

**In the Matter SHEARSON LEHMAN BROTHERS, INC.; STEIN ROE & FARNHAM \***

*\* Inadvertently omitted from Vol. 48.*

**Admin. Proc. File No. 3-6733; (8-12324), (801-00517)  
SECURITIES AND EXCHANGE COMMISSION**

**SECURITIES EXCHANGE ACT OF 1934, Release No. 23640;  
INVESTMENT ADVISORS ACT OF 1940, Release No. 1038**

**September 24, 1986**

**TEXT: ORDER INSTITUTING PROCEEDINGS PURSUANT TO SECTION 15(b)(4) OF THE  
SECURITIES EXCHANGE ACT OF 1934 AND SECTION 203(e) OF THE INVESTMENT ADVISERS  
ACT OF 1940 AND FINDINGS, OPINION AND ORDER IMPOSING REMEDIAL SANCTIONS**

**I.**

The Commission deems it appropriate and in the public interest that proceedings pursuant to Section 15(b)(4) of the Securities Exchange Act of 1934 ("Exchange Act") and Section 203(e) of the Investment Advisers Act of 1940 ("Advisers Act") be, and hereby are, instituted against Shearson Lehman Brothers, Inc. ("Shearson"), a broker/dealer and Stein Roe & Farnham ("Stein Roe"), a registered investment adviser. n1

Simultaneous with the institution of these proceedings, Shearson and Stein Roe have submitted Offers of Settlement to the Commission. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or in which the Commission is a party and without admitting or denying the allegations, findings of fact, or conclusions of law, Shearson and Stein Roe consent to the entry of this Order Instituting Proceedings, Findings, Opinion and Order Imposing Remedial Sanctions (the "Order"). n2

The Commission has determined that it is appropriate and in the public interest to accept the Offers of Settlement.

Accordingly, IT IS ORDERED that public proceedings, pursuant to Section 15(b)(4) of the Exchange Act and Section 203(e) of the Advisers Act be, and hereby are, instituted.

**II.**

**A. RESPONDENTS**

**1. Shearson Lehman Brothers, Inc.**

Respondent Shearson is a broker/dealer headquartered in New York, New York. Shearson, or its predecessor companies, has been registered with the Commission as a broker/dealer since March 2, 1965. During the relevant period, Shearson acted as primary broker (through its Utica branch office) and custodian for several Upstate New York Teamster pension & welfare funds ("The Teamster Funds"). n3

**2. Stein Roe & Farnham**

Respondent Stein Roe has been registered with the Commission as an investment adviser since November 1, 1940 and is headquartered in Chicago, Illinois. With approximately 57 general partners, it currently has about \$12 billion in assets under management, including registered investment companies.

As will be explained, from June 1981 until September 1985, about 75% of the Teamster Funds' assets, approximately \$310 million was under its management.

## **B. RELATED PARTIES**

### **1. John Giura**

John Giura ("Giura") was a partner n4 of Stein Roe until June 12, 1985. Giura joined Stein Roe in 1961, and in 1971 he became a partner and eventually a "team leader." n5 Giura's team was Stein Roe's largest, with about \$1.5 billion in assets under management out of Stein Roe's then total of approximately \$9 billion. Giura's team always ranked first or second in terms of securing new business.

Giura was one of seven members of Stein Roe's Executive Committee, which is analogous to a board of directors. The Executive Committee's powers include determining the individual partners' share of the profits and making assignments to positions on other committees. Giura was a member of the Account Department Operating Committee ("ADOC") which is responsible for establishing account department operating procedures and working through team leaders to insure their implementation, as well as reviewing "unusual activities." In addition, Giura was the partner to whom Stein Roe's trading desk reported. His responsibilities included the allocation of Stein Roe's clients' brokerage. As one of the three most senior partners, Giura was at all times able to act as he wished, for there was no one supervising him. n6

### **2. George Inserra**

George Inserra ("G. Inserra"), a registered representative at Shearson's Utica branch office until October 1985, was credited with all the commissions generated on behalf of the Teamster Funds. This included all trades, whether initiated by Stein Roe or by the other advisers to the Teamster Funds. At Shearson, G. Inserra operated under two registered representative numbers, 001 and 002. The commissions generated by the 002 account, which included all Teamster trades, were split with the house, with 60% going to Shearson. Of the remaining 40%, G. Inserra retained 60% and his brother John was allocated 40%. n7 The 001 account was split 50-50 with Shearson and was solely for G. Inserra. It was established solely for Giura-directed business. n8

### **3. John Inserra**

John Inserra ("J. Inserra") was also a registered representative at Shearson's Utica Office until October 1985. He shared all commissions on the 002 account with his brother George. His business was primarily retail; it is estimated that he and his brother have approximately 1,500 clients.

