generally will require disclosure to and the consent of its clients.

The 1994 Examination Report and the 1995 Examination Report noted multiple instances in which registered representatives in the Financial Square and Boston (Retail) branch offices effected discretionary purchases in customer accounts of primary and secondary distributions of issues in which the Firm participated as underwriter, without prior disclosure to the customers of the potential conflict of interest.

For example, one registered representative in the Boston (Retail) branch office who effected discretionary purchases in his customers' accounts of syndicate offerings in which the Firm participated as underwriter testified he was unaware of the requirement to disclose the potential conflict of interest to his discretionary customers and did not do so.

The required disclosures provide the discretionary customers with material information regarding a potential conflict of interest between the Firm, due to its participation as an underwriter in the offering, and the customer with respect to the purchase of syndicate offerings.

As set forth above, the Firm lacked appropriate systems of supervision and control, including a separate system of follow-up and review: to ensure that it possessed the requisite knowledge and/or representations with respect to each beneficial owner of each conduit account in order to determine the account's eligibility to participate in hot issue syndicate offerings; and to ensure that discretionary purchases of syndicate offerings, in which offerings the Firm participated as underwriter, were not effected without prior disclosure to the customer of the potential conflict of interest.

**Failure to Supervise Producing Branch Office Managers**
**Acting in the Capacity of Registered Representative**

who was this?

The Firm's policies and procedures providing for supervision of producing BOMs acting in the capacity of registered representatives were deficient in that certain supervisory duties, such as supervision of outgoing correspondence and compliance with Reg. T, were assigned to branch personnel who, while qualified as supervisors, were immediately subordinate to the producing BOM.

For example, the investigation revealed that one producing BOM sent a letter to a former customer in order to solicit the transfer of that customer's account to the Firm. Such correspondence contained:

unsubstantiated statistical data.

language that was promissory in nature.

past performance records used explicitly to promise future results.

unsupported comparisons of Firm services.

undated information and unsupported past performance information.

The investigation also revealed that this same producing BOM violated Reg. T and related Exchange Rules in his customer accounts as follows:

effected purchase and sale transactions in new and established accounts, including discretionary accounts, without any deposits or payments, resulting in free-rides.

permitted multiple free-rides in numerous customer accounts.

traded through 90 day restrictions imposed by the Firm.

engaged in "flipping" syndicate issues resulting in free-rides. ("Flipping" refers to the same day and/or next day sale of a syndicate purchase at a profit with the proceeds being used, in many instances, almost immediately to pay for a subsequent syndicate purchase.)

As set forth above, the Firm lacked appropriate systems of supervision and control, including a

separate system of follow-up and review, to supervise BOMs acting in the capacity of registered representatives, particularly with respect to correspondence and customers' payments for purchases.

**Failure to Supervise**

Exchange Rule 342(a) provides:

> Each office, department or business activity of a member or member organization (including foreign incorporated branch offices) shall be under the supervision and control of the member or member organization establishing it and of the personnel delegated such authority and responsibility.
>
> The person in charge of a group of employees shall reasonably discharge his duties and obligations in connection with supervision and control of the activities of those employees related to the business of their employer and compliance with securities laws and regulations.

In relevant part, Exchange Rule 342(b) provides:

> The general partners or directors of each member organization shall provide for appropriate supervisory control and shall designate a general partner or principal executive officer to assume overall authority and responsibility for internal supervision and control of the organization and compliance with securities laws and regulations. This person shall:

delegate to qualified principals or employees responsibility and authority for supervision and control of each office, department or business activity, and provide for appropriate procedures of supervision and control.

establish a separate system of follow-up and review to determine that the delegated authority and responsibility is being properly exercised.

As set forth above, the Firm failed to reasonably supervise and provide for appropriate supervision and control, including a separate system of follow-up and review, with respect to:

the preparation, entry and maintenance of order tickets, including the designation of customer accounts, identification of discretionary transactions and time stamping.

the daily calculation of margin requirements.

obtaining timely payment for cash purchases and satisfaction of margin requirements.

liquidating securities in customer accounts when payments were not timely received.

the imposition and enforcement of 90 day freezes on customer accounts.

the form and content of outgoing correspondence.

supervisory analyst approval of firm generated research.

the inclusion of disclosures and disclaimers on research purchased and generated by the Firm and disseminated to the public.

the obtaining of written discretionary authorizations.

the identification, approval, designation and frequent review of discretionary accounts.

the allocation of hot issues to conduit accounts without a determination of the eligibility of the beneficial

owners of such accounts to participate in such offerings.

the disclosure of the potential conflict of interest to discretionary customers in connection with syndicate offerings in which the Firm participated as underwriter.

BOMs acting in the capacity of registered representatives particularly with respect to correspondence and customer payments for purchases.

**Other**

The Firm has represented and the Division has considered that the Firm has made a number of enhancements to its policies and procedures relating to the areas cited above, including the following:

The Firm has effected the following personnel changes:

Margin Department

the hiring of a new Margin Department manager.

the designation of Margin Department personnel specifically to monitor free-riding and 90-day restriction reports.

the termination of employment of those personnel which the Firm deemed responsible for the deficiencies noted in the 1994 and 1995 Examination Reports.

Compliance Department

the hiring of new Compliance personnel specifically responsible for reviewing syndicate activity and ensuring that appropriate records are maintained in compliance with the NASD's Free-Riding and Withholding Interpretation (the "Interpretation").

the hiring, in August 1996, of a new Associate General Counsel and Director of Regulatory Affairs to whom the Compliance Department reports.

the hiring of a new compliance examiner specifically responsible for conducting retail branch examination.

The Firm has changed and/or reiterated its policies and procedures as follows:

responsibility for oversight of the Firm's adherence to the Interpretation has been reassigned from the Syndicate Department to the Compliance Department.

on a quarterly basis the Compliance Department distributes a list of all accounts designated by the Firm as discretionary to Investment Executives and Branch Office Managers who are required to review the lists and verify them for accuracy.

the branches now maintain separate files of Branch Office Managers' correspondence which files are reviewed by the Compliance Department monthly.

a memorandum was issued to all Branch Office Managers reiterating the Firm's policy that Branch Office Managers' compensation shall be directly related to their supervision of their branch offices regarding sales practice issues, customer complaints and related matters.

In addition to the specific enhancements and/or remedial actions referenced in paragraph 70. above, the Firm will continue to restructure its management and commit substantial resources to implementing

those changes which it has previously represented to the Exchange it would make to further enhance its compliance and supervisory functions.

**DECISION**

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

**PENALTY**

In view of the above findings, the Hearing Panel, by unanimous vote, imposed the penalty consented to by the Firm of a censure, a fine of $380,000 and a requirement that the Firm comply with an undertaking to:

1.within six months from the date a decision rendered by an Exchange Hearing Panel accepting this agreement becomes final, the Firm will have an appropriate review done, by a person or entity not unacceptable to the Exchange, and prepare a report of that review (the "Report") indicating all actions taken by the Firm, including but not limited to: those which the Firm has previously represented to the Exchange it has taken and/or will take; and any additional changes in personnel, systems, and/or policies and procedures which actions and changes are reasonably designed to ensure compliance with federal securities laws and Exchange Rules to prevent recurrence of the violations described in sections B-J of the Stipulation and Consent;

2.have the Report submitted to the Firm's Board of Directors together with an affirmation by the reviewer(s) that all actions and/or changes referred to in the Report have been completely implemented; and

3.submit to the Exchange a copy of the Report together with a written representation by the Firm's Board of Directors and Chief Executive Officer that all actions and/or changes referred to in the Report have been completely implemented.

For the Hearing Panel

Vincent F. Murphy
Hearing Officer

4/27/02 Plain Dealer (Clev.) C3
2002 WL 6365752

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Saturday, **April 27, 2002**

Business

NYSE investigating **Gruttadauria** ex-aide

Teresa Dixon Murray; Plain Dealer Reporter

Distribution zones: All

The New York Stock Exchange is now investigating Frank **Gruttadauria's** former assistant and ex-lover, Laurene Kacludis English, authorities said yesterday.

That English is also a target of the probe was disclosed yesterday as part of civil charges filed by the NYSE.

She was charged with failing to answer the NYSE's questions.

People found guilty by the NYSE can face action against their professional licenses and/or fines.

The NYSE, the FBI and the U.S. Securities and Exchange Commission are all separately investigating the **Gruttadauria** case, which broke three months ago.

**Gruttadauria** is accused of defrauding roughly 50 clients of nearly $300 million, half through theft and half through exaggerated gains.

**Gruttadauria,** who faces criminal and civil fraud charges, remains in jail without bond.

The SEC accuses him of stealing some client money for himself and using some of it to shower English with $600,000 in cash and $100,000 worth of gifts.

The NYSE said English, 39, didn't cooperate with its "investigation into [her] activities" as **Gruttadauria's** sales assistant for the last 12 years in Cleveland, most recently at Lehman Brothers Inc.

She and three others at Lehman Brothers were fired in February.

English's lawyer, Paul Mancino Jr., said that English had met once with NYSE investigators for about two hours but that he had

advised against a second interrogation.

"You come in believing you're a witness and end up being a target," he said.

"They wouldn't tell me what new information they had and where this was going."

In an unrelated action yesterday, SG Cowen Corp., **Gruttadauria's** other former employer, filed a motion in U.S. District Court to throw out at least three lawsuits against it.

The company said the disputes should be handled in arbitration.

