

Chapter Twelve

INVESTOR COMPLAINTS

A. Introduction

The Securities and Exchange Commission's ("SEC" or "Commission") Office of Consumer Affairs and Information Services (the "Office") conducted an in-depth special study of complaints received by the Commission and self-regulatory organizations ("SROs") to identify and analyze the kinds of problems experienced by investors during, or associated with, the market break. "Market break complaints" were broadly defined as those complaints and inquiries filed by, or on behalf of, individual or institutional investors that stemmed from the volatile market activity during the period of October 14-30, 1987.

1. Brief Background on SEC Complaint Processing

The Commission's consumer affairs staff in headquarters (Washington, D.C.) and the nine regional offices received in excess of 40,000 investor complaints and inquiries during Fiscal Year (FY) 1987. These written or telephone complaints and inquiries are routinely tracked and analyzed through the Complaint Management and Processing Index (CMPI) mainframe computer program. In addition to tracking basic information about the specific entity named, investor information and dates of correspondence, special codes are used to identify the type of entity and the nature of the complaint.

Upon receipt of a call or letter, consumer affairs specialists research reference materials or databases in order to respond to inquiries. The investor is required, however, to submit a complaint in writing if he or she wants Commission assistance in obtaining an explanation or resolution. In processing the majority of written complaints, the consumer affairs specialist requests a review of the complaint by the compliance or legal department of the appropriate broker-dealer, mutual fund, or issuer, along with a report of that department's findings. This report is then reviewed to determine whether it is responsive to the issues raised in the complainant's letter. In many cases, corrective action is initiated by the firm to resolve the problem. In others, the investor's claims or allegations are disputed. Since the Commission is not authorized to serve as a judge or arbitrator, the specialist advises the investor of his or her general rights of private recourse.

Investor complaints serve as an important source of information in the Commission's regulatory and enforcement programs. Historically, between 20% and 25% of the enforcement investigations opened each year result, at least in part, from information on a variety of securities industry or corporate violations obtained through investor complaints. Complaints alleging broker-dealer sales practice abuses are carefully screened for indications of violations of Federal securities laws or SRO rules and, where warranted, are referred for further review to Commission regulatory staff and/or SRO staff. In some cases, these reviews may ultimately result in SRO disciplinary action against a firm or registered representative, increased oversight of specific regulated entities, or administrative proceedings. Analysis of overall trends in complaint types, complaints about industry practices, or complaints against specific entities also assists in planning oversight and regulatory program activities.

2. Study Methodology

The Office collected detailed information from Commission headquarters, regional and branch offices, and SROs on both written and telephone complaints. The information collected on telephone complaints was necessarily general because of differences in the extent to which various regional offices and SROs captured data on telephone calls, as well as the general lack of detail and supporting documentation inherent in such complaints. Emphasis was therefore placed on the analysis of written complaints.

Prior to sending out the data requests (copies of which are attached as Appendix H), a special personal computer ("PC") based program was developed to provide a means for tracking multiple complaints in a letter and to define better the specific types of problems associated with the high market volume and volatility. ^{1/} The categories of complaints chosen were based on trends identified in investor telephone complaints during the three week period beginning October 19. Five broad categories of complaints were selected, each consisting of a series of between five and twelve specific complaint codes, as follows:

- a. General Inquiry or Complaint -- This series of 12 codes was divided into four categories for the analysis:
 - o Access to brokers or quotes;
 - o Public Commentary (general comments about the market break, program trading, or SEC/SRO intervention)
 - o Allegations of law or rule violations, or faulty advice
 - o Miscellaneous
- b. Confirmation Problems -- The pricing code in this category was combined with execution pricing problems for the analysis.
- c. Execution Problems

^{1/} The program was designed to supplement the existing CMPi system; therefore, it did not duplicate the majority of normal complaint codes, such as those associated with sales practices, fees, and issuer problems. Some identifying data such as assigned number, entity code, entity name, and issuer were repeated in order to facilitate analysis and to permit manual cross referencing between the two systems. The new system also captured additional data elements, such as the transaction date(s), the securities market or exchange associated with the problem(s), the type of security, and the source of the complaint. The format included a "NOTES" column and a supplemental sheet to cover information not adequately captured in the existing codes or format, and to allow for additional comments. The supplemental sheet was an integral part of the program and entries were analyzed for trends in complaint data. The Office also developed a special designator in the CMPi system to distinguish market break complaints from regular complaints received during the same time period.

d. **Margin Problems**

- e. **Mutual Fund Problems** -- This series contained 11 codes related to redemptions, transfers, and pricing.

SEC and SRO staff reviewed the written complaints related to the market break and summarized pertinent information using the special format and coding instructions provided with the data requests (Appendix H). Data in the new system and in the regular CMPI system, for SEC complaints, was reviewed to identify evidence of possible securities law violations and sales practice abuses that may have been brought to light as a result of the extraordinary market drop.

B. Summary of Telephone Complaints

Information was collected on trends evidenced by approximately 14,430 calls made by investors to the SEC and SROs during the period of October 14 to November 27, 1987. Of these, the SEC received approximately 9,360 calls. ^{2/}

Table 12-1, a graph depicting daily SEC call volume for the last half of October, demonstrates the dramatic increase in telephone complaints following the October market break. Table 12-2 displays weekly totals of telephone complaints for the last half of October and for November, 1987. The volume of calls, which was highest for the week of October 19, 1987, remained well above average (approximately double the normal average) for most of the period, gradually decreasing until the end of November, when the number of telephone complaints stabilized. The increase in telephone complaints is attributable to the market break.

The most prevalent problems mentioned by investors who contacted the SEC were inability to contact brokerage firms, problems with order executions, and complaints about margin calls. The callers also indicated dissatisfaction and frustration stemming from the inability to confirm whether certain transactions had been executed, as well as uncertainty about the ability of the market to function properly under the conditions of the market break.

Discount brokers tended to be the target of the most telephone complaints, particularly during the week of October 19, 1987. Numerous calls also were received in connection with firms rumored to be experiencing financial difficulties or going out of business. During the early part of that week, investors also complained about mutual funds, particularly fund redemption policies and difficulties in reaching funds by telephone.

^{2/} The Office maintained close contact with regional and branch offices to gather information on the total number of calls as well as to elicit comments on general categories of complaints. Some of the regional offices reported as much as four times the normal volume of complaints. Due to the heavy volume and assignment of additional staff to cover phones, normal documentation of telephone complaints was not universally maintained; as a result, the statistics in the CMPI system for October only partially reflect the telephone complaints received and shown in the graphs.