### **4. Nicholas J. Gentile**

Nicholas J. Gentile ("Gentile") is the branch manager of Shearson's Utica office. He began in the brokerage business in 1961 as a registered representative. In 1974 he joined Loeb Rhoades as manager of its Utica branch office. He retained the position of manager when Loeb Rhodes merged with Shearson. Almost his entire compensation is based on a percentage of the branch's profits.

## **III.**

### **A. FACTS**

#### **1. Background**

Prior to Stein Roe becoming adviser to the Teamster Funds, Giura directed that some of the brokerage commissions generated by Stein Roe clients' transactions be credited to G. Inserra. According to Giura,

this was in return for, and in anticipation of, the direction of investment advisory business by G. Inserra to Stein Roe. n9

In the late 1970's, G. Inserra introduced Giura to the Teamster trustees. After he made a number of presentations, both written and in person, Giura won a contract for Stein Roe to manage about 75% of the Teamster Funds' assets. G. Inserra was to receive commissions on all Teamster transactions. Shearson also became custodian of the Funds' assets and provided these services gratis.

## **2. The Stein Roe General Account**

In June 1982, the Inserras caused a brokerage account to be established in the Utica branch office, which they denominated the "Stein Roe General Account." The purpose of the General Account was to enable the Inserras to have a place where securities could be purchased and be transferred, "as of" the trade date, either to retail clients of the Inserras if the current market price of the securities went up, or transferred to the Teamster Funds' accounts if the current market price declined and a quick profit could not be made. The transfers were usually effected prior to settlement date, through Shearson's trade corrections procedures.

The actual paper work to open the General Account was done by Gentile and the Inserras' sales assistant. However, throughout its existence, it lacked a taxpayer I.D. number which, under Shearson's procedures, should have caused it to be cleared out each day, i.e., no securities should have been in the account at the end of the day. If transactions did not clear out, the account should have been restricted. As a restricted account, no trades should have been effected through it after a reasonable period of time had passed without obtaining the I.D. number. Despite the fact that it should have been restricted, approximately 100 trades were effected in the General Account in the course of a year. In addition, there were ten instances where trades remained in the account past settlement date. At least four of these should have generated last day cash calls and requests for extensions from the New York Stock Exchange ("NYSE"). n10 Extensions, however, would not have been granted, for the NYSE requires that a social security number or taxpayer I.D. number be provided. The General Account had neither.

## **3. The Inserras' Trading**

On at least nine occasions when shares were transferred from the General Account to J. Inserra's customers' accounts, J. Inserra withdrew money from his brokerage account, often borrowing on margin. Shortly thereafter, he wrote checks to his retail customers and this money was deposited by the customers in their brokerage accounts in time to make payment on settlement date. These money transfers took place contemporaneous with the transfer of a security from the General Account to the customer's account. The security was sold the same day as the transfer and, after the sale settled, the customer withdrew the proceeds. Although J. Inserra claimed that these were loans, he received back the money he had "lent," often with all or most of the profits from the trade going to him. n11

Shearson's internal rules require that the branch manager sign all account change requests filled out on "PK" forms. n12 However, on numerous occasions, PKs were entered without Gentile's signature, for he was frequently out of the office and his duties fell to his subordinates to fulfill. Even when he did sign, he did not obtain the "essential facts relative" to the change, although Rule 410 of the Constitution of the NYSE requires the authorizer to be so personally informed.

The 85 PKs involving Inserras' customers n13 reflect trade changes from the General Account to the Teamsters; from the General Account to retail customers of the Inserras; from Inserra retail customers to other Inserra retail customers; from no-name accounts to the Teamsters; from the Inserras' personal or related accounts to Teamster accounts; and from the Inserras' beneficial accounts to Inserra retail customers. n14

#### **4. Shearson's Transfer Mechanisms**

All trade corrections made prior to settlement date are done at the branches. After reviewing the confirmation, any errors are noted thereon and brought to the operations department. An error can exist in price, number of shares, or commissions, or the trade could have been executed in the wrong account. The operations people fill out a PK form and send the information over the wire to New York. At that point, it is date and time-stamped. Prior to transmission, Shearson's internal rules require that the PK be signed by the branch manager or his assistant. n15

For post-settlement date transfers, the corrections department (in New York) had to have a basis for the change. Needed was a letter of authorization from the customer or some assurance from the branch manager that he spoke to the customer, an error had been committed, and the trade should be corrected to another account. There is no documentary or testimonial evidence that Gentile obtained customer authorizations.