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---- INDEX REFERENCES ----

NAMED PERSON: **GRUTTADAURIA,** FRANK

ORGANIZATION: NEW YORK STOCK EXCHANGE

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Wednesday, **April 17, 2002**

National

**Gruttadauria** lawsuits threaten Lehman profits
Teresa Dixon Murray; Plain Dealer Reporter

Distribution zones: All

Lehman Brothers Inc. yesterday said payouts in the Frank **Gruttadauria** case could hurt profits in the future.

In its quarterly financial report released yesterday, the nation's fourth-largest investment firm said the avalanche of lawsuits stemming from the Cleveland broker's conduct "may be material to the company's operating results" in the future.

"Well, that's unusual," said New York analyst Guy Moszkowski, who follows Lehman for Salomon Smith Barney.

He noted that Lehman, like most major firms, is almost always defending itself against some kind of lawsuit but hasn't, at least in recent years, warned of a financial impact.

In the **Gruttadauria** case, Lehman al- ready is facing six lawsuits that seek combined damages of nearly $1 billion. Dozens more lawsuits are almost certain.

Lehman and SG Cowen Corp., which sold **Gruttadauria's** division to Lehman in October 2000, are defending themselves against the Cleveland scandal that broke in January.

**Gruttadauria,** of Gates Mills, is accused of defrauding at least 50 clients out of nearly $300 million during the last 15 years.

After a month as a fugitive, he surrendered to the FBI Feb. 9 and remains in jail without bond.

In issuing the cautionary note, Lehman said that it considered "all relevant facts . . . available insurance coverage . . . and established reserves." It also maintained that according to the purchase agreement, it is not liable for anything **Gruttadauria** did while working for Cowen.

As a publicly traded company, Lehman is required by federal law

to release financial statements quarterly. Lehman spokesman William Ahearn said, "The **[Gruttadauria]** situation wasn't material from a financial standpoint, but the issue has received such widespread press attention in Cleveland and elsewhere that we felt it was important to point it out to shareholders."

Analysts said the language strongly suggests that Lehman expects that it doesn't have enough in reserve to cover potential payouts. Reserve levels, which financial institutions must maintain to cover unanticipated expenses, aren't disclosed to shareholders or analysts.

The language also raises questions about how much Lehman may pay out of pocket and how much, if any, might be covered by insurance. Analysts pointed out that insurance policies don't always cover broker fraud, much as homeowners policies don't cover cases of arson.

"We have insurance for a wide range of issues," Ahearn said, "but I won't comment on its applicability to this situation."

Analyst Craig Woker of Morningstar Inc. in Chicago said, "You are potentially looking at a nine-figure type settlement that, no question, would have a huge impact on Lehman, at least in the short term."

Analyst Ken Worthington said Lehman's potential liability is noteworthy and raises questions about how much homework it did before buying Cowen's division of brokers. But Worthington, of CIBC World Markets in New York, said he views it as a one-time nightmare that shouldn't happen again.

Lehman's profits should be adequate to cover any payouts, analysts said. The company earned $298 million in the quarter ending Feb. 28, a decline of 23 percent. It earned $1.25 billion last year.

Moszkowski added that Lehman's disclosure may also be related to post-Enron sensitivity. "I think companies are trying to address every potential material event."

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---- INDEX REFERENCES ----

NAMED PERSON: **GRUTTADAURIA,** FRANK

NEWS SUBJECT: English language content; Page-One Story; Content Types; Front-Page Stories;

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May 21, 2002

SENT BY FEDERAL EXPRESS

The Honorable Sue Kelly
Chairman, House Subcommittee
on Oversight and Investigation
1127 Longworth House Office Building
Washington, D. C. 20515-3219

Dear Congresswoman Kelly:

I am writing to advise you that our client Samuel Glazer has decided, with great regret, not to participate as a witness in the Gruttadauria-SG Cowen-Lehman hearing on May 23, 2002 of the House Financial Services Oversight and Investigation Subcommittee. The decision was difficult, but Sam Glazer is much too energetic and successful to fit the profile of a "victim" and he is not qualified to debate with high-priced and high-powered industry representatives the core subjects of security industry self-regulation and corporate responsibility.

As you proceed with your hearing on May 23 and your deliberations thereafter, we urge you to give limited time and attention to the individual victims or even Frank Gruttadauria -- Gruttadauria is just another in a long line of financial criminals and there will certainly be future Gruttadaurias. The true problem worthy of your attention is the moral decay on Wall Street -- caused by unbridled self-interest -- that has created a malignancy in our financial markets and our financial institutions. Simply put, over the past 10-15 years our major financial institutions have become so consumed by their own self-interest (some would call it greed) that they have gone from being the custodians of the marketplace and the fiduciaries of their customers to the bandits in the marketplace and the enemies of their customers. As the distinguished Columbia Law School Professor John Coffee, Jr. observed in a May 13, 2002 article in the *New York Times*, self-regulation on Wall Street is an "oxymoron".

The settlement with Merrill Lynch today included a $100 Million payment to New York and other states and that is just the beginning of their liability. We are not class action lawyers and Sam Glazer has no interest in destroying our great securities companies or even their unique privilege of self-regulation. But Sam Glazer and many other ordinary people who trusted the character and integrity of SG Cowen and Lehman deserve more in the area of corporate responsibility than "we're sorry". Sam Glazer thought he had $24 Million in United States Treasury Bonds and other high-quality investment grade bonds in his account in December, 2001, and one day Lehman called him up and said "Mr. Glazer your account doesn't have $24 Million -- it has $15,000. We're sorry."

Many years ago in the 1930's a great political statesman looking out over the world landscape said "If we do not now act decisively, history will cast its verdict with those terrible, chilling words: 'Too late'." Once again the ground is trembling, and if Winston Churchill were alive today I believe he would tell SG Cowen and Lehman and Merrill Lynch and Goldman, Sachs and all the others to do the right thing now or it may be "too late". Of course, Winston Churchill is not around today, so we respectfully request this Committee to find the strength of character to deliver his message to SG Cowen and Lehman and the entire American securities industry on May 23, 2002.

Very truly yours,

Robert P. Duvin

RPD/cr

cc: The Honorable Michael G. Oxley
The Honorable Luis V. Gutierrez
The Honorable Steven C. LaTourette
The Honorable Stephanie Tubbs Jones
The Honorable Bob Ney
The Honorable Patrick J. Tiberi
The Honorable Paul Gillmor
Mr. Terry Haines
Mr. Samuel Glazer

The recent catch phrase in Washington is "connect the dots" -- everyone is now attempting to reach one judgment or another by looking at fragmented communications and pieces of paper and trying to connect the dots. Unfortunately the Wall Street corruption dots have become so prominent and so frequent that they virtually connect themselves. Deceptive financial reporting made the headlines with Enron and the once great accounting firm of Arthur Andersen but it quickly spread to corporate giants such as IBM and General Electric. Analysts and investment bankers at Merrill Lynch sent e-mails about the "junk" stocks that they were touting as strong buys and the "garbage" stocks that they wanted to sell to the public in new underwritings. Moreover, the Merrill Lynch $100 Million settlement announced today by the New York State Attorney General will soon be extended to other high-powered elite securities companies. Even *Business Week* -- in its May 13 issue -- had a sobering message on the cover: WALL STREET HOW CORRUPT IS IT?

At the very center of this ugly Wall Street landscape of moral decay and corruption is the Frank Gruttadauria experience involving Cowen, SG Cowen and Lehman. The companies will glibly describe him as a "rogue broker" but that characterization of Frank Gruttadauria is both obvious and irrelevant. What is special about Frank Gruttadauria has nothing to do with Frank Gruttadauria: What is special about Frank Gruttadauria is that he was able to steal approximately $150 Million of real money from SG Cowen and Lehman clients and create an additional $250-$300 Million of fictional net worth by sending fraudulent monthly statements and 1099's to SG Cowen and Lehman clients -- AND HE DID THIS OVER A 15-YEAR PERIOD! When Lehman bought the high net worth brokerage business from SG Cowen in October, 2000 -- *13-1/2 years after Gruttadauria initiated this massive criminal enterprise* -- Lehman gave Gruttadauria a *$5 MILLION BONUS* just to stay with the company. From their perspective, in October, 2000, blinded by an industry culture obsessed with self-interest, Frank Gruttadauria was not a rogue broker but a "star broker". They were more thrilled by his admission to the elite Pepper Pike Club than they were interested in whether he was stealing tens of millions of dollars from ordinary people with names like Glazer and Visconsi and Fazio and Yale. The only way they did not see what he was doing is that they did not look. Failing to look over a *15-year period* is not a compliance problem -- it is willful blindness.