SEC Telephone Complaints by Day

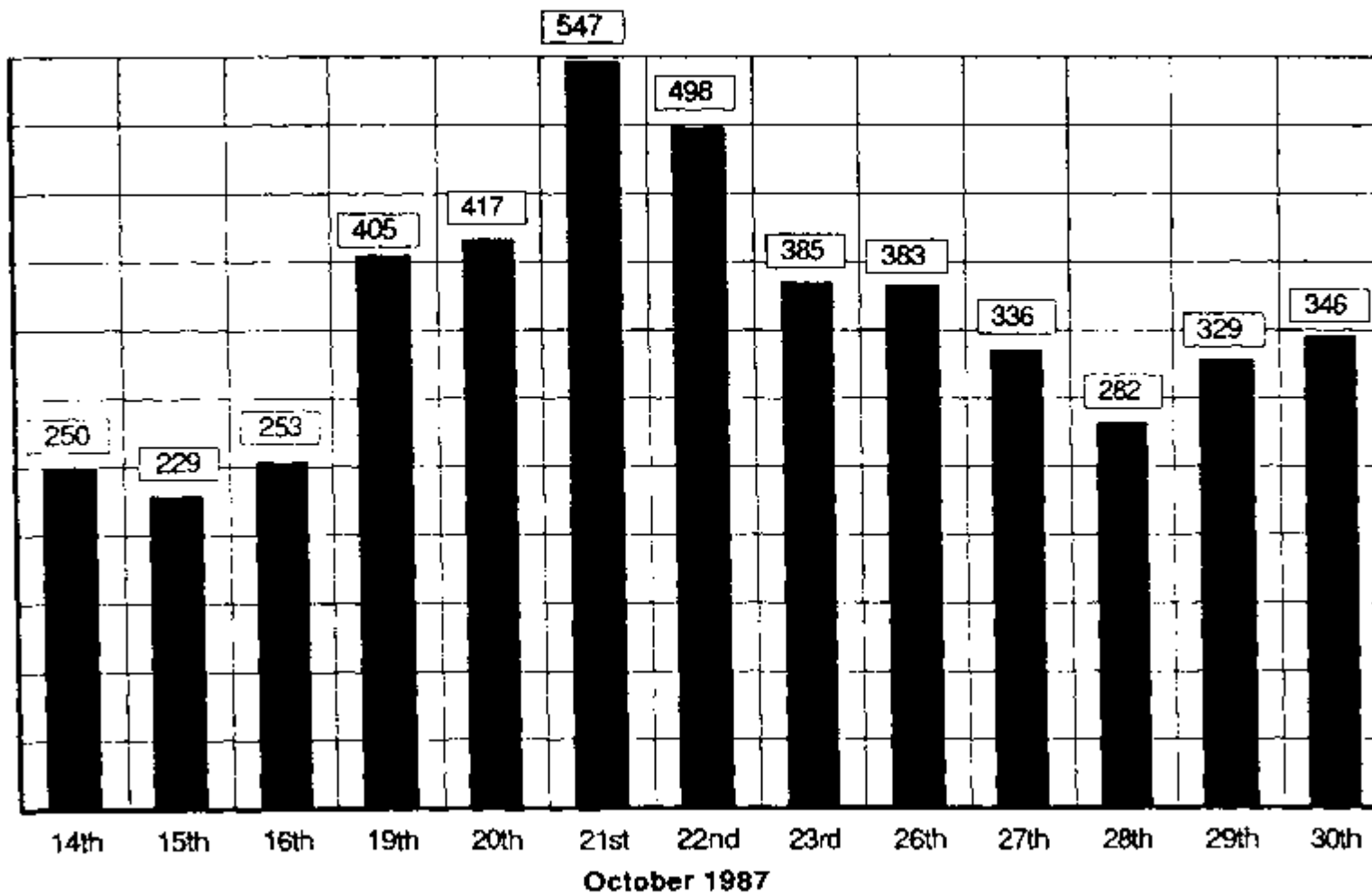


Table 12-1

SEC Telephone Complaints by Week

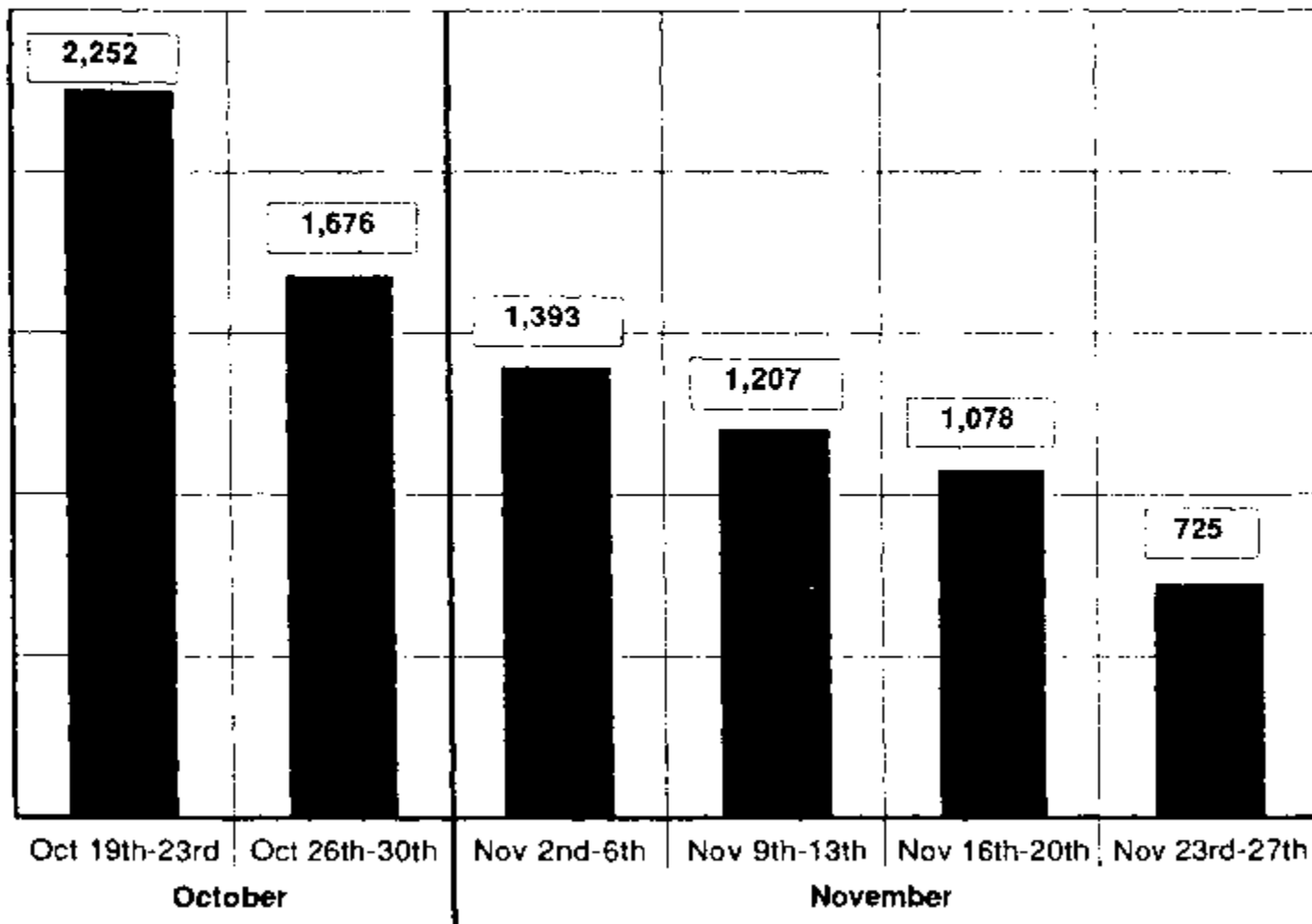


Table 12-2

12-5

The SROs submitted information on approximately 5,070 telephone complaints. Of these, 2,972 calls were received by the New York Stock Exchange ("NYSE"). The National Association of Securities Dealers ("NASD") estimated that 1,870 calls were handled by its headquarters and district offices. The only other SROs reporting substantial telephone traffic related to the market break were the Chicago Board Options Exchange ("CBOE") with 120 calls and the American Stock Exchange ("Amex") with 86. The SROs' analyses of their telephone complaints revealed that execution problems were predominant, although numerous problems involving confirmations and margin accounts were also cited. This analysis of trends paralleled the Commission's experience.