#### **B. J. INSERRA'S CHURNING OF A CUSTOMER'S ACCOUNT**

J. Inserra engaged in excessive, unsuitable and unauthorized trades in the account of his wife's grandfather ("the Customer") a retired electrical contractor. In addition, J. Inserra transferred profitable trades from his Customer's account to the account of a friend. J. Inserra also caused unprofitable trades to be PK'd from the General Account to the Customer.

J. Inserra began handling the Customer's account in 1975. At that time, the Customer, whose investment objective was to increase income, told J. Inserra to use his best judgment in buying and selling securities for him. However, no written discretionary authority was obtained from the Customer by J. Inserra.

Beginning in 1980, up through June 1983, J. Inserra caused the Customer to incur brokerage commissions of about \$65,600. During the same period, the Customer paid interest on debits in his account of about \$39,700. His dividend income for this period was about \$15,400. J. Inserra also made unsuitable trades in the Customer's account by engaging in day trades and options trading. These unauthorized trades resulted in losses of over \$18,000 and commission costs in excess of \$10,000. n16 Moreover, on four occasions, J. Inserra transferred trades out of the Customer's account into a friend's account. These securities were sold, on the same day as their transfer, for a total profit to J. Inserra's friend of \$17,000.

On several occasions, Shearson's Compliance Department brought to Gentile's attention the amount of commissions and level of activity in the Customer's account. Gentile was specifically directed by the Compliance Department, in a branch audit report, to send a letter to the Customer requesting the Customer's acknowledgement that the activity in the account was consistent with his objectives and that he approved of such activity. Instead of sending the letter specified by the Compliance Department, Gentile sent the Customer a "thank you for your business letter." Shearson should have followed up to ensure that Gentile sent the proper letter. It failed to do so.

#### **IV. SHEARSON'S VIOLATIONS - SECTION 15(b)(4)(E) OF THE EXCHANGE ACT**

It is the responsibility of broker/dealers to supervise their employees through "effective established procedures." n17 As we have frequently stated, the system of internal controls must be adequate and effective, especially in large organizations. n18 "[E]ven a small branch poses the potential for significant problems if subjected to inadequate supervision by the . . . home office." n19

The facts in this case demonstrate that the branch manager was deeply involved in the fraudulent schemes. A firm's reliance on a manager's "integrity" absent other functioning checks, will prove ineffective in preventing fraud when a manager is in confederation with the sales force. n20 Moreover,

although the next step up in the chain of responsibility was the regional manager, he apparently only pursued matters if requested to by the Compliance Department.

Although it is evident that the violations herein occurred within one branch, the shortcomings within Shearson's trade corrections and compliance audit follow-up systems failed to prevent them. In these areas, where Shearson had procedures in place, there were insufficient checks to insure that the first line of compliance, the branch manager, was functioning adequately.

## **1. Account Change Procedures**

Shearson has procedures which require the branch manager's approval for all pre-settlement date account changes. The procedure is that the branch manager is required to sign the PK; the manuals specifically state this requirement. Even though the PK form itself has a box entitled "error detail" and requests a detailed description of the error and the name of the individual responsible, no PKs initiated by the Inserras had this box filled in. Thus, it is impossible to determine why the branch manager approved the PK and the reasons, if any, he was told the change was needed.

Given the manner in which PK "corrections" are handled, with no authorization required from either customer, the potential exists for the undetected use of a holding account for improper purposes, such as occurred in Utica. Such an account can be used as a repository, as it was herein, without the threat of detection, as long as all changes are made before settlement date. In addition, as there was no written explanation on the PK forms, Gentile's signature was meaningless for there was no mechanism to determine whether he was a co-conspirator, whether he was the primary perpetrator, or if he, himself, was being victimized. The Utica documents left no paper trail showing why the transfer was made.