# Account of Carl Fazio

| Month | Equity | Total Purchases | Wired Out |
|---|---|---|---|
| January 1990 | $9,888.52 | $24,815.78 | |
| February 1990 | $150,561.05 | $291,506.00 | |
| March 1990 | $127,449.25 | $205,011.27 | |
| April 1990 | $133,128.49 | $220,931.68 | |
| May 1990 | $316,488.07 | $504,740.05 | |
| June 1990 | $333,691.11 | $100,500.00 | |
| July 1990 | $85,519.79 | $111,625.00 | |
| August 1990 | $37,620.79 | $80,337.87 | |
| September 1990 | $3,923.26 | $3,651.31 | $33,000.00 |
| October 1990 | $3,881.75 | $0 | |
| November 1990 | $19,947.34 | $16,000.00 | |
| December 1990 | $19,970.77 | $19,771.69 | |
| ***Total 1990*** | ***$1,242,070.19*** | ***$1,578,890.65*** | ***$33,000.00*** |
| ***Average 1990*** | ***$103,505.85*** | ***$131,574.22*** | |

**TURNOVER RATIO = 15.25**

**1990 COMMISSIONS = $67,471.70**

# Account of Dominic A. Visconsi, Sr.

## (Client of Gruttadauria's from 1992-2002)

| Year | Purchases (dollar amt.) | Average Equity | Commissions | Turnover Ratio | Equity/Commission Rate |
|---|---|---|---|---|---|
| 1992 | $ 3,699,000.00 | $ 416,000.00 | $ 113,000.00 | 18 | 54% |
| 1993 | 7,590,000.00 | 447,000.00 | 221,000.00 | 34 | 99% |
| 1994 | 2,262,000.00 | 466,000.00 | 87,000.00 | 5 | 19% |
| 1995 | 2,238,000.00 | 77,000.00 | 77,000.00 | 29 | 100% |
| 1996 | 5,427,000.00 | 372,000.00 | 160,000.00 | 15 | 43% |

**STATEMENT OF GEORGIA C. SARANTAKIS
SUBMITTED TO THE SUBCOMMITTEE ON OVERSIGHT
AND INVESTIGATIONS OF THE COMMITTEE
ON FINANCIAL SERVICES OF THE U.S. HOUSE OF REPRESENTATIVES**

May 23, 2002

**Introduction**

Madam Chairwoman, and members of the subcommittee, my name is Georgia C. Sarantakis and I am an 80 year old widow from Buffalo Grove, Illinois. I wanted to be with you today to tell you how it came to be that I am virtually penniless, but I have no means to travel from my home to Washington, D.C. That is because I recently learned that my life savings, which, according to the last Lehman Brothers statement I received totaled almost $900,000, had been depleted to just over $5100. I now exist on social security and a small pension left to me by my late husband, James. Unfortunately, this income does not allow me to pay all of my monthly bills, let alone provide me with the means to travel, even for such an important purpose as this subcommittee's hearing.

Neither I, James or my daughter, Carol Ann Coyle, were ever millionaires nor were we influential in business or politics. Ours was a much simpler life, created by what many would consider the American dream: the combination of hard work, a little luck and an honest and ethical manner about which we conducted our daily lives. That dream came to an end in January of this year, when I learned of the fraud that Mr. Gruttadauria had perpetrated for so long, facilitated, by his own admission, by the carelessness and disregard of his employers, Lehman Brothers, S.G. Cowen, Cowen & Company and Hambrecht & Quist.

**The "Facts" We Thought Were True**

I began investing with Mr. Gruttadauria in 1987 while Hambrecht & Quist employed him. I was referred to Mr. Gruttadauria by my accountant, who told me he and Mr. Gruttadauria were friends and former classmates.

I met with Mr. Gruttadauria in the fall of 1987. At that time, I had been widowed for eight years and my savings totaled approximately $226,000, which represented the entirety of what James had left me upon his passing in 1979.

During my first meeting with Mr. Gruttadauria, he convinced me that my savings would be safe if I invested with him and that he understood my financial situation as a widow with no other source of income, except for the small pension and social security income which, by themselves, were not enough to live on. Based on Mr. Gruttadauria's understanding of my situation, and based on the fact that he worked for a reputable firm, Hambrecht & Quist, I turned over the entire $226,000 to Mr. Gruttadauria to invest on my behalf. I gave Mr. Gruttadauria discretion to act on my behalf, to invest as he determined was most appropriate based on my financial situation. Until January of this year, all indications were that he was just doing that. Mr. Gruttadauria seemed to care about me and my financial security, and it was on this basis that I continued to invest with him for over 15 years, even as Mr. Gruttadauria changed employers, first from Hambrecht & Quist

to Cowen & Company, which then became S.G. Cowen, and later to Lehman Brothers. None of these changes concerned me because each firm was a well known and, presumably, reputable investment firm.

Throughout this entire time, I received account statements from these investment firms, all on their letterhead, which reflected a steady increase in the value of my account. My account statements came to my home, were addressed to me, and appeared legitimate. I had no reason to question their authenticity. Nor did I have any reason to question Mr. Gruttadauria's veracity. Whenever he spoke to me about my accounts, the discussions were consistent with the information I received in my account statements. All of the information that was conveyed to me suggested that my account was secure, steadily growing and, in all respects, legitimate.

My daughter, Carol Ann Coyle, also invested with Mr. Gruttadauria in the early 1990's. Like me, she received account statements that reflected a steadily increasing value. Like me, she had no reason to suspect the statements were not legitimate and, like me, she had no reason to doubt Mr. Gruttadauria's veracity as he would speak about her account consistently with what was conveyed on the account statements.

Mr. Gruttadauria suggested that we use Joseph DeGrandis of DeGrandis & DeGrandis as our accountant, and he became both Carol Ann's and my accountant in 1991. Since that time, DeGrandis & DeGrandis has been filing tax returns for me and Carol Ann and taxes were paid based on the amounts reflected in the account statements that we thought came from Hambrecht & Quist, Cowen & Company, S.G. Cowen and Lehman Brothers.

In October of 2000 when Mr. Gruttadauria moved on to Lehman Brothers, he also suggested to Carol Ann that she combine her account with mine as a joint account. We did so on Mr. Gruttadauria's advice. Carol Ann has invested over $69,000 dollars with Mr. Gruttadauria, both before and after his move to Lehman Brothers. While Mr. Gruttadauria was at Lehman Brothers, we would receive statements from Lehman Brothers (on Lehman Brothers' letterhead) which were addressed to us as joint account holders and sent to Carol Ann.

**The Truth Comes Out**

Everything changed in January 2002. I learned then, for the first time, that our Lehman Brothers account did not contain the amounts indicated in the statements sent to us, the most recent of which indicated a joint account balance of $896,500. That amount was the culmination of the steadily increasing value of my account that was amassed in the 15 years of my relationship with Frank Gruttadauria, Hambrecht & Quist, Cowen and Company, S. G. Cowen and Lehman Brothers, and the 11 years of Carol Ann Coyle's relationship with Frank Gruttadauria, Cowen and Company, S.G. Cowen and Lehman Brothers. But as we would soon find out, this account did not have $896,000 in it or anywhere near that amount.

Mr. DeGrandis telephoned me in January of this year and told me that the statements I was receiving from Lehman Brothers may not accurately reflect the value of my account. Carol Ann telephoned Lehman Brothers to confirm the status of our joint account. She was told that the account did not contain over $896,000 but only a little over

$6100. She was also told that the account was not a joint account at all, and that Lehman Brothers had no record of Carol Ann as a client of Lehman Brothers at any time.

Words cannot describe the despair I felt when I learned the truth about my financial situation. I relied on my account to supplement my income which, as I previously indicated, is limited. While I lead a modest life, I have found it difficult to get by on what remains of my monthly income from my social security and pension. Carol Ann's life has also been deeply affected, and she too relied on the money in our account to survive.

My despair has been deepened by how I've been treated by Frank Gruttadauria's employers. Despite having documents in its possession indicating that our account balance exceeded $141,000 when Frank Gruttadauria joined Lehman Brothers in October of 2000, Lehman Brothers has made no attempt to repay any of this money to me. If this wasn't demoralizing enough, I have learned through newspaper accounts that Lehman Brothers has, apparently, made payments to other Lehman Brothers' customers or has, at least, offered to make these payments. Cowen & Company, S.G. Cowen and Hambrecht & Quist have made no attempts whatsoever to repay to me any of the sums that I invested with them.

Instead, I have had to file a lawsuit against Mr. Gruttadauria, Hambrecht & Quist, S.G. Cowen, Cowen & Company, Lehman Brothers and Joe DeGrandis in the hopes of recovering the savings that I have lost. I was fortunate enough to find a law firm in Chicago, Illinois, Williams Montgomery & John, Ltd., who agreed to represent me and my daughter, Carol Ann and pursue this matter on our behalf. I understand, however, that the process will be long, arduous, and that everyone against whom we had to bring the lawsuit will challenge the process every step of the way and will delay Carol Ann's and my attempts to recoup the money we thought was rightfully ours.

My despair has also been further deepened by the way Lehman Brothers has handled my account since the revelation that my account has been depleted. When Carol Ann spoke with Lehman Brothers in January, she told them that no further activity was to take place on the account and that the account should be closed as soon as possible. It wasn't, but was instead depleted by another $1000, from $6,100 to approximately $5,100, before the account was closed in late March.

Now, two months later, despite the assistance of the attorneys who are representing me and repeated requests to Lehman Brothers to stop sending my account statements and other information to anyone other than me, my account statements and related information continue to go to Joe DeGrandis and even to my son, Anthony Sarantakis, who was never authorized to receive my account information. To this day, we have not received written confirmation from Lehman Brothers that my address in Buffalo Grove, Illinois is the one to which my mail will be sent in the future.

**Closing**

Today, instead enjoying the security that was mine just a few short months ago, I'm now in the midst of a Federal lawsuit which, I am told, will take months if not years to resolve. In the meantime, I am barely able to make ends meet. Neither my daughter nor I have much to look forward to and we are told we must be patient while we work through the litigation process. The security that I once knew is gone, and the only comfort I have

now is the knowledge that, in the end, those responsible for taking from me my peace of mind will be made to answer for their actions. While Mr. Gruttadauria certainly perpetrated a fraud on all whom he victimized, it is inconceivable to me that his actions could have continued for so long absent the carelessness and neglect by those who employed him and by those who profited most by his misdeeds, Hambrecht & Quist, Cowen & Company, S.G. Cowen and Lehman Brothers. I also find it inconceivable that as Mr. Gruttadauria moved from one job to the next, actual account balances were not discovered by his employers. I suspect they never bothered to inquire given all the money Mr. Gruttadauria was making for them.