C. Analysis of Written Complalats

A total of 1,283 market break complaint letters, representing 1,973 categorized complaints, were analyzed for this Study. The 620 letters to the SEC contained 1,170 categorized complaints, or an average of 1.9 complaints per letter. The 663 letters to the SROs contained 803 complaints, or 1.2 complaints per letter. The difference in categorized complaints per letter was primarily attributed to differences in the extent to which the Office received general comments and complaints about the market break, program trading, and similar issues. ^{3/} Table 12-3 provides a summary of the letters and complaints received by each of the SROs and SEC offices.

Over 97% of the written complaints were related to problems experienced by individual investors. Of these, 91% represented investors who wrote directly to the SEC or to one of the SROs, approximately 3% of the complaints came from individual investors through a representative (e.g., Congressman or attorney), and 3% were from brokers writing on behalf of individual investors. The remaining 3% were divided between complaints from institutional investors and brokers themselves.

The overall distribution of complaints by category (representing all entities) is shown in Table 12-4. Execution problems represented the largest single category of complaints, accounting for over 43% of the total received and almost equaling the total percentage of the next five categories in the ranking. Three categories, public commentary, ^{4/} confirmation problems, and margin problems each accounted for approximately 10% of the total complaints.

^{3/} There also were noticeable differences in the extent to which the various SEC offices and SROs identified and categorized multiple complaints as provided for in the special computer program.

^{4/} The public commentary category was used to track complaint letters containing general comments, complaints, or suggestions on the market break situation, program trading, or degree of SEC or SRO intervention; questions about broker solvency/insolvency or the Securities Investor Protection Corporation; and general allegations that firms put their own interests before investors' interests. These general complaints and comments provided an indication of public sentiment and perceptions of the market break. Allegations of firms' promoting their own interests ahead of investors' will be reviewed for possible referral during complaint handling in the context of the specific situation or problem.

Complaints were also analyzed by the type of entity about which the complaint was lodged, as shown in Table 12-5. Broker-dealer (BD) complaints represented almost 74% of the total complaints categorized and were the subject of approximately 72% of the letters.

Table 12-3. SUMMARY OF LETTERS AND COMPLAINTS

| SEC | Letters | Complaints |
|---|-------------|-------------|
| Headquarters | 263 | 620 |
| Atlanta Regional Office | 19 | 38 |
| Boston Regional Office | 35 | 35 |
| * Chicago Regional Office | 52 | 66 |
| ** Denver Regional Office | 20 | 21 |
| Fort Worth Regional Office | 27 | 39 |
| Houston Branch Office | 27 | 81 |
| Los Angeles Regional Office | 46 | 49 |
| Miami Branch Office | 11 | 30 |
| New York Regional Office | 34 | 70 |
| Philadelphia Regional Office | 22 | 30 |
| San Francisco Branch Office | 42 | 60 |
| Seattle Regional Office | 22 | 31 |
| SEC Total: | <u>620</u> | <u>1170</u> |
| SRO | | |
| American Stock Exchange (Amex) | 58 | 60 |
| Chicago Board Options Exchange (CBOE) | 114 | 116 |
| National Association of Securities Dealers (NASD) | 250 | 356 |
| New York Stock Exchange (NYSE) | 230 | 253 |
| Philadelphia Stock Exchange (Phlx) | 9 | 14 |
| Pacific Stock Exchange (PSE) | 2 | 4 |
| SRO Total: | <u>663</u> | <u>803</u> |
| SRO & SEC Total: | <u>1283</u> | <u>1973</u> |

* Includes complaints received by the Detroit Branch Office.

** Includes complaints received by the Salt Lake City Branch Office.

Table 12-4. OVERALL DISTRIBUTION OF COMPLAINTS BY CATEGORY
(all entities)

| <u>Rank</u> | <u>Category of Complaint</u> | <u>SEC</u> | <u>SROs</u> | <u>Total</u> | <u>%</u> |
|-------------|---|-------------|-------------|--------------|---------------|
| 1. | Execution Problems | 349 | 505 | 854 | 43.3% |
| 2. | Public Commentary | 203 | 8 | 211 | 10.7% |
| 3. | Confirmation Problems | 140 | 65 | 205 | 10.4% |
| 4. | Margin Problems | 108 | 91 | 199 | 10.1% |
| 5. | Mutual Fund Problems | 131 | 24 | 155 | 7.8% |
| 6. | Miscellaneous | 74 | 56 | 130 | 6.6% |
| 7. | Access Problems | 89 | 30 | 119 | 6.0% |
| 8. | Allegations of violations, abuse, or faulty advice | 76 | 24 | 100 | 5.1% |
| | Total | <u>1170</u> | <u>803</u> | <u>1973</u> | <u>100.0%</u> |

Table 12-5. COMPLAINT DISTRIBUTION BY ENTITY TYPE

| <u>Rank</u> | <u>Entity Type</u> | <u>Total Complaints</u> | <u>%</u> | <u>Number of Letters</u> | <u>%</u> |
|-------------|--|-----------------------------|------------|------------------------------|------------|
| 1. | Broker-Dealer (BD) | 1451 | 73.5 | 928 | 71.7 |
| 2. | General and Miscellaneous (GN) | 206 | 10.4 | 118 | 9.1 |
| 3. | Self-Regulatory Organizations (SR)* | 155 | 7.8 | 142 | 11.0 |
| 4. | Mutual Fund (MF) | 134 | 6.8 | 91 | 7.0 |
| 5. | Transfer Agent (TA) | 10 | 0.5 | 5 | 0.4 |
| 6. | Bank (BK) | 9 | .5 | 6 | 0.4 |
| 7. | Investment Adviser (IA) | 7 | .4 | 4 | 0.3 |
| 8. | Issuer (IS) | <u>1</u> | <u>0.1</u> | <u>1</u> | <u>0.1</u> |
| | TOTAL | 1973 | 100.0% | 1295** | 100.0% |

* This code was used by some SROs to categorize complaints about options market makers, specialists, and SRO order execution facilities.

** Some letters contained complaints against more than one entity type.

1. Broker-Dealer Complaints

Broker-dealer ("BD") complaint data was analyzed separately, in order to facilitate more direct comparisons between SEC and SRO data. The pie chart in Table 12-6 shows the relative percentages of BD complaints by problem category. In addition, as shown in Table 12-7, the findings were compared with summary information on market break complaints received by a selected group of broker-dealers that accounted for a substantial portion of NYSE volume during the October market break. ^{5/}

Execution problems (48% of total BD complaints) represented 40% of complaints received by the SEC and 59% of complaints received by the SROs. Complaints categorized by the SEC and SROs indicated that failure to execute an order was the problem most frequently encountered, constituting 45% of all execution problems. Also significant, in descending order of importance, were pricing problems, delayed execution of orders, and problems specifically associated with specialist or market maker performance. These three additional problem areas totaled 47% of the execution category. In comparison, 45% of complaints received by the selected group of broker-dealers related to execution problems.

Confirmation problems was the second largest category of BD complaints, accounting for 17% of SEC complaints and 10% of SRO complaints. Inability to obtain or delays in receiving oral confirmations represented 60% of these problems, and the remaining 40% were various problems with written confirmations such as late or no written confirmation and discrepancies between oral and written confirmations. In addition, supplemental sheet entries described several cases of subsequent corrections made to written confirmations adjusting the price to either the maximum limit set by the investor in a limit order or to the maximum/minimum price of the issue for the day (depending upon whether the order was a buy or sell order, respectively). For the complaints received by the selected group of broker-dealers, lack of oral confirmations accounted for 9% of complaints received and problems with written confirmations were included in their "general" category.