Post-settlement date transfers were processed by the corrections department in New York. The margin department also had to be notified to make the appropriate journal entries. It is unclear whether Compliance had to be notified. It is also unclear whether there were written procedures governing post-settlement date transfers. But it is clear that whatever procedures or policies were established or followed within Shearson were not thoroughly articulated up and down the line. Although there is evidence that post-settlement date transfers had to be substantiated, Shearson's official procedures only required that on all transfers between customer and employee-related accounts, prior approval from Compliance must be obtained. On post-settlement date transfers from customer-to-customer accounts, Compliance had to give prior approval if it was an "aged" item, i.e., the trade was three to four weeks old.

The breakdowns in coordination between Compliance and the operating departments contributed to the failure to prevent both the trading and the transfers in the General Account. Both the new accounts department and the margin department should have caused the General Account to be restricted. Yet, neither department fulfilled its responsibilities. It is the margin department that should have red-flagged the large number of transfers. It is also the margin department that should have red-flagged the fact that the General Account lacked a taxpayer I.D. number for, on at least four occasions, the margin department should have sought extensions from the NYSE. In addition, as the margin department was responsible for entering restriction notices it received from the new accounts department, a supervisory gap existed over the margin department.

## **2. Branch Audits**

Another deficiency was the lack of follow-up to branch audits in Utica. For the 1982 audit, no response was ever received from Gentile, although he was sent a second notice to respond by Compliance. In addition, although copies of responses to the activity letters requested as a result of the audit should have been forwarded to the auditor, no responses could have been received by the auditor as Gentile did not send the required letters. Gentile's recurring failure to send the form letter requesting a response from the Customer validating the activity in his account was never pursued by Compliance.n21

Further, in preparation for the audit, there appear to have been failures in reviewing the prior year's workpapers and reports. Had this been done, the 1982 auditor would have noticed that J. Inserra's Customer's name appeared on the 1981 audit report as a customer to whom an activity letter was to be sent. The 1982 auditor would also have noted that no response was received. A closer look would have shown that a "thank you for your business" letter was sent instead of the required one.

### **3. Conclusion**

The Commission has often expressed its views that a system of supervisory procedures which rely solely on the branch manager is insufficient. n22 As a broker/dealer's Compliance Department is the primary means for assuring that its employees comply with the federal securities laws, n23 its supervisory procedures are rendered ineffective if the firm's Compliance Department can be disregarded by the branch manager, as occurred herein.

Although it might appear that the conduct was contained within one branch office, the failures of departments in New York, e.g., in the new accounts department, the corrections department and the margin department, undoubtedly assisted in the perpetration of the frauds.

Shearson's procedures failed to prevent n24 the violations described above because of the lack of follow-up and the discrepancies in explanations as to whether certain activities require particular supervisory and/or Compliance action. In the absence of follow-up action, and clearly defined departmental authority which fostered inaction, Shearson's procedures were ineffective.

## **V.**

### **A. STEIN ROE'S VIOLATIONS SECTION 203(e)(5) OF THE ADVISERS ACT**

Section 203(e)(5) of the Advisers Act provides for the Commission to bring an action where an adviser has failed reasonably to supervise, with a view to preventing violations of the federal securities laws and the rules and regulations thereunder, another person who commits such a violation, if the person is subject to his supervision. Having procedures in place that are reasonably designed to prevent such violations is a defense. n25 The facts as described herein demonstrate an absence of procedures within Stein Roe to review and monitor the activities of the most senior partners or personnel, such as Giura. Given the opportunity for self-dealing, and the delicate fiduciary relationship n26 between adviser and client, there is an obligation to create and follow such procedures.

### **B. FACTS**

#### **1. Giura's Obtaining Hot Issues For Union Officials**

During the 1982 and 1983 hot issue market, n27 Giura obtained hot issues for various pension funds' officials. Using both the ability of Stein Roe to obtain an allocation n28 for these hot issues, and his own control over Stein Roe's trading desk, Giura was able to obtain hot issues for his "special" clients, even if it was at the expense of fee-paying advisory clients of Stein Roe. n29 Even when Stein Roe clients were not directly disadvantaged, Giura was violating the securities laws for he was failing to disclose that he was benefiting those people whom he believed were able to hire Stein Roe as adviser to their union's funds. n30 Giura obtained hot issues for trustees and administrators of various unions. He also caused the purchase of new issues by individuals who he believed might introduce new business to Stein Roe.