In closing, I would like to thank the subcommittee once again for an opportunity to present my story. It is my hope that the subcommittee will do all in its power to make sure that what has happened to me and my daughter, Carol Ann, as well as many others, will not happen again to anyone else.

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STATEMENT OF JUDY MEYERHOFF YALE

I am here today because I am victim of one of the most pernicious financial frauds in the history of U.S. investment firms.

We entrusted our funds to large reputable firms, SG Cowen and Lehman Brothers, with whom we thought our money would be safe. It was devastating to discover that our trust was betrayed. We trusted the system and it failed.

My husband and I have lost nearly all of our life savings. But even more crushing was the news about my family. My father was a self made man with an eighth grade education, who worked until he died at age 92. As a result of the wrongdoing of Cowen and Lehman, his entire life savings are gone. My mother who is now 87 years old is left to agonize over her future. My brother has lost his child's college fund.

How could this happen to my family?

The answer is, the complete and flagrant lack of internal controls at SG Cowen and Lehman Brothers. This reckless disregard of common practices of oversight left fertile ground for fraud to occur. From the accounts in the Wall Street Journal, Cleveland Plain Dealer and Chicago Tribune, the red flags were overwhelming.

The arrogance and greed of the companies involved in this disaster is appalling. They did not even notify us; we had to find out on our own. And, so far they have made no offers of restitution.

A few days ago I received a letter from a friend who read about our misfortune in the newspaper. I quote her here: "I long ago concluded that there is no one left in the business world that is honest . . . It really scares me that this is what our world has become. I hate to pick up the paper in the morning."

In conclusion, I ask you to restore confidence to the investing public by making reforms that empower and require the SEC, the NYSE, and the NASD to enforce their regulation of financial firms.

Judy Meyerhoff Yale
Chicago, Illinois
May 23, 2002

**June 7, 2002**

**This is a follow-up to our statement of May 23, and subsequent to our attendance at the Subcommittee on Financial Services Hearing, of the same date, chaired by Congresswoman Sue Kelly.**

**We are thankful that the members of the Committee focused on many significant issues. And, by placing this statement into the Congressional Record, we would like to draw attention to the areas that we consider to be the most important.**

**Our first observation is that the result of an investigation, such as the one regarding the issue of churning in 1993, should not be left to the discretion of one SEC agent or a firm's compliance department. Testimony by the fox should not be the only evidence weighed in the looting of the chicken coop. A new regulation should require the firm's notification of any potential victim.**

**When speaking of the issue of posted statements, one of the witnesses testified that it is not unusual for wealthy individuals to have P.O. Boxes. But, no one mentioned that in the Gruttadauria fraud many statements were going to the same P.O. Box and that the P.O. Box was located in the town where Mr. Gruttadauria lived, not where the clients lived.**

**Mr. Hommel of Lehman Brothers stated that these P.O Boxes were on the records when Lehman Brothers acquired the high asset business of SG Cowen, but a simple perusal of accounts would have revealed that our IRA statements were going to our home while our other account statements went to fraudulent addresses. The fact that statements were sent to two different addresses, with regard to these accounts, should have been a clear red flag.**

**Lip service was given to the client's right to pursue legal remedies. But many victims do not have the resources or may not outlive a long legal battle. There should be a fast track for immediate compensation to people whose accounts have been drained.**

**Mr. Hommel testified that his firm did not acquire liability from SG Cowen. Lehman Brothers should not be allowed to do business under these circumstances. The NYSE and the NASD should not permit their members to go without responsibility for their clients. In fact, the**

**member firms should be required to carry insurance to cover investor losses suffered by their clients as a result of a broker's misconduct.**

**The most basic issue to be raised in this forum was the question of self-regulation. Since the securities industry seems to have compliance systems that are woefully inadequate, it must not be allowed to police itself.**

**The current environment has led to a callous disrespect for speedy and fair resolutions. This arrogance must stem from the lack of significant regulatory penalties for repeat offenders. Firms should face the possibility of losing their right to do business in the United States as a result of their blatant disregard for simple compliance practices.**

**We hope that you will continue your investigation and will make reforms that protect decent human beings who save all their lives only to be wiped out by fraud. The investing public has no reason to feel confident in the system as it is today. To quote an editorial by Molly Ivins that appeared in the Chicago Tribune on May 30, 2002, ".... a mentality of crookedness has pretty much taken over many of the advanced reaches of capitalism." Or as the Wall Street Journal noted "The failures of Wall Street's compliance efforts are coming under intense scrutiny – *part of a growing awareness of how deeply flawed the U. S. financial markets really are."***

**Thank you for the opportunity to contribute to the process. We remain committed to cooperating in any way we can.**

**Judy Meyerhoff Yale**

**Alan Reynolds Yale**

Gruttadauria, Frank D.

Dear Sir:

I was a Managing Director with Lehman Brothers in Cleveland, Ohio from October 16, 2000 through to January 11, 2002.

During the course of the past 15 years I have caused misappropriation through various methods which resulted in other violations. It has occurred at Lehman Brothers, SG Cowen Securities Corp, Cowen & Co., Hambrecht & Quist, Inc. and LF Rothschild Inc.. I did not take monies for my personal use and I was the sole knowing participant.

It is a complicated and substantial interwoven fabric of digressions, most of which will be evident in the digital tapes that I have put in the credenza of the conference room in the Lehman Brothers office in Cleveland for you.

Management at Lehman Brothers and any of my former employers or customers are unaware of the activities.

This began as an attempt to make up lost monies for customers and mushroomed over the course of time I suppose I was emboldened with the process continuing and I can hardly beleive that I could have done this without detection for so long, the various firms greed and lack of attention at the senior level contributed greatly to that. Be that as it may, I am unwilling to continue and am ashamed and sorry for what I have done.

I don't have the strength presently to face this but wanted to get this into your hands so that it will stop.

Frank Gruttadauria

Lehman Brothers Inc.- aquired SG Cowen Private Client Group 10/16/2000
399 Park Ave
New York, NY 10022

SG Cowen Securities Corp
1221 Avenue of the Americas
New York, NY 10021

Cowen & Co- aquired by Societe Generale 7/1/1998

Hambrecht & Quist Inc.- aquired by Chase Manhattan Bank 1999

LF Rothschild Inc- aquired by Franklin S&L and recieved by RTC 1989

Dear Ms. Willoughby:

I am following up with my conversation of last week with Congresswoman Stephanie Tubbs-Jones regarding the recent hearings into the Frank Gruttadauria matter. I represent several members of a family who were victimized by Mr. Gruttadauria. The Congresswoman has asked that I provide you with information concerning the arbitration agreements at issue between the parties.

My clients, the Lopardo family, have known Mr. Gruttadauria since 1988. Like Carl Fazio and Judy Stout, they treated him as though he were a family member. At one point, my clients were led to believe that they had in excess of $14 million dollars in just one of their many accounts. According to Lehman Brothers, that account is worth approximately $4,000.

Needless to say, the discovery of Mr. Gruttadauria's fraud has wreaked havoc on their lives. For years, the Lopardos made virtually every major decision based upon their belief that they were financially secure. They are now forced to sell assets just to meet living expenses. One member of the family is awaiting a liver transplant, and is uncertain as to how to pay for the surgery.

My clients have filed suit in the U.S. District Court for the Northern District of Ohio against Mr. Gruttadauria, Lehman Brothers, SG Cowen, JP Morgan, and DeGrandis & DeGrandis. (The latter is an accounting firm that received copies of my clients "real" account statements each month, but prepared income tax returns based upon the statements falsified by Mr. Gruttadauria.) Lehman and SG Cowen have asked the Court to stay the litigation so that claims against those entities may proceed in arbitration. I find this request outrageous in light of the circumstances.

By way of background, "agreements" to arbitrate are found in virtually every brokerage agreement, as part of the pre-printed language. Simply put, an individual who wishes to open a brokerage account must agree to arbitrate any claims that he or she may have, and has no opportunity to negotiate the terms of the standard contract. Federal law, both legislative and judicial, strongly favors enforcement of these types of agreements. See, e.g., The Federal Arbitration Act (cite), and (Greentree case.)

In our particular case, as with many of Mr. Gruttadauria's former clients, there is every reason to believe that the customer signatures on those agreements were forged. Proving this will, of course, be costly and time-consuming to all involved.

I am enclosing a copy of the Motion to Stay filed by SG Cowen. As you can see, Cowen is demanding that the litigation be stayed pending referral of

the claims against it to a panel of industry arbitrators. Lehman Brothers has filed a similar motion, claiming that because it purchased these accounts from Cowen, the same arbitration agreements require claims against it to be arbitrated.

If the Court should grant these motions, the effects of arbitration will be devastating to my clients. Essentially, we will be required to try this matter twice - once against Lehman and Cowen in arbitration, and once against the remaining Defendants in court. The judge does have authority to stay the entire action until the arbitration is resolved. This will result in unnecessary expense and delay. My clients, like most of Mr. Gruttadauria's victims, simply cannot afford to wait years to obtain a complete recovery.

Aside from the irreparable damage an arbitration proceeding will cause to Mr. Gruttadauria's victims, forcing these cases to arbitration will assure that the facts underlying the brokerage firms' lack of controls will remain hidden. Unlike court proceedings, arbitrations are not a matter of public record. The congressional committee investigating this matter has been charged in part with determining how it was possible for Mr. Gruttadauria to get away with this for so long. The answer to that question will remain evasive if the facts cannot be presented in a judicial forum.