Problems associated with margin accounts comprised the third largest category of BD complaints, accounting for 13% of SEC complaints and 14% of SRO complaints. Almost 84% of margin-related complaints concerned lack of notice or time to meet margin calls and/or of liquidation of their position or account without notice. Other complaints described changes from brokers' past practices with regard to handling margin calls; unknown or changing margin requirements; and complaints about the extent of liquidation of holdings or the particular sales made to cover margin calls. The supplemental notations contained a number of allegations that investors were not aware they had been placed in margin accounts or were not aware of the specific provisions for margin calls or account liquidations. The selected group of broker-dealers reported

^{5/} The Division of Market Regulation requested and received reports of written (and in some cases oral) customer complaints from a selected group of 25 broker dealers that have an aggregate of close to 13 million customer accounts. These firms were asked to report total complaints in five categories: inability to contact the broker-dealer, verbal confirmation problems, execution problems, lack of notice related to margin accounts, and other.

Total Broker-Dealer (BD Entity) Complaints by Category

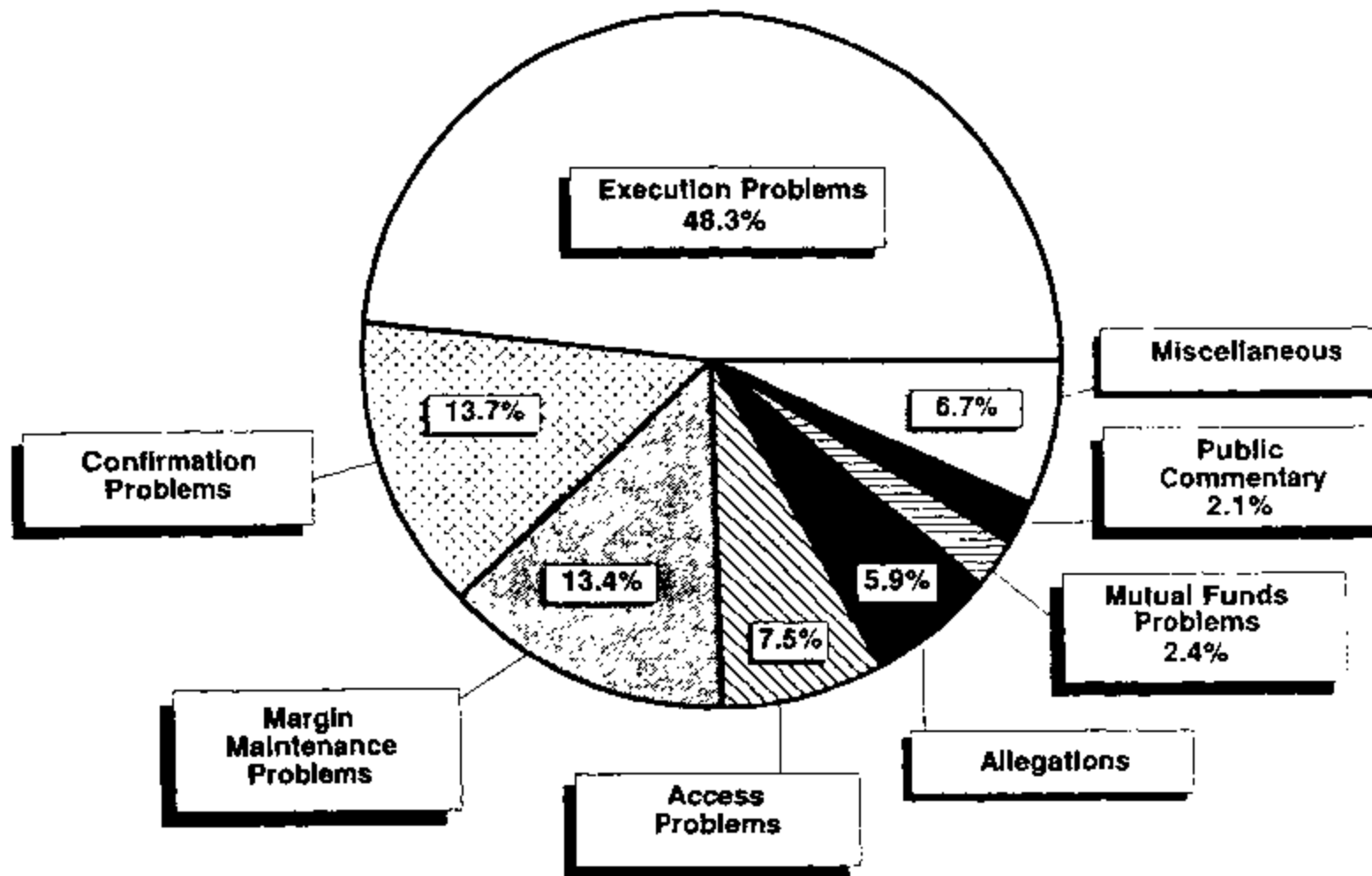


Table 12-6

COMPLAINTS TARGETED AT BROKER-DEALERS (AS ENTITY)

| Type of Complaint | SEC | | SROs | | Selected Broker-Dealers | |
|-------------------------------------|-----|-------|------|-------|-------------------------|-------|
| | # | % | # | % | # | % |
| Execution | 321 | 39.6% | 379 | 59.1% | 1243 | 44.9% |
| No execution | 77 | 9.5 | 165 | 25.7 | | |
| Delay | 65 | 8.0 | 72 | 11.2 | | |
| Price Discrepancies | 82 | 10.1 | 61 | 9.5 | | |
| Specialist/Market Maker | 22 | 2.7 | 30 | 4.7 | | |
| Stop-limit orders | 24 | 3.0 | 22 | 3.4 | | |
| Systems Problems | 19 | 2.3 | 16 | 2.5 | | |
| Refusals to accept orders | 32 | 4.0 | 13 | 2.0 | | |
| Confirmation | 134 | 16.5% | 65 | 10.1% | 269 | 9.7% |
| No Late Oral Confirmations | 79 | 9.8 | 40 | 6.2 | 269 | |
| Problems with Written Confirmations | 55 | 6.8 | 25 | 3.9 | * | |
| Margin | 104 | 12.8% | 91 | 14.2% | 501 | 18.1% |
| Liquidation without notice | 46 | 5.7 | 35 | 5.5 | | |
| Insufficient time or notice | 41 | 5.1 | 41 | 6.4 | | |
| Other | 17 | 2.1 | 15 | 2.3 | | |
| Access | 81 | 10.0% | 28 | 4.4% | 182 | 6.6% |
| To Brokers | 55 | 6.8 | 24 | 3.7 | 182 | |
| To Quotes | 26 | 3.2 | 4 | 0.6 | * | |
| General | 170 | 21.0% | 78 | 12.1% | 573 | 20.7% |
| Alleged abuses | 64 | 7.9 | 22 | 3.4 | | |
| Mutual-fund specific | 20 | 2.5 | 15 | 2.3 | | |
| Public commentary | 25 | 3.1 | 5 | 0.8 | | |
| Miscellaneous | 61 | 7.5 | 36 | 5.6 | | |
| | 810 | | 641 | | 2768 | |

*complaints would be included in general category

that over 18% of their complaints concerned lack of notice in connection with margin accounts.