One individual for whom Giura obtained hot issues made profits of over \$180,000. In order to purchase the securities for Giura's "special" clients, n31 Stein Roe's trading desk had to obtain shares wherever it could by contacting different members of the selling syndicate and had to open accounts at least 21 different brokers to effect these purchases.

## **2. "Special Orders"**

Stein Roe, as a courtesy to employees, has a procedure whereby trades for its own employees' accounts and for employees' family members could be put through its trading desk. These orders are easily identifiable for they are written on colored tickets entitled "special" order tickets. It was this mechanism that Giura used to place the orders for hot issues for non-clients of Stein Roe. Most of the special orders for new issues placed by the trading desk were at Giura's direction. In fact, in 1982 and early 1983, with the exception of two of Stein Roe's investment companies, Giura was the only one at Stein Roe placing orders for new issues, for both clients and non-clients. Thus, Giura was able to allocate the shares for his team, ensuring that his "special" clients' orders were entirely filled and adjusting his fee-paying clients' orders for the remaining shares.

Beginning in or about April 1983, with the increase in orders for new issues, Stein Roe initiated a procedure for allocating shares when indications of interest exceeded the allotments. The trading desk would report the allotment to the accounting department n32 which would allocate the shares to the teams that had ordered them. The basis for the allocation was each team's assets under management. It was then left to each team to allocate the shares among its clients. Once the allocation went to the teams, however, there were no procedures to ensure that allocations made by the team leaders were consistent with Stein Roe's fiduciary obligations.

However, Giura by-passed Stein Roe by contacting members of the selling syndicate directly. For instance, Giura secured 45,000 shares of Televideo Systems, Inc. for G. Inserra from Shearson's syndicate desk. This allocation was over and above the Utica branch office's shares, and was solely for G. Inserra's customers.

Giura directly approached managing underwriters to obtain additional allocations for specific registered representatives. In several instances, Stein Roe's clients had indications of interest outstanding. However, these clients were unable to obtain their entire orders partly because Giura had by-passed Stein Roe's trading desk and directed the shares elsewhere.

In addition, after a meeting with Giura, G. Inserra, Gentile and Shearson's regional manager responsible for the Utica Office, where syndicate business and the direction of selling concessions to Utica were discussed with the head of Shearson's institutional trading desk, the amount of Stein Roe business with Shearson increased appreciably. This meeting was held to obtain the institutional department's approval for the direction by Giura of business to Utica to be credited to G. Inserra in the 001 account.

## **3. The Effect**

In at least seven instances where Giura's "special" clients received hot issues at the offering price, fee-paying clients of Stein Roe had part of their orders filled in the secondary market at higher prices. Two of the victims were Stein Roe investment companies of which Giura was a director. Stein Roe has recompensed the investment companies a total of \$36,000. n33

## **4. The Direction of Selling Concessions and Brokerage**

Selling concessions are the fees paid to members of the selling group which are included in the price of a new issue. They are very valuable to both the broker and the adviser. The broker (and the registered representative) do not have to be members of the selling group to obtain the selling concession. Most selling concessions come from the "pot stock." This is stock put aside by the manager of the underwriting and not allocated to members of the selling group. An institutional purchaser can request that part or all of its allocation come out of the pot and that a specific broker or registered representative be paid the selling concession. The manager bills the purchaser and delivers the securities. The selling concession is sent by the managing underwriter to the broker/registered representative with a note telling who directed it to the broker. Typically, the adviser (or some other

large institution) uses the direction of the selling concession to reward a broker or to pay for some service. Individual registered representatives often split the selling concession 50-50 with the house.

At least six registered representatives received selling concessions directed by Giura. These registered representatives included relatives of union officials who were in a position to select advisers for their union pension and welfare funds. Other registered representatives received selling concessions and then were directed to make payments to certain individuals who Giura believed could secure or introduce new business to Stein Roe.

Some of these same registered representatives also received agency business directed by Giura. With these funds, they were directed by Giura to hire "consultants," make charitable contributions to Giura's favorite charities, and pay for part of the costs of Stein Roe's business functions. In total, from about 1979 through about June 1985, Giura directed over \$2.9 million of Stein Roe's clients' brokerage to these registered representatives.