Another concern is the ability of the industry arbitration panels to properly handle complex cases such as these. Typically, NASD and NYSE arbitration panels hear cases involving employment disputes between a member firm and its employees, and between a brokerage firm and a customer who claims his or her account was mishandled. Claims concerning the latter typically involve unauthorized trading or unsuitability of a particular investment, and not the large scale fraud which occurred here. In this case, the panels will be asked to determine issues involving civil RICO violations, state securities law violations, common law fraud, employer liability, punitive damages, and contribution and/or indemnification amongst the brokerage firms involved. The federal courts are much better equipped to deal with these issues than is a panel of three arbitrators.

It was for all of these reasons that I suggested to Congresswoman Tubbs-Jones that she inquire further into this issue. Specifically, I believe it would be helpful for the committee to question the NASD and NYSE representatives concerning their organizations' ability to properly manage an arbitration of the scope involved herein. Moreover, SG Cowen and Lehman Brothers should be made to answer as to what they believe will be the benefits to the parties of arbitration.

The Congresswoman also asked me for my thoughts on legislation to address this issue. I note initially that brokerage firms are by far not the only

entities who impose these types of "agreements" on their customers. Arbitration provisions are now commonly found in insurance policies, automobile purchase agreements, credit card agreements, and loan agreements. In almost each instance, the consumer who signs the agreement has virtually no understanding of what arbitration is, let alone how much the process will end up costing them. I believe the only way to address this is to amend the Federal Arbitration Act to prevent enforcement of standardized arbitration agreements contained in consumer adhesion contracts.

I thank you for your time and attention to this matter. Please do not hesitate to contact me if you need further information.

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Murray & Murray
111 E Shoreline Dr.
Sandusky, OH 44870

Phone (419) 624-3000 ext 205
Fax (419) 624-0707

email jotm@murrayandmurray.com

IN THE UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF OHIO
EASTERN DIVISION

| | | |
|---|---|---|
| RICHARD LOPARDO, et al., | ) | 1:02CV764 |
| Plaintiffs, | ) | |
| - v. - | ) | JUDGE JOHN M. MANOS |
| FRANK GRUTTADAURIA, et al., | ) | |
| Defendants. | ) | |

**MEMORANDUM IN SUPPORT OF MOTION OF DEFENDANT SG COWEN SECURITIES CORPORATION TO STAY PENDING ARBITRATION OR TO DISMISS**

Defendant SG Cowen Securities Corporation ("SG Cowen") submits this memorandum in support of its motion, pursuant to Section 3 of the Federal Arbitration Act, 9 U.S.C. § 3 ("FAA"), to stay this action in favor of arbitration before a panel of an appropriate self-regulatory organization in accordance with the agreements to arbitrate signed by Plaintiffs. In the alternative, Defendant moves to dismiss the federal securities law claims and the claims for promissory estoppel and for violation of the Ohio Pattern of Corrupt Activities statute pursuant to Fed. R. Civ. P. 12(b)(6) for failure to state a claim. Under the Private Securities Law Reform Act, the filing of this motion triggers an automatic stay of discovery and other proceedings in this case until the motion is decided.

**PRELIMINARY STATEMENT**

Plaintiffs have refused to submit their claims to arbitration, even though SG Cowen has provided their counsel with copies of agreements that make arbitration compulsory for "[a]ny controversy arising out of or relating to any of [the] accounts" held by Plaintiffs. See Exhibit D of Declaration of Paul Mitsakos, attached hereto ("Mitsakos Dec."). Plaintiffs' claims

are "relat[ed] to" their accounts with SG Cowen, and we respectfully submit that federal law therefore demands that this litigation be stayed while Plaintiffs pursue their claims against SG Cowen in arbitration. See 9 U.S.C. § 3.

In the alternative, the federal securities law claims should be dismissed pursuant to Fed. R. Civ. P. 12(b)(6) for failure to state a claim. The Complaint alleges misappropriation of the funds in Plaintiffs' accounts but not any misrepresentations or omissions inducing particular purchases and sales. The Complaint thus fails to assert that the alleged fraud was "in connection with" a purchase or sale of a security as required by section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5. See SEC v. Zandford, 238 F.3d 559, 562-63 (4th Cir.), cert. granted 122 S. Ct. 510 (2001). The Complaint also fails to allege that any false statements were made pursuant to a public offering as required by section 12(a)(2) of the Securities Act of 1933. See Gustafson v. Alloyd Co., 513 U.S. 561, 578 (1995). Under the Private Securities Litigation Reform Act (PSLRA), discovery and other proceedings may not continue until SG Cowen's motion is resolved. See 15 U.S.C. §§ 78u-4(b)(3)(B), 77z-1(b)(1). SG Cowen has provided informal discovery to Plaintiffs in the form of account documentation, and it will continue to provide such documents notwithstanding the PSLRA and Plaintiffs' failure to provide any documents to SG Cowen despite repeated requests.

Plaintiffs' claims for promissory estoppel and violation of the Ohio Pattern of Corrupt Activities statute also fail to state a claim and should be dismissed pursuant to Fed. R. Civ. P. 12(b)(6).

## I. Plaintiffs Must Pursue Their Claims In Arbitration Before A Panel Of An Appropriate Self-Regulatory Organization.

Plaintiffs' claims clearly fall within the terms of the broad arbitration provisions contained in numerous signed account agreements. The arbitration provisions cover all disputes

relating to "any of [Plaintiffs'] accounts" with SG Cowen. (Emphasis added). Under the FAA, Plaintiffs may only pursue their claims through arbitration, and litigation must be stayed pending the outcome of the arbitration.

**A. Plaintiffs' Accounts are Governed by Standard Agreements to Arbitrate Any Disputes.**

Following the filing of this action, SG Cowen conducted a search of its records for accounts bearing the names of Plaintiffs. See Mitsakos Dec. ¶¶ 2-3. SG Cowen located multiple agreements with arbitration provisions signed by Plaintiffs. See id., Exhibits A – G.

Agreements Signed by Richard and Catherine Lopardo

Attached to this motion are 4 arbitration agreements signed by Plaintiffs Richard and Catherine Lopardo, including one Account Agreement, one Option Agreement, and two Margin Agreements. See Mitsakos Dec. ¶ 4 & Exhibits A - D.[1] The Account Agreement and the Margin Agreements each contain a broad arbitration clause providing for arbitration of "[a]ny controversy arising out of or relating to [the Lopardos'] accounts." See id. Exhibit A ¶ 14; see also id. Exhibits B & C. In addition, the Option Agreement contains a similar broad arbitration provision set forth in bold print:

> **Any controversy arising out of or relating to any of [Lopardos'] accounts, to transactions with [Cowen] for [the Lopardos], or to this or any other agreement or the construction, performance or breach thereof, shall be settled by arbitration only before the NASD or the New York Stock Exchange, Inc. or the American Stock Exchange, Inc. as [the Lopardos] may elect.**

[1] For two of the agreements, Richard Lopardo appeared to sign the agreement on behalf of himself and on behalf of his wife. See Mitsakos Dec., Exhibits A, C.

Id., Exhibit D ¶ 10. In addition, the Option Agreement contains a warning in bold capital letters just above the signature that the agreement "**CONTAINS A PRE-DISPUTE ARBITRATION CLAUSE.**"

Agreements Signed by Emily Lopardo

SG Cowen also located two Account Agreements containing arbitration provisions signed by Emily Lopardo. See Mitsakos Dec. ¶ 5 & Exhibits E & F. Each of these agreements also contains a broad arbitration provision set forth in bold print:

> **Any controversy arising out of or relating to any of [Lopardo's] accounts, to transactions with [Cowen] for [Lopardo], or to this or any other agreement or the construction, performance or breach thereof, shall be settled by arbitration only before the NASD or the New York Stock Exchange, Inc. or the American Stock Exchange, Inc. as [Lopardo] may elect.**

Id., Exhibit E ¶ 9 & Exhibit F ¶ 9. These agreements also contain a warning in bold capital letters just above the signature that the agreement "**CONTAINS A PRE-DISPUTE ARBITRATION CLAUSE.**"

Agreement Signed by James Lopardo

SG Cowen also located an Account Agreement containing an arbitration provision signed by Plaintiff James Lopardo. See Mitsakos Dec. ¶ 6, Exhibit G. This agreement contains an identical arbitration provision to those quoted above, set forth in bold print:

> **Any controversy arising out of or relating to any of [Lopardo's] accounts, to transactions with [Cowen] for [Lopardo], or to this or any other agreement or the construction, performance or breach thereof, shall be settled by arbitration only before the NASD or the New York Stock Exchange, Inc. or the American Stock Exchange, Inc. as [Lopardo] may elect.**

Id., Exhibit G ¶ 9. In addition, the agreement contains a warning in bold capital letters just above the signature that the agreement "**CONTAINS A PRE-DISPUTE ARBITRATION CLAUSE.**"

SG Cowen has not yet located arbitration agreements signed by Charles Lopardo or Melissa Lopardo, but as explained in part I.B below, their claims should nevertheless be stayed because they are factually related to claims that must be referred to arbitration.

Plaintiffs' Opposition to Arbitration

Plaintiffs allege in their Complaint that Gruttadauria "forge[d] plaintiffs' signatures on account agreements and other key documents." Complaint ¶ 21. Plaintiffs have not, however, challenged the authenticity of the signatures on the agreements attached to this Motion, despite a letter from Defendant's counsel to Plaintiffs' counsel citing these agreements and requesting an explanation for Plaintiffs' opposition to arbitration. See Exhibit H. Plaintiffs' counsel has neither replied to Defendant's counsel's letter nor otherwise explained their opposition to arbitration. There is absolutely no basis for opposing arbitration.