Another area of complaint concerned the inability to contact a broker or to obtain timely or accurate price quotes. These complaints, which accounted for 8% of the BD problems, were typically a secondary complaint in the letter, although they tended to exacerbate the main problem, particularly in cases of inability to contact brokers in connection with margin problems. As expected, the overall distribution by date of complaints about inability to contact brokers showed that investors had the most difficulty reaching brokers and mutual funds on October 19 and 20, when 39% and 48% of these complaints, respectively, were reported to have occurred. Inability to contact brokers accounted for 10% of SEC and 4% of SRO BD complaints. Almost 7% of the complaints received by the selected broker-dealers concerned inability to contact the broker. Inability to obtain quotes was included in their general category.

Allegations of securities law violations, faulty advice and breach of fiduciary duty accounted for 6% of the SEC and SRO BD complaints. These complaints were not broken out in the data received from the selected group of broker-dealers and are included in the general category, which constituted 21% of their complaints. The remaining BD complaints to the Commission and SROs were related to mutual fund problems (2%), public commentary (2%), and miscellaneous (7%).

a. Comparison of Complaints by Type of Broker-Dealer

The complaint data was analyzed by the broker-dealer firm named in the complaint. Those firms about which ten or more complaints were received were identified and categorized as Discount, National Full Service or Other. The categorization as Discount or National Full Service was based upon a number of factors including the firm's customer account base, its classification by the NASD, and the firm's description as provided in Standard & Poor's Security Dealers of North America (1987 Edition). This subset of broker-dealers represents over 48% of the entire database of complaints and is a reasonably representative sample. Table 12-8 depicts the distribution within the subset by proportion of complaints and proportion of customer account base for each category, as well as the average number of complaints per 1000 accounts and the range of average complaints for firms within the category.

Table 12-8 highlights the higher proportion of complaints targeting those firms in the Discount and Other categories relative to their respective customer account bases. It also points out the lower proportion of complaints (relative to the account base) citing National Full Service firms. A comprehensive comparison of the three categories by type of complaint is presented in Table 12-9.

As Table 12-8 illustrates, the firms in the Discount category received a greater proportion of complaints relative to their known account base in all categories, and more than their overall percentage of complaints in the execution, confirmation, and access areas. Access complaints constituted the highest proportion of complaints. It is likely that the overall number of executions handled by Discount firms was greatly increased; however, the percentage of problems reported by investors is still very significant. The one Discount firm included in the group of selected broker-dealers who reported on investor complaints received directly, provided similarly high levels of investor complaints across the board.

The four firms in the Other category are generally regional firms; however, given the small sample and its not being representative of the majority of regional firms, no general conclusions can be drawn. These particular firms received a greater proportion of complaints relative to their account base in all categories; however, this was not true for all regional firms in the database, most of which received fewer than 10 complaints.

In contrast, the National Full Service firms received both the lowest proportion of complaints relative to account base and the lowest ratio of complaints per 1000 accounts. Care must be exercised in drawing definitive conclusions from this subset and categorization of firms. Factors such as each firm's level of trading activity during the period, peak period operating capacity and identified business philosophy or objectives must be taken into account, as well as the unprecedented volume experienced during the market break.

Table 12-8. COMPLAINT DISTRIBUTION BY TYPE OF FIRM
(Firms with 10 or more complaints)

| <u>Category</u> | <u>Proportion of Customer Acct. Base</u> | <u>Proportion of Complaints</u> | <u>Average Number of Complaints per 1000 Accounts</u> | <u>Category Range of Average Complaints</u> |
|-----------------|--|---|---|---|
| Discount | 13.0% | 49.3% | .36 | .052 - .602 |
| National | 85.8% | 44.0% | .03 | .015 - .070 |
| Other | 1.2% | 6.7% | .95 | .085 - 2.00 |
| Total | <u>100.0%</u> | <u>100.0%</u> | | |

BROKER-DEALER FIRMS
Accounting for 10 or More Complaints

Total 958 = 48.5 of all complaints

| Type of Complaint | | Discount (7 firms) | | National (11 firms) | | Other (4 firms) | | Total |
|---------------------|-------------------------------------|--------------------|-------|---------------------|-------|-----------------|------|-------|
| | | # | % | # | % | # | % | |
| Execution | Sub-total | 200 | 46.3% | 196 | 45.4% | 36 | 8.3% | 100% |
| | No executions | 52 | | 69 | | 19 | | |
| | Delay | 36 | | 41 | | 4 | | |
| | Price Discrepancies | 55 | | 43 | | 3 | | |
| | Specialist/Market Maker | 8 | | 15 | | 0 | | |
| | Stop/limit orders | 25 | | 15 | | 1 | | |
| | Systems Problems | 16 | | 4 | | 3 | | |
| | Refusals to accept orders | 8 | | 9 | | 6 | | |
| Confirmation | Sub-total | 86 | 62.8% | 42 | 30.6% | 9 | 6.6% | 100% |
| | No-Late Oral Confirmations | 50 | | 25 | | 5 | | |
| | Problems with Written Confirmations | 36 | | 17 | | 4 | | |
| Margin | Sub-total | 79 | 54.8% | 60 | 41.7% | 5 | 3.5% | 100% |
| | Liquidation without notice | 27 | | 28 | | 1 | | |
| | Insufficient time or notice | 34 | | 24 | | 3 | | |
| | Other | 18 | | 8 | | 1 | | |
| Access | Sub-total | 57 | 70.4% | 16 | 19.7% | 8 | 9.9% | 100% |
| | To Brokers | 43 | | 7 | | 7 | | |
| | To Quotes | 14 | | 9 | | 1 | | |
| General | Sub-total | 50 | 30.5% | 108 | 65.8% | 6 | 3.7% | 100% |
| | Alleged abuses | 9 | | 51 | | 0 | | |
| | Mutual-fund specific | 0 | | 17 | | 0 | | |
| | Public commentary | 12 | | 9 | | 1 | | |
| | Miscellaneous | 29 | | 31 | | 5 | | |

Table 12-9

b. Sales Practice Complaints Related to the Market Break

The CMPI mainframe tracking system was researched to identify SEC market break complaints that alleged sales practice abuses. Percentages of complaints alleging sales practice abuses against broker-dealers were compared for the market break and for all broker-dealer complaints during several time frames. The relative percentages of complaints primarily concerning execution problems and margin problems were likewise compared. Table 12-10 summarizes the result of these comparisons.

The CMPI data substantiates the finding that order execution problems accounted for the largest percentage of market complaints. ^{6/} Whereas only 9% of total FY 1987 broker-dealer complaints involved order execution problems for equities or options transactions, 49% of the market break complaints focused on this problem.

Margin account problems was the category of complaint that showed the largest increase in percentage, from .7% for FY 1987 to 17% for the market break complaints, an increase of twenty-four fold. Seventy-two market break complaints concerned margin problems; however, only 137 similar complaints were registered during all of FY 1987. As evidenced by the earlier discussion of margin problems identified by the special market break coding system, these complaints primarily dealt with situations in which no notice or what was characterized as inadequate notice of margin calls was given, with investors' positions in many cases being liquidated to cover maintenance margin requirements. It should be noted that margin agreements typically provide the broker wide latitude to take action to meet margin requirements without providing notice. A few margin-related complaints raised questions of suitability.

The overall percentage of sales practice complaints related to the market break (13%) was 3% less than the percentage of sales practice complaints for FY 1987, according to CMPI data. The drop is primarily attributable to a decrease in complaints of "High pressure sales, fraudulent statements, or churning." By comparison, two other individual sales practice code percentages were higher for market break complaints than for the fiscal year. Unauthorized transactions in equity securities were alleged in 6.1% of market break complaints but only 4.8% of FY 1987 BD complaints. Option account suitability problems showed a slight increase for market break complaints; however, with only three market break complaints, the sample is too small to draw a conclusion.