## **5. The Teamster Funds and the "Stein Roe General Account"**

Stein Roe's procedures require that all trades for all Stein Roe clients be placed by Stein Roe's trading desk. The procedure obviously has dual advantages. It prevents inadvertent conflicts between Stein Roe's clients who might be competing against each other in the marketplace were individual portfolio managers to deal independently with executing brokers. In addition, this procedure requires the trade information to be inputted into Stein Roe's records as soon as an order is executed. n34 From Stein Roe's daily ledger sheets, maintained for each account, one can determine each trade by security, trade date, settlement date, price per share, broker and commissions. In addition, the date the data was inputted in the system appears next to every transaction.

Most of the trades for the Teamster Funds were executed in accordance with these procedures. Giura's team would transmit the order to Stein Roe's trading desk which would call Shearson's institutional trading desk. The trade information would then be inputted in the Teamster Funds' records on the same day as the trade. Since Stein Roe was informed of the trades only after the transfer from the General Account to the Teamsters, a discrepancy existed between the Funds' holdings and those reflected on Stein Roe's records. At times, the reconciliation of these discrepancies took as long as six weeks. The explanation given to Stein Roe's records department by Giura as to why these reconciliations were necessary was that he had placed these orders directly with G. Inserra. n35

## **D. WEAKNESSES IN INTERNAL CONTROLS**

The Commission believes that Stein Roe had significant weaknesses in its internal controls. n36 Stein Roe allowed one partner to allocate the firm's brokerage. With such a valuable commodity, guidelines and policies should have been formulated and followed to ensure that, when brokerage was directed to a specific broker or registered representative, the reason for the direction and the expected return be stated. Although Stein Roe maintained a list of which registered representatives to direct brokerage to, no written requests for the inclusion of a registered representative on the list were retained by the firm. Thus, review of the justification for direction of brokerage could not be made. Additionally, the dollar amounts of brokerage directed to registered representatives is readily available; however, no review was made within Stein Roe of the reasons for the direction. Moreover, no review was made of Giura's supervision of allocations and his own allocations in order to insure that a "good faith" determination that clients' brokerage was being used for client benefit in keeping with Stein Roe's fiduciary obligations was made. Such a review and justification procedure would have caught and questioned the large amounts of brokerage directed to certain registered representatives and/or broker/dealers.

In addition, there was no disinterested review of allocations of new issues to insure that Stein Roe's clients' orders were filled prior to filling any orders for non-clients. And no separate arrangements between a Stein Roe partner or portfolio manager and broker/dealers regarding procurement of



additional allocations of new issues should exist. If additional shares could have been obtained from a member of the selling group, they should have gone to fill Stein Roe's clients' orders.

Had Stein Roe had procedures in place to insure that all orders for its clients be placed by its trading desk, Giura's, the Inserras' and Gentile's scheme involving the General Account could not have succeeded. Although its normal practices called for orders to be placed by the trading desk, there were no controls to spot or question repeated transactions that had to be inputted into the record-keeping system at a later date in order to reconcile clients' records. Despite a complaint from the trading desk regarding Giura by-passing normal procedures, no action was taken.

Another weakness in Stein Roe's system was the failure to record in clients' accounts the reasons why reconciliations were made and why trades did not initially appear in Stein Roe's books and records. Had such written explanations been required, patterns of trades such as those which occurred in the Teamsters accounts could have been identified and questioned.

Another weakness in internal controls is also illustrated by the purchase of securities not on the firm's recommended list, which occurred in the Teamster Funds. There was no requirement that the reasons for such purchases be documented by the portfolio manager and retained by Stein Roe.

## **E. CONCLUSION**

Given Giura's unsupervised and un-reviewed responsibilities, it was simple for him to by-pass even the most elementary procedures, such as putting all trades through Stein Roe's trading desk and allocating new issues in conformity with his fiduciary obligations. Even more alarming is the apparent totality of the control Giura had over allocating the firm's brokerage. No one reviewed or questioned the direction of substantial amounts of brokerage to individuals who were not even institutional brokers. The Commission believes that, in the investment advisory context, harm will occur in the industry if egregious breaches of fiduciary duty, such as those described herein, go undetected by those responsible for supervision. This case illustrates the variety of ways that illegal activities can proceed without being detected if proper procedures are not in place and/or not enforced. There is over \$1 trillion dollars of pension money alone available in the marketplace today. The beneficiaries of that money have no ability to police its use and must rely on fiduciaries, including investment advisers, to see that their interests are paramount. Misuse of such vast amounts of money has the potential for a myriad of results, none beneficial to the marketplace as a whole. The Commission believes that if the adviser is not held ultimately accountable, there will be no incentive for self-policing to help in preventing such occurrences.