**B. The Federal Arbitration Act Plainly Requires Plaintiffs to Pursue Their Claims Through Arbitration.**

Plaintiffs' accounts are governed by numerous binding agreements to submit all disputes relating to any of their accounts to arbitration before a panel of a recognized stock exchange. In light of the plain language of the broad arbitration provisions and the strong federal policy favoring enforcement of agreements to arbitrate, we respectfully submit that this Court must stay this action while Plaintiffs pursue their claims in an appropriate arbitration forum.

Once a district court determines that a valid arbitration clause covers a particular dispute, the FAA "leaves no place for the exercise of discretion by a district court, but instead mandates that district courts shall direct the parties to proceed to arbitration." Dean Witter

Reynolds, Inc. v. Byrd, 470 U.S. 213, 218 (1985) (emphasis in original); id. at 221 (requiring courts to "rigorously enforce agreements to arbitrate"); see Ferro Corp. v. Garrison Indus., Inc., 142 F.3d 926, 932 (6th Cir. 1998) (reversing district court's determination that issue was nonarbitrable and noting that the FAA was designed to "to overcome judicial reluctance to allow arbitration"). Courts have uniformly recognized the "strong federal policy in favor of arbitration," and have consequently held that "any ambiguities in the contract or doubts as to the parties' intentions should be resolved in favor of arbitration." Stout v. J.D. Byrider, 228 F.3d 709, 714 (6th Cir. 2000); see also Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24-25 (1983) ("[A]ny doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration."); Southland Corp. v. Keating, 465 U.S. 1, 10 (1984) (noting that Congress has "declared a national policy favoring arbitration"). In the Sixth Circuit, "[o]ne who signs a contract is presumed to know its contents." Stout, 228 F.3d at 715 (internal quotation marks omitted).

Against this undisputed legal background, the account agreements signed by Plaintiffs – Exhibits A - G of the attached Declaration – require arbitration of Plaintiffs' claims against SG Cowen. The agreements require arbitration of "[a]ny controversy arising out of or relating to any of [Plaintiffs'] accounts." (Emphases added). Plaintiffs' claims based on Gruttadauria's alleged misconduct in managing their accounts unquestionably fall within the scope of these broad arbitration agreements as a "controversy arising out of or relating to" Plaintiffs' accounts. Courts routinely enforce standard-form arbitration agreements signed by customers of broker-dealers alleging federal securities fraud, state common law fraud, or other intentional torts. See, e.g., Rodriguez de Quijas v. Shearson/American Exp., Inc., 490 U.S. 477 (1989); City of Painesville, Ohio v. Schulte, 1994 WL 447090 (N.D. Ohio 1994); Gerhardstein v.

Shearson/American Exp., Inc., 1986 WL 2691 (N.D. Ohio 1986); Andre v. Gaines Berland, Inc., 1996 WL 383239 (S.D.N.Y. 1996); McEntee v. Ormes Capital Markets, Inc., 1995 WL 716734 (S.D.N.Y. 1995); 99 Commercial Street, Inc. v. Goldberg, 811 F. Supp. 900 (S.D.N.Y. 1993); Brener v. Becker Paribas Inc., 628 F. Supp. 442 (S.D.N.Y. 1985); cf. Roney & Co. v. Goren, 875 F.2d 1218 (6th Cir. 1989). The Supreme Court expressly endorsed – and mandated – this practice in Shearson/American Exp., Inc. v. McMahon, 482 U.S. 220, 232 (1987). The broad arbitration provisions applicable here – covering "any of [Plaintiffs'] accounts" – fall squarely within this routine practice of the federal courts.

Although the Complaint alleges that signatures on some account documents were forged, see Complaint ¶ 21, Plaintiffs' have not challenged the validity of the signed agreements containing arbitration provisions attached to this Motion. Absent factual evidence that all of the attached agreements are forged, Plaintiffs' conclusory allegations are not sufficient to avoid a stay of this action in favor of arbitration. If Plaintiffs do present facts constituting a prima facie case of forgery, SG Cowen requests that prompt discovery and a hearing be held on that issue while discovery on all other matters is stayed. See, e.g., Donato v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 663 F. Supp. 669, 676 (N.D. Ill. 1987) ("Before proceeding further with this case, we must determine whether the document was indeed forged.").

Referring claims of fraud against broker-dealers to arbitration pursuant to provisions such as those agreed to by Plaintiffs is not only routine in the federal courts, but required by the Supreme Court's McMahon decision. Defendant's position is cemented by the "strong federal policy in favor of arbitration," which resolves any doubts "in favor of arbitration." Stout, 228 F.3d at 714 (6th Cir. 2000).

SG Cowen has not yet located arbitration agreements signed by two of the Plaintiffs in this action, Charles Lopardo and Melissa Lopardo. But even if the claims by those two Plaintiffs are nonarbitrable, the Supreme Court's decision in Byrd requires a stay of the arbitrable claims of the other Plaintiffs. See Byrd, 470 U.S. at 219-221. SG Cowen respectfully submits that the Court should also stay any nonarbitrable claims of Melissa and Charles Lopardo because all of the claims arise from the same factual circumstances. See, e.g., Sierra Rutile, Ltd. v. Katz, 937 F.2d 743, 750 (2d Cir. 1991); United States v. Neumann Caribbean Int'l, 750 F.2d 1422, 1426-27 (9th Cir. 1985); American Home Assur. Co. v. Vecco Concrete Const. Co., 629 F.2d 961, 964 (4th Cir. 1980). Indeed, the Complaint lumps all of the Plaintiffs together and does not make separate allegations for each. The Court should stay the claims of all of the Plaintiffs.

**II. In The Alternative, Plaintiffs' Claims Should be Dismissed.**

In the alternative, Plaintiffs' Counts 3, 4, 7 and 12 are subject to dismissal pursuant to Rule 12(b)(6) for failure to state a claim upon which relief can be granted.

**A. The Complaint Fails to State a Claim Under 15 U.S.C. § 78j(b).**

Count 3 of the Complaint alleges a violation of Section 10(b) of the 1934 Securities Exchange Act, 15 U.S.C. § 78j(b) (the "'34 Act"), and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5. Count 3 also alleges that SG Cowen is liable under section 20(a) of the '34 Act as controlling person of Gruttadauria, who allegedly violated Section 10(b). The factual allegations in the Complaint, however, fail to satisfy the federal requirement of a fraud "in connection with" the purchase or sale of a security. Count 3 should therefore be dismissed for failure to state a claim.

Section 10(b) prohibits misstatements or material omissions that are made "in connection with the purchase or sale of any security." See also SEC Rule 10b-5 (same). The "in

connection with" requirement reflects the fact that "Congress, in enacting the securities laws, did not intend to provide a broad federal remedy for all fraud." Marine Bank v. Weaver, 455 U.S. 551, 556 (1982). Instead, the primary purpose of the '34 Act is to ensure "full and fair disclosure of the character of the securities sold." SEC v. Zandford, 238 F.3d 559, 562-63 (4th Cir.), cert. granted 122 S. Ct. 510 (2001).

Nowhere do Plaintiffs allege any misrepresentation or omission that induced the purchase or sale of a security. In fact, the Complaint does not allege a single purchase or sale of any particular security. The Complaint primarily alleges that Gruttadauria "misrepresented to clients that he had bought and sold specific securities" in furtherance of a scheme to "loot millions of dollars from [Plaintiffs'] accounts." Complaint ¶ 1. Gruttadauria allegedly sent Plaintiffs false account statements reflecting superior investment returns to disguise his misappropriation of the funds in the accounts. See id. ¶¶ 1, 19-21. If true, the allegations might state a cause of action for common law fraud, but they do not constitute a fraud "in connection with" the purchase or sale of a security under federal law.

In a factually indistinguishable case, the Fourth Circuit recently held that the "in connection with" requirement was not satisfied where a broker had misappropriated the proceeds from the sale of securities held in a discretionary trading account. Zandford, 238 F.3d at 559. The court noted that plaintiffs had failed to allege any misstatements going to the value or merits of a single security transaction. The court concluded that "Zandford's securities sales were incidental to his scheme to defraud. Zandford's fraud lay in absconding with the proceeds of the

sales." 238 F.3d at 564. The Zandford court's reasoning applies with equal force to the facts alleged here.[2]

Other courts have reached the same conclusion. In Smith v. Chicago Corp., 566 F. Supp. 66 (N.D. Ill. 1983), the court held that a broker's failure to invest certain funds as instructed and the broker's subsequent unauthorized withdrawal of those funds for his own benefit failed to satisfy the "in connection with" requirement because "none of the acts complained of by plaintiffs involved the actual sale or purchase of securities." Id. at 70; see also Bochicchio v. Smith, Barney, Harris Upham & Co., 647 F. Supp. 1426, 1430 (S.D.N.Y. 1986) (no section 10(b) claim where broker made unauthorized withdrawals and disguised his conduct by providing false account statements to his clients).

Moreover, even if the Complaint alleges that Gruttadauria induced an investment in securities while secretly harboring an intent to convert the proceeds in the future, it fails to satisfy the "in connection with" requirement. See Pross v. Katz, 784 F.2d 455, 459 (2d Cir. 1986) ("An intent to cause a conversion of ownership interests at some uncertain future time and through uncertain means does not bring federal law into play, even though that intent is held at the time a purchase or sale of securities occurs."); see also Crummere v. Smith Barney Harris Upham & Co., 624 F. Supp. 751, 754-55 (S.D.N.Y. 1985); Bosio v. Norbay Securities, Inc., 599 F. Supp. 1563, 1566 (E.D.N.Y. 1985) (broker's failure to deliver all the proceeds from the sale of securities to the plaintiff failed to satisfy the "in connection with" requirement since any misrepresentations went "not to any inducement by the defendants regarding the investment purpose of the sale, but the arrangements concerning the mechanics of the sale"). But see United

[2] The Supreme Court granted certiorari in Zandford and the case was argued in March 2002.