When a preliminary analysis of these same categories of sales practice complaints was prepared on December 4, 1987 for a Congressional staff briefing, the analysis showed that 10% of the market break complaints received at that time concerned sales practice problems. The increase to 13% in the intervening three weeks, along with a slight decrease in the percentage of order execution problems from 51% to 49%, is understandable assuming that most complainants first try to resolve problems directly with their brokers before writing to the SEC. Order execution problems involve a specific incident that occurred at a particular point in time and these problems tend to be more clear-cut, so that the broker's position in a dispute can be more quickly identified. Sales practice problems, on the other hand, frequently involve the entirety of the account history and particularly the relationship between the investor and the

^{6/} Since the CMPI system tracks only one complaint per letter and the PC based system established for this study tracked multiple complaints, the percentages in this section differ slightly from the percentages discussed above.

| COMPARISON OF SALES PRACTICE, MARGIN, AND ORDER EXECUTION COMPLAINTS Market Break vs. All Complaints | | | | |
|--|--|--------------------|---|---|
| Complaint Codes & Categories/Numbers | All FY 1987 (prelim.) ¹ | October 1986 | October 1987 (prelim.) ² | Market Break Letters Oct. 14-Dec. 14 ³ |
| All Complaints & Inquiries | 40,441 | 3,315 | 3,698 | 648 |
| All Broker Dealer Complaints | 19,763 | 1,484 | 2,080 | 423 |
| Sales Practices | | | | |
| 12—High Pressure Sales, Fraudulent Statements, or Churning | 1,959 (9.9%) | 134 | 186 | 25 (5.9%) |
| 24—Unauthorized Transactions | 948 (4.8%) | 69 | 97 | 26 (6.1%) |
| 25—Sustainability Problems — options | 105 (.5%) | 11 | 8 | 3 (.7%) |
| 29—Unauthorized Trans- actions — options | 57 (.3%) | 7 | 8 | 0 |
| Total (%) | 3,069 (15.5%)⁴ | 221 (15.0%) | 299 (14%) | 54 (12.7%) |
| Margin Problems | | | | |
| 10—Margin | 111 | 9 | 54 | 65 |
| 28—Margin — options | 26 | 0 | 8 | 7 |
| Total (%) | 137 (.7%) | 9 (.6%) | 62 (3%) | 72 (17.0%) |
| Order Execution | | | | |
| 06—Execution of Order | 1,651 (8.4%) | 129 | 363 | 192 (45.4%) |
| 27—Execution of Order — Options | 101 (.5%) | 8 | 17 | 17 (4.0%) |
| Total (%) | 1,752 (9.1%) | 137 (9.0%) | 380 (18%) | 209 (49.4%) |
| <p>¹Preliminary figures — not all complaints received within this time frame have been entered into SFC's CMPI system in regions. Based on December 17, 1987 printout.</p> <p>²Due to the volume of telephone complaints in late October, the majority of telephone complaints received were not documented for entry into CMPI.</p> <p>³Written market break complaints were tracked with a special designation in the CMPI system. On-line statistics as of December 30, 1987.</p> <p>⁴Percentages computed as total of all BD complaints, not all complaints and inquiries.</p> | | | | |

Table 12-10

registered representative; therefore, the broker-dealer tends to require more time to research the situation and respond to the investor. This built-in delay, which would account for the increase in percentage of sales practice complaints between December 4 and December 30, would also lend support to the hypothesis that as additional market break complaints are received, the proportion of sales practice complaints would also be higher.

Information on the market break supplemental coding sheets was also reviewed to identify alleged sales practice abuses. In particular, the review centered on supplemental entries for allegations of violations, abuse, or faulty advice; margin problems; and miscellaneous. For SEC complaints, the vast majority of the notes relating to sales practices repeated the problem identified by the corresponding CMPI code.^{7/} The following table (Table 12-11) contains SRO and additional SEC complaints that had textual notes indicating sales practice problems. These SEC complaints are distinguished from those included in Table 12-10 because the sales practice notes represented secondary rather than primary problems, which therefore were not captured on the CMPI system.

Table 12-11. SUPPLEMENTAL SALES PRACTICE COMPLAINTS

| | <u>Number of Letters</u> | | |
|---|--------------------------|------------|--------------|
| | <u>SEC</u> | <u>SRO</u> | <u>Total</u> |
| Unauthorized transactions (sales or purchases) | 4 | 9 | 13 |
| Suitability | 1 | 0 | 1 |
| Churning | 2 | 0 | 2 |
| Unaware of, or no authorization for, margin account | 1 | 3 | 4 |
| Unauthorized trading (options) | <u>2</u> | <u>0</u> | <u>2</u> |
| TOTAL | 10 | 12 | 22 |

Of the complaints analyzed for the study, sales practice complaints represented a smaller percentage of BD complaints than are normally received. Nevertheless, the letters containing such potential sales practice abuses described situations that were amplified by the market volatility. For example, one investor held a margin account with an equity position of over \$210,000 on Friday, October 16. After the market's severe drop on October 19, the account had an unsecured deficit of over \$170,000. The investor was unable to meet a margin maintenance call; consequently the account was liquidated, resulting in a debit balance of approximately \$116,000. This deficit was primarily due to the fact that the account was short index put options.

In this instance the investor did not raise the issue of suitability. However, questions arise concerning the amount of money at risk as well as the investor's understanding of the product involved. Whether this complaint and other complaints in this category involve actual sales practice abuses depends on the investor's overall

^{7/} The balance of supplemental notes included with the entries primarily related to execution errors or to back-office problems (payments, fees, delivery, etc.).

trading history, investment objectives and financial condition. The regular complaint handling process, which generally includes an opportunity for the firm to respond to the complaint letter, will shed additional light on which complaints involve actual sales practice abuses. In those cases, appropriate referrals will be made.

2. Complaints Concerning Mutual Funds

Mutual fund complaints were reviewed in the aggregate as a category of complaints involving a type of security. Mutual fund complaints, which accounted for 9.6% of the total market break complaints, were most frequently directed at the mutual funds as the entity responsible for the problem (70.5%), but complaints were also directed at broker-dealers (18.4%), transfer agents (5.3%), banks (3.7%) and investment advisers (2.1%). ^{8/} Table 12-12 provides the distribution of complaints by general category and entity, with the SEC and SRO complaints against mutual funds ("entity") identified separately.

Only 7% of all complaint letters analyzed by the SEC and SROs were directed at mutual funds. ^{9/} SEC staff identified 122 problems in the 82 letters received (1.5 complaints per letter), while SROs found 12 complaints in the 9 letters analyzed (1.3 complaints per letter).

The 35 broker-dealer (BD) complaints concerning mutual fund investments accounted for 18.4% of all mutual fund related complaints but only 2% of the market break complaints about broker-dealers. Of these 35 complaints, at least 26% involved a mutual fund sponsored by the broker-dealer named in the complaint.

Overall, 76.8% of mutual fund complaints involved, generally, redemptions and transfers. Delayed redemptions were the most frequently cited problem, accounting for almost 30% of all mutual fund complaints. Problems involving transfers within a "family" of funds was second, accounting for almost 23% of total mutual fund complaints. Other redemption complaints were divided among the subcategories of redemption procedures, exit fees, and miscellaneous matters.

The remaining 23.2% of mutual fund complaints was distributed among the six categories shown in Table 12-12 under the caption "Other". Of significance is the small number of complaints in these "Other" categories. Only 8 complaints (4.2% of mutual fund complaints) related to the inability to contact funds by telephone (access problems), which was surprising given that the SEC had received a substantial number of telephone complaints about this during the week of October 19 and considerable media attention had been focused on this aspect of mutual fund performance during the market break. A similar small percentage (4.2%) of mutual fund problems involved sales practice problems, such as misrepresentation of market risks and faulty advice or breach of fiduciary duty.