## **VI.**

### **FINDINGS**

Based on the foregoing, the Commission finds:

A. Shearson failed reasonably to supervise G. Inserra, J. Inserra and Gentile with a view to preventing violations of Section 206 of the Advisers Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, thereby violating Section 15(b)(4)(E) of the Exchange Act; and

B. Stein Roe failed reasonably to supervise Giura with a view to preventing violations of Section 206 of the Advisers Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, thereby violating Section 203(e)(5) of the Advisers Act.

In view of the foregoing, it is in the public interest to impose the sanctions specified in Respondents' Offers of Settlement. Accordingly, IT IS ORDERED that Shearson and Stein Roe be, and they hereby are, censured.

IT IS FURTHER ORDERED that Shearson shall:

Within 15 days after the date of the Order, engage an independent Consultant, with expertise in broker/dealer operations and acceptable to the Commission, who shall review and examine Shearson's supervisory and compliance procedures with respect to (a) through (h) below:

- (a) the transfer of securities by PK, from or between customer accounts and/or employee-related accounts;
- (b) the use and authorization of trade correction forms;
- (c) extensions and last day cash calls as a result of trade corrections;
- (d) the transfer of funds to, from or between customer accounts and/or employee-related accounts as a result of trade corrections;
- (e) review of procedures for establishing, monitoring and restricting allocation accounts in branch offices n37;
- (f) review of procedures for responding to branch office audit reports and follow up on control weaknesses contained in branch audit reports;
- (g) review of procedures regarding adherence to specific instructions of the Compliance Department by branch office personnel, which relate to compliance with Shearson's supervisory and compliance procedures and the follow-up thereto;
- (h) the procedures for the dissemination to branch office personnel of compliance manuals and other guidelines regarding compliance procedures generally and the education of such personnel therewith.

1. The Consultant's duties shall include without limitation or restriction of any kind, full authority to review, report upon, and make recommendations relating to Shearson's said procedures. In evaluating said procedures, the Consultant shall compare and contrast Shearson's policies and practices with prevailing industry practices. The Report shall identify such policies and practices and determine whether such policies and practices conform to the federal securities laws, the rules and regulations thereunder, the rules and regulations of the National Association of Securities Dealers, Inc. and other self-regulatory organizations of which Shearson is a member.

2. In order for the Consultant to achieve the goals of the aforementioned Report, he, and agents designated by him for such purpose, shall have access to any and all documents relating to said procedures above in the possession of Shearson and may meet with any person, including, but not limited to, any officer, director, agent and employee of Shearson.

3. The Consultant shall receive the full cooperation of Shearson and all of its officers, directors, agents and employees in obtaining such access and in making persons available for interviews by the Consultant.

4. The Consultant may communicate with the staff of the Commission in the course of performing his responsibilities.

5. The Consultant shall report to the Commission on his activities as the Commission shall request.

6. The Consultant may engage such assistance, clerical, legal or expert, as necessary and at reasonable cost, to carry out his duties.

7. Within 120 days after the date of the Order, the Consultant shall prepare and submit to the Commission and Shearson a Report of his findings and recommendations for any changes in Shearson's operations. The Report shall also contain recommendations relating to new procedures and the continuation of existing procedures concerning items (a) to (h) above, to ensure that all such operations and procedures are in accordance with applicable law. The Report shall be provided to Shearson's Board of Directors.

8. Adopt the recommendations of the independent Consultant within 45 days of the submission of his Report to the Commission, unless otherwise directed by the Commission, within 30 days of its receipt of the Consultant's Report, either as a result of its own review of the recommendations or in response to any request by Shearson not to implement any recommendation.

9. Within 60 days of the submission of the independent Consultant's Report, submit to the New York Regional Office and the Division of Market Regulation, an affidavit setting forth the details of its implementation of the recommendations contained therein.

IT IS FURTHER ORDERED that Stein Roe shall:

Within 15 days after the date of the Order, engage an independent Consultant, knowledgeable in investment adviser operations and acceptable to the Commission, who shall review and examine the manner in which Stein Roe administers its investment adviser operations. The Consultant's duties and responsibilities shall include, without limitation or restriction of any kind:

1. Full and complete authority to review, report upon, and make recommendations relating to Stein Roe's policies and practices and determining whether such policies and practices