States v. Kendrick, 692 F.2d 1262, 1265 (9th Cir. 1982); Henricksen v. Henricksen, 486 F. Supp. 622, 629 (E.D. Wis. 1980).[3]

Because the Complaint fails to allege that Gruttadauria's misrepresentations were made "in connection with" the purchase or sale of securities, Count Three must be dismissed.

Automatic Stay of Discovery and Other Proceedings

The filing of this motion to dismiss the federal securities law claims triggers the automatic stay provision of the Private Securities Law Reform Act, which provides that "all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss." 15 U.S.C. § 78u-4(b)(3)(B) (emphasis added). This mandatory stay applies to all of the asserted claims, including the state claims, which arise from the same factual circumstances. See SG Cowen Securities Corp. v. U.S. Dist. Court for the Northern District of CA, 189 F.3d 909, 913 n.1 (9th Cir. 1999); Angell Investments, LLC v. Purizer Corp., 2001 WL 1345996 (N.D. Ill. 2001); In re Trump, 1997 WL 442135, at *1 (S.D.N.Y. 1997). The stay may be lifted only if the Court decides this motion or if Plaintiffs move and show – which they cannot – that "particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that

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[3] Other courts have found the persuasive value of Henricksen weakened by the district court's failure to cite any supporting authority for the conclusion that the conversion of funds from a brokerage account satisfies the "in connection with" requirement under § 10(b). See, e.g., Zandford, 238 F.3d at 565; Crummere, 624 F. Supp. at 756; Smith, 566 F. Supp. 69. Sup't of Ins. of the State of New York v. Bankers Life and Cas. Co., 404 U.S. 6 (1971) is readily distinguishable from the present case. That case involved the purchase of the stock of an insurance company, paid for from proceeds of the sale of treasury securities owned by the company. The directors were allegedly deceived into authorizing this sale by the misrepresentation that the proceeds would be exchanged for a certificate of deposit of equal value. See id. at 167 n.1. As explained in Zandford, the misrepresentation in Bankers Life thus related to a particular security and induced a sale of that security. Plaintiffs here have not alleged any misrepresentation about a security that induced them to make an investment in that security.

party." 15 U.S.C. § 78u-4(b)(3)(B). Notwithstanding the PSLRA, Defendant will continue to engage in informal discovery while this motion is pending.

**B. The Complaint Fails to State a Claim Under 15 U.S.C. § 77*l*.**

Count 4 of the Complaint, brought under § 12(a)(2) of the Securities Act of 1933, codified at 15 U.S.C. § 77*l*, must be dismissed because the Complaint fails to allege conduct by the Defendant in connection with a public offering, which is an essential element of a § 12(a)(2) claim. Section 12(a)(2) of the Securities Act of 1933 creates civil liability for any person who "offers or sells a security . . . by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements." 15 U.S.C. § 77*l*(a)(2).

The Supreme Court has squarely held that liability under this provision is limited to misrepresentations or omissions made to a potential buyer of securities that are sold in a public offering. See Gustafson v. Alloyd Co., 513 U.S. 561, 578 (1995). Misrepresentations or omissions made with respect to secondary market sales of securities do not fall within the purview of § 12(a)(2). Similarly, only those oral misrepresentations "relate[d] to a prospectus" are prohibited under the statute. Gustafson, 513 U.S. at 567-78; see also Ballay v. Legg Mason Wood Walker, Inc., 925 F.2d 682, 688 (3d Cir. 1991). "The intent of Congress and the design of the statute require that [§ 12(a)(2)] liability be limited to public offerings. . . . It is not plausible to infer that Congress created this extensive liability for every casual communication between buyer and seller in the secondary market." Gustafson, 513 U.S. at 578.

Because Plaintiffs do not allege conduct relating to sales of securities in a public offering, Count 4 should be dismissed.[4] Like the motion to dismiss the section 10(b) claim, the filing of this motion triggers a provision of the PSLRA that automatically stays "all discovery and other proceedings" until the motion is resolved. 15 U.S.C. § 77z-1(b)(1).

**C. The Complaint Fails to State a Claim under Ohio Rev. Code § 2923.32**

Count 7 of the Complaint, alleging violations of Ohio Rev. Code § 2923.32, the Ohio Pattern of Corrupt Activities statute, should also be dismissed because the Complaint fails to allege the existence of an "enterprise" distinct from the "person" charged with violating the statute.

Section 2923.32 holds "persons" liable for "conduct[ing] or participat[ing] in the affairs of [an] enterprise through a pattern of corrupt activity." Ohio Rev. Code § 2923.32(A)(1); see also id. § 2923.31(C),(G) (defining "person" and "enterprise" to include corporate entities). The Ohio statute is "directly adopted from" the federal RICO statute, Universal Coach, Inc. v. New York City Transit Auth., Inc., 90 Ohio App.3d 284, 290 (1993), and like its federal analogue, requires that the entity constituting the "person" be a separate entity from the "enterprise." U.S. Demolition & Contracting, Inc. v. O'Rourke Construction Co., 94 Ohio App.3d 75, 84 (1994); see also Pucket v. Tennessee Eastman Co., 889 F.2d 1481, 1489 (6th Cir. 1989); Miller v. Norfolk Southern Railway Co., 183 F. Supp. 2d 996, 1002 (N.D. Ohio 2002).

The Complaint alleges that from May 1989 until October 2000, Gruttadauria participated in an "enterprise comprising the offices of Defendants Cowen & Co. and SG Cowen Securities." Complaint ¶ 62. Plaintiffs seek to hold SG Cowen liable as a "person" participating

[4] Plaintiffs' failure to state a claim under 15 U.S.C. § 77*l* dooms their related claim for control person liability under § 77*o*. See Payne v. Fidelity Homes of America, Inc., 437 F. Supp. 656, 658 (W.D. Ky. 1977).

in an enterprise's affairs, but they fail to allege an "enterprise" separate from SG Cowen itself. This failure is fatal to the claim. See U.S. Demolition, 94 Ohio App.3d at 94 ("[A]n organization cannot join with its own members to do that which it normally does and thereby form an enterprise separate and apart from itself."). Accordingly, Count 7 should be dismissed.

**D. The Complaint Fails to State a Claim for Promissory Estoppel**

Plaintiffs' claim of promissory estoppel (Count 12) must be dismissed because the Complaint fails to allege any clear and unambiguous promise by Frank Gruttadauria to perform a specific act in the future. Rather, the Complaint only alleges misrepresentations regarding past or existing facts. To establish a claim for promissory estoppel, a plaintiff must show: (1) a promise, clear and unambiguous in its terms; (2) reasonable and foreseeable reliance; and (3) injury resulting from the reliance. Andersons, Inc. v. Consol, Inc., 185 F. Supp. 2d 833, 840 (N.D. Ohio 2001). "A promise, for promissory estoppel purposes, must involve commitment, or manifestation of an intention to act or refrain from acting in a specified way." Id. (internal quotation marks omitted).

Frank Gruttadauria's allegedly false representations regarding the status of Plaintiffs' accounts do not constitute a promise. Courts have drawn a sharp distinction between statements of "a past or existing fact" (which may give rise to a claim for misrepresentation) and statements that constitute "commitments of future performance" (which may give rise to a claim for promissory estoppel). In re Smartalk Teleservices, Inc. Sec. Litig., 124 F. Supp. 2d 487, 499 (S.D. Oh. 2000); Schoff v. Combined Ins. Co. of Am., 604 N.W.2d 43, 51 (Iowa 1999) (holding that statements of past or existing facts do not constitute a promise under the doctrine of promissory estoppel); Woodall v. Citizens Banking Co., 507 N.E.2d 999, 1000-01 (Ind. Ct. App. 1987) (same). Gruttadauria's alleged misstatements about the funds and securities in Plaintiffs' accounts were representations of then-existing facts, not promises of future performance. If an

account statement were deemed a promise, then innocent mistakes in those statements would bind banks and brokerages – but of course they do not. Intentionally false account statements may give rise to a cause of action for misrepresentation, but they do not constitute a clear and unambiguous promise to perform a specific act in the future and thus cannot sustain a claim of promissory estoppel.

**CONCLUSION**

For the reasons set forth above, Defendant's motion to stay pursuant to Section 3 of the FAA should be granted. In the alternative, Counts 3, 4, 7, and 12 should be dismissed for failure to state a claim. Pursuant to the PSLRA, discovery and other proceedings must be stayed on all claims until this motion is decided.

Respectfully Submitted,

*s/ Mark O'Neill*

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Counsel for SG Cowen Securities Corporation

**CERTIFICATE OF SERVICE**

I hereby certify that on this 15th day of May, 2002 a copy of the foregoing motion was filed electronically. Notice of this filing will be sent to all parties by operation of the Court's electronic filing system. Parties may access this filing through the Court's system.

*s/ Mark O'Neill*
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One of the Attorneys for SG Cowen Securities Corporation

*Privileged and Confidential*

**Responses to Questions of the Congressional Subcommittee on Oversight and Investigations Dated June 5, 2002**

1(a). As part of the transaction wherein Lehman Brothers purchased certain accounts of S.G. Cowen's Private Client Group, the parties agreed that the Cowen investment representatives joining Lehman Brothers would be eligible to receive a bonus, in the form of a loan which would be forgiven over a 5 year period. The purpose of the loans was to encourage individuals to join Lehman Brothers and to remain with the firm during the time the loans remained outstanding. In the event the investment representative left the firm during the forgiveness period they were obligated to pay back to the firm the balance of any amount that had not been forgiven.