^{8/} All but four of the small number of complaints concerning transfer agents, banks and investment advisers dealt with mutual fund transactions.

^{9/} CMPI data show that 8.5% of complaint letters received by the Commission in FY 1987 concerned mutual funds.

COMPLAINTS RELATING TO MUTUAL FUNDS
(Targeting Mutual Funds, Broker-Dealers and Other Entities)

| TYPE | TRANSFERS | | REDEMPTIONS | | | OTHER | | | | | | TOTALS |
|--|--------------------|------------------|--------------------|------------------|--------------------|------------------|-------------------|------------------|-------------------|-----------------------------|------------------|--------------------|
| | Intra-Family | Inter-Family | Delayed | None | Other Difficulties | Confirmation | Pricing | Access | Public Commentary | Sales Practices Allegations | Miscellaneous | |
| SEC: Mutual Fund Entity | 28 | 6 | 27 | 2 | 21 | 3 | 14 | 7 | 6 | 6 | 2 | 122 64.2% |
| SRO: Mutual Fund Entity | 4 | | 6 | | | | | 1 | | 1 | | 12 6.3% |
| BD Entity with Mutual Fund Complaint | 10 | 2 | 14 | | 5 | | 3 | | | | 1 | 35 18.4% |
| Transfer Agent Entity with Mutual Fund Complaint | | | 4 | 3 | 3 | | | | | | | 10 5.3% |
| Bank Entity with Mutual Fund Complaint | | | 4 | | 3 | | | | | | | 7 3.7% |
| Investment Advisor Entity with Mutual Fund Complaint | 1 | 1 | 1 | | 1 | | | | | | | 4 2.1% |
| TOTALS | 43 22.6% | 9 4.7% | 56 29.5% | 5 2.6% | 33 17.4% | 3 1.6% | 17 8.9% | 8 4.2% | 6 3.2% | 7 3.7% | 3 1.6% | 190 100% |

Table 12-12

12-19

Under the direction of the Division of Investment Management, ("Investment Management"), the regional offices conducted limited inspections of 16 fund complexes and 4 transfer agents to obtain information on the number and type of complaints and inquiries they received. While most of the funds and transfer agents inspected did not have records identifying by category the complaints and inquiries received, ^{10/} the regional office examiners were able to collect data on the number of telephone and written complaints and inquiries. Table 12-13 shows the weekly tally over a five week period.

Table 12-13. COMPLAINTS AND INQUIRIES RECEIVED BY THE MUTUAL FUNDS AND TRANSFER AGENTS INSPECTED

| | |
|------------------|---------|
| October 12 to 16 | 297,768 |
| October 19 to 23 | 443,596 |
| October 26 to 30 | 312,139 |
| November 2 to 6 | 239,464 |
| November 9 to 13 | 219,107 |

The findings of those inspections indicated that the funds and transfer agents examined, on average, experienced roughly a 50% increase in the level of shareholder complaints and inquiries during the week of October 19 as compared to the level of complaints received during the preceding week. The largest surge of investor complaints and inquiries experienced by one fund was 72%.

Data from the only fund complex that could distinguish complaints from inquiries and categorize them revealed that complaints accounted for only 6% of the total calls and letters received. The remaining shareholder contacts were considered inquiries. Most complaints were related to problems experienced by shareholders in executing fund share transactions, primarily transfers and other redemptions, as illustrated in Table 12-14.

^{10/} While Rule 31a-1 under the Investment Company Act of 1940 requires funds and their agents to maintain copies of written complaints received from investors, it does not require funds to categorize these complaints in any particular way or to categorize them at all. Furthermore, it does not prohibit funds from filing complaint letters in ways that are associated with individual shareholder accounts so that retrieving all shareholder correspondence received in a particular period during an inspection is virtually impossible. Normally, this approach to filing complaints does not impede the inspection process. Within the time constraints imposed on the limited inspections, however, it would not have been feasible for the regional office staff to attempt to retrieve and categorize all complaints and inquiries received from investors during even part of the five-week period reviewed.

Table 12-14. MOST FREQUENT COMPLAINTS -- ONE COMPLEX'S EXPERIENCE

| <u>Complaint</u> | <u>Percentage Week of Oct. 19</u> | <u>Average Percentage Week of Oct. 12 to Week of Nov. 13 (excluding) Week of Oct. 19</u> |
|--|---------------------------------------|--|
| Problems transferring between funds | 27% | 11% |
| Non-execution or delayed execution of transactions | 12% | 6% |
| Inability to contact the fund or its transfer agent <u>11/</u> | 14% | 4% |

Of the total of 19 entities examined, 5 reported that they did not experience a significant increase in either the volume of transactions or the number of complaints and inquiries during the week of October 19. Those fund groups that did have significant increases in the volume of complaints uniformly reported being able to handle the increased volume without delaying the processing of transactions. The profile of complaints resulting from Investment Management's review was generally consistent with the analysis of SEC and SRO complaints.

3. Complaints Directed at Self-Regulatory Organizations

Of the complaint data targeting SROs as the entity about which the complaint is made (SR category), 84% were received by the SROs themselves, while only 16% were received by the SEC. There were 155 SR complaints constituting 8% of the entire data base. 12/ Once again, execution problems were most prevalent, accounting for 80% of the complaints targeting SROs. An even more striking statistic is that "problems

11/ This problem was primarily attributed to an insufficient number of telephone lines to handle the extremely high number of shareholders calling in; however, some problems were also attributed to overloading the telephone company's trunk line in one area.

12/ This entity code was used by some SROs to categorize complaints about market makers, specialists, and SRO order execution facilities.

specifically associated with market makers' or specialists' performance" accounted for 63% of all SR complaints. The other 20% of the complaints in this category were categorized as general. There were no complaints about margin problems and only one complaint concerning a written confirmation was found within the SR category.

The CBOE submission accounted for 75% of the SR complaints received and 78% of the SR coded complaints. Most of these complaints named market makers in "the crowd" on the floor of the exchange who are responsible for fixing prices on various options products. Since these market makers are members of the CBOE, complaints against them were designated as complaints against the CBOE. It should be noted that a majority of these complaints (94%) involve pricing or execution problems and, as such, are attributable to the CBOE in its capacity as a market, rather than in its capacity as a regulator.

4. Market-Specific Complaints

Complaints were also analyzed in relation to the market or exchange upon which the transaction complained about was executed. The exchange/market was identified in 56% of the complaints. The remainder either did not identify a particular market or the market category did not apply (e.g., general complaints and inquiries or mutual fund problems).

Table 12-15 provides the breakdown of complaints identified by market for confirmation and execution problems, as well as the proportion of total complaints identified for each market.

Table 12-15. MARKET-SPECIFIC COMPLAINTS WHERE MARKET WAS IDENTIFIED

| <u>Market</u> | <u>% of Total Complaints</u> | <u>Confirmation Problems</u> | | <u>Execution Problems</u> | |
|---------------|----------------------------------|----------------------------------|----------|-------------------------------|----------|
| | | <u>#</u> | <u>%</u> | <u>#</u> | <u>%</u> |
| NYSE | 25.0% | 95 | 66.0% | 276 | 41.7% |
| NASDAQ | 10.7% | 19 | 13.2% | 131 | 19.8% |
| CBOE | 10.5% | 10 | 6.9% | 154 | 23.3% |
| Amex | 4.9% | 9 | 6.3% | 56 | 8.4% |
| OTC | 3.4% | 10 | 6.9% | 28 | 4.2% |
| Phlx | 1.0% | 0 | | 11 | 1.7% |
| PSE | .5% | 1 | .7% | 6 | .9% |
| | 56.0% | 144 | 100.0% | 662 | 100.0% |

As expected, the number of complaints citing problems with transactions on these respective markets is reasonably proportionate to the volume of trading on each. However, there were several instances where a particular market received a disproportionate share of complaints. For example, 66% of the confirmation problems were experienced in connection with transactions on the NYSE. The only other market with a significant percentage in this category was the NASDAQ which was cited in 13.2% of these complaints.

Analysis of execution problems revealed that over 70% of the complaints were concentrated in three subcategories: non-execution of orders (31.9%); delays in the execution of orders (19.2%); and problems specifically associated with specialists' or

market makers' performance (19.3%). Table 12-16 presents the percentage of complaints attributable to each market.

Table 12-16. SPECIFIC EXECUTION PROBLEMS BY MARKET

| | <u>NYSE</u> | <u>NASDAQ</u> | <u>CBOE</u> | <u>Amex</u> | <u>OTC</u> | <u>Other</u> |
|----------------------|-------------|---------------|-------------|-------------|------------|--------------|
| No Execution | 42.2% | 21.3% | 8.5% | 6.2% | 4.6% | 17.3% |
| Delays | 27.7% | 18.1% | 10.3% | 2.5% | 4.5% | 36.9% |
| SP/MM Performance | 16.0% | 3.2% | 63.4% | 11.5% | .1% | 5.8% |

It should be emphasized that this data does not necessarily reflect the performance of a given market, since the complaint may not result from a problem with the market itself but may have occurred at some other stage in the transaction process. However, complaints of problems associated with specialists' or market makers' performance are attributable to a particular market. Table 12-16 shows that the CBOE was most often cited, with the Amex also showing a relatively high percentage compared to its other complaint percentages.

5. General Inquiries and Complaints

The General and Miscellaneous (GN) category of complaints represented 10% of the total complaints and 9% of the letters. Ninety-four percent of these complaints were filed with the SEC. Most significant of the SEC general complaints were: comments or suggestions on the degree of SEC or SRO intervention (36%); comments on program trading (34%); and general comments and complaints on the market break (19%).

The overall theme of the GN category concerned investors' vehement opposition to program trading. Most complaints categorized as the degree of SEC or SRO intervention were actually requests for SEC action to curtail program trading. A number of investors called on the SEC to eliminate program trading altogether. Specific suggestions for improving the market included restricting program trading to a limited number of hours each trading day, imposing a small tax on each securities trade, placing daily fluctuation limits on stock index futures, eliminating street name holdings of securities for hidden owners, developing further the Commission's short sale rule and abolishing all sell or buy orders "at the market." While other causes for market volatility were named, such as overpriced corporate shares due to misapplication of corporate income tax and changes in long term capital gains tax law, investors were virtually unanimous in their perception that program trading is a detriment to the stock market, and that it places the small investor at an unfair disadvantage.

D. Comparison With Other Sources of Investor Complaint Data

Data collected by the SEC and the SROs was compared and contrasted with that reported by the North American Securities Administrators Association (NASAA), which instituted a hotline to receive investor complaints on November 9, 1987. NASAA reported on 2,562 specific complaints (out of the more than 8,000 total calls received). Of these, they identified 1,321 complaints, or 51.6%, as "crash-specific", and 1,242

complaints as "pre-existing". ^{13/} The "crash-specific" complaints were categorized as follows:

Table 12-17. NASAA COMPLAINTS RELATED TO MARKET BREAK

| | <u>No.</u> | <u>% of Crash- specific</u> | <u>% of NASAA Total</u> |
|--------------------------|------------|---------------------------------|-----------------------------|
| Trade Execution Problems | 752 | 56.9% | 29.4% |
| Margin Calls | 349 | 26.4% | 13.6% |
| Broker Not Available | <u>220</u> | <u>16.7%</u> | <u>8.6%</u> |
| Total | 1321 | 100.0% | 51.6% |

These complaints are the only ones that appear to be directly comparable to the "market break complaints" definition covered in the scope of the Commission's study of investor complaints. In this regard, the NASAA data is generally consistent with SEC and SRO telephone and written complaint data.

Among the remaining 1,242 pre-existing complaints, NASAA found a high percentage of sales practice complaints. Unsuitable investments (362 complaints) was the most prevalent problem, particularly with regard to options (144, or 39.8% of those complaints).

Since the NASAA data did not appear to distinguish between pre-existing complaints and those only brought to light by the unprecedented steep decline in prices on October 19, it is difficult to determine the extent to which the market break was associated with the various kinds of sales practice abuses they reported. To date, the written complaints received by the SEC and SROs relating to the market break do not contain similarly high percentages of sales practice abuses. The SEC historical database indicates that approximately 12 - 15% of broker-dealer complaints each year are attributable to sales practice problems. The one category identified in the NASAA statistics that does appear to have rapidly increased as a result of the market break is options-related suitability complaints. The SEC received a total of 105 options-related suitability complaints during all of FY 1987, whereas NASAA received 144 during the first four weeks of the hotline's operation.

Investor complaints are also received in generally smaller quantities by state securities regulators. NASAA, however, testified that no follow-up survey had been conducted to determine the numbers or types of complaints received by the states.

A representative of the Commodity Futures Trading Commission ("CFTC") has indicated that they have received very few complaints related to the market break. The

^{13/} NASAA's Report to the Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, House of Representatives (December, 1987) defines pre-existing complaints as problems arising as a "consequence of abusive sales practices that had taken place before Black Monday." (emphasis in original)

CFTC normally anticipates a three to six month lag between an investor's experiencing a problem and his or her filing a formal application to their reparations program.

E. Implications for Investor Protection

The market break was a sobering experience to a great many investors. The complaints received underscore the importance of the Commission and the SROs acting decisively to address weaknesses identified during the market break.

As discussed in Chapter Seven, while the volume of the market break was extraordinary, customer complaints concerning order execution and confirmation problems suggest a need for both the firms and the self-regulatory organizations to look carefully at the capacity of existing broker-dealer systems. The customer complaint data will be useful to the SROs in allocating examiner resources to this area. Furthermore, the complaint data suggests a need for a comprehensive review by the SROs of their systems and operational capacity to handle future requirements associated with increased volume. The small investor must be assured of liquidity (ready access to both brokers and the market) and efficient execution of small orders.

Customer complaints relative to margin account problems suggest that this area merits close scrutiny in relation to investor protection. Indications that some investors were unaware of the ramifications of holding a margin account point to the need for better, or more easily understandable, disclosure of the information required under Rule 10b-16 under the Securities Exchange Act of 1934. The feasibility of requiring specific notice and time for investors to meet margin calls (consistent with the need to assure broker-dealer solvency) might be worthy of study, as well as the feasibility of raising futures and options margin requirements.

Disclosure is the cornerstone of investor protection. In addition to margin agreements, the account agreements, options agreements, and risk disclosure statements used by broker-dealers may need to be reviewed and modified as necessary to ensure that they are written in plain language.

It is important for the SEC, in cooperation with the SROs and the securities industry, to take visible and effective steps to correct any systemic problems that may be identified through this study and its aftermath; to utilize the information on investor complaints, including any sales practice abuses that may be uncovered, in targeting examinations; and to positively influence the perceptions of the market held by small investors.