1(b). The criterion used to determine the amount of the forgivable loans payable to former Cowen investment representatives hired by Lehman, including Mr.Gruttadauria, was based on an agreed formula in the Purchase Agreement. The formula was essentially a percentage range of the investment representatives total commissions and asset management fees for the period July 1,1999 through June 30, 2000.

1(c). Mr.Gruttadauria was the investment representative with the largest production at Cowen during the period of July 1, 1999 through June 30, 2000. Accordingly, based on the formula as set forth above, he received the largest forgivable loan. See answer to item 1(b) regarding how the amounts were determined.

2. The Finance, Real Estate, Operations, Administration, Human Resources, Compliance and Legal Departments of Lehman Brothers were responsible for reviewing the assets and operation of Cowen prior to entering into the Purchase Agreement. This review was ongoing and conclusions were reached along the way based on the information reviewed, price considerations and the various terms of the transaction, including certain representations, warranties and covenants received from Cowen. Ultimately it was concluded that from a business perspective it was logical to proceed with the transaction.

3. n/a

4. As set forth in response to question # 2, many factors led Lehman Brothers to proceed with the purchase of the Cowen assets after due diligence. One factor was the assurances Cowen had made to the New York Stock Exchange following the 1994-1995 audit of the firm by the NYSE and the subsequent fine that was levied in 1998. As part of its Consent to Penalty, Cowen retained a major New York law firm to review their business, to recommend changes, and affirm that such changes were made by the business within 6 months of the Consent to Penalty. This was done to the apparent satisfaction of the NYSE. Additionally, many of the concerns or criticisms raised by the NYSE in its original report, although corrected by Cowen, were not applicable under the Lehman Brothers framework. For example, the NYSE criticism of Cowen that related to the handling of margin calls at the branch level would not be applicable in the Lehman framework in that Lehman Brothers operated margin activity from a centralized location.

The transaction was structured as an asset purchase agreement. Lehman agreed to acquire the accounts of the institutional and retail customers of Cowen's Private Client Group, and in return agreed to pay Cowen a purchase price that was scaled based on the investment representatives (and their production) that ultimately joined Lehman Brothers. As part of the agreement Cowen made certain representations and retained certain liabilities associated with the business.

5. The Ohio State Treasurer's Office conducted transactions with Lehman Brothers Inc. from December, 2000 through January 11, 2002. There were approximately 147 transactions during that fourteen month period, that generated total gross sales credits of $636,988 to Lehman. Of that amount, $68,523 was payable to Mr. Gruttadauria. Mr. Gruttadauria's total compensation for salary and sales credits for that same time frame was approximately $1,007,000. Sales credits were determined on a transaction by transaction basis and included in the price that was quoted up front prior to each transaction. The amounts were in accordance with industry standards and subject to competitive factors.

6. Lehman Brothers is not in a position to respond to these questions, and respectfully refers the Committee to the NYSE and/or Cowen for such answers.

7. In most circumstances, arbitration offers a dispute resolution process that is quicker and less expensive for all parties than litigation. The relative merits of arbitration and litigation must be weighed on a case-by-case basis

8. During the period of time Mr. Gruttadauria was employed by Lehman Brothers Inc., the gross revenue generated by transactions in the accounts serviced by

him was $3,122,515. This is based upon the actual records for the actual transactions that did in fact take place in those customer accounts.

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September 12, 2002

*VIA ELECTRONIC MAIL* (fsctestimony@mail.house.gov)

Committee on Financial Services
U.S. House of Representatives
2129 Rayburn House Office Building
Washington, DC 20515

Attn: Janice Zanardi

Re: May 23, 2002 testimony of Mark E. Kaplan

Dear Ms. Zanardi:

This firm is counsel to SG Cowen Securities Corporation ("SG Cowen"). We respectfully submit this letter (1) to provide information requested by the Subcommittee on Oversight and Investigations during the testimony of SG Cowen's General Counsel, Mark E. Kaplan, on May 23, 2002, and (2) to respond to a set of supplemental questions subsequently posed in writing by Representative Stephanie Tubbs-Jones.

A. Information Requested at Page 121, line 2664 *et seq.* of the Transcript

From July 1, 1998 to October 13, 2000, the period of time that Frank Gruttadauria was employed with SG Cowen, Mr. Gruttadauria generated commission revenues that resulted in income to SG Cowen of $6,107,176.

B. Information Requested at Page 126, line 2793 *et seq.* of the Transcript

SG Cowen's internal policies and procedures do not prohibit an account executive from serving as the executor of a customer's estate, or as the trustee of a trust

established for a customer's benefit, so long as (1) the circumstances do not give rise to a conflict of interest and (2) the account is properly identified and coded as an employee or employee-related account.[1] Although the account established for the estate of Frank Gruttadauria's former customer, Ann Cuneo, for which Mr. Gruttadauria served as the executor, was initially not coded as an employee or employee-related account, the designation was corrected in 1999 after it was discovered during a compliance audit that the account was not so coded.

C. Responses to Supplemental Questions by Representative Stephanie Tubbs-Jones for Mark E. Kaplan of SG Cowen and/or Thomas Hommel of Lehman Brothers

1. As a result of Lehman Brothers purchase of certain accounts from SG Cowen, Frank Gruttadauria was given a $5 million forgivable note.

   a. What was the purpose of this payment?
   b. What criterion was used to determine the amount of payment to Mr. Gruttadauria?
   c. Were any other payments of this magnitude made to other former Cowen employees? If so, to whom and how much? How were these amounts determined?

Response to Question 1: This question is properly addressed to Mr. Hommel.

2. Whose responsibility was it to review the assets that were purchased by Lehman Brothers? What kind of conclusions did they come to? Are these conclusions recorded anywhere?

Response to Question 2: This question is properly addressed to Mr. Hommel.

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[1] The policies of Cowen & Company were substantially the same on this subject.

3. Why did SG Cowen decide to sell those particular assets to Lehman Brothers? What were the terms of the sale?

Response to Question 3: SG Cowen and its corporate parent, Société Générale, decided to sell substantially all of the assets associated with SG Cowen's retail brokerage business because they had made a strategic, business decision to focus on business lines other than retail brokerage, including investment banking, equity research and institutional sales and trading. The sale ultimately was made to Lehman Brothers, Inc. in October 2000. The terms of the sale have not been publicly disclosed.

4. What factors led Lehman to proceed with the purchase of the Cowen assets after the due diligence process? What were the terms of the sale?

Response to Question 4: This question is properly addressed to Mr. Hommel.

5. The Cleveland Plain Dealer on May 31, 2002 reported that "Gruttadauria's employers, first SG Cowen and then Lehman Brothers Inc., did a combined $5.9 billion in trades with Deters office from 1999 to 2001. My questions to each firm are:

   a. How much was made by each firm each year during which transactions took place? How many transactions per year?

   b. How much of this was paid out to Mr. Gruttadauria each year? What was his total compensation in each of these years?

   c. How were the commissions on transactions with Deter's office determined? Where they negotiated up front? Were they the best available rates?

Response to Question 5:

   a. In 1999, accounts at SG Cowen in the name of the Treasurer of the State of Ohio generated a total of $3,124 in commissions; in 2000, the accounts generated a total of $237,523 in commissions.

   b. To date, we have been unable to determine the compensation Mr. Gruttadauria received from accounts in the name of the Treasurer

of the State of Ohio. Mr. Gruttadauria's total compensation, as reflected on the corresponding IRS Forms W-2, was $2,609,170.21 in 1999 and $3,218,352.93 in 2000.

c. To date, we have been unable to locate information that would enable us to answer these questions. We are continuing to search for information that would enable us to do so.

6. What were the contents of the complete NYSE file on SG Cowen (including investigation notes)? Can this file be submitted to the subcommittee for the record?

Response to Question 6: SG Cowen does not have access to the complete NYSE file on SG Cowen, including its investigation notes, and respectfully refers the Committee to the NYSE. We would object to the submission of the NYSE file to the Subcommittee. That file was developed in the course of a private inquiry and was resolved consensually by a settlement between the parties, which did not provide for the public disclosure of the information in the file.

7. Do you prefer arbitration to litigation as a means of settling customer disputes? Why or why not?

Response to Question 7: SG Cowen and each of its customers enter into a written agreement to arbitrate any disputes that may arise with respect to any matters concerning the customer's account because arbitration tends to be a speedier, more efficient and less lawyer-intensive means of resolving disputes. Whenever possible, however, SG Cowen prefers to avoid both arbitration and litigation by negotiating resolutions to any disputes with customers.

8. During the period that Mr. Gruttadauria worked for your firm, how much revenue did he generate for the firm? How do you know?

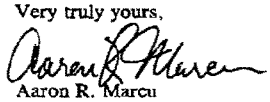
Response to Question 8: As reflected on SG Cowen's commission records, between July 1, 1998, and October 13, 2000, Mr. Gruttadauria generated commission revenues that resulted in income to SG Cowen of $6,107,176.

9. We would like financial statements for SG Cowen for 1999, 2000 and 2001.

Response to Question 9: We are contacting the Committee Staff to arrange for submission of the financial statements of SG Cowen Securities Corporation for 1999, 2000 and 2001 in hard copy.

Please do not hesitate to contact me should you have any questions about the information provided above, or to discuss any other aspect of this matter.

Very truly yours,



Aaron R. Marcu

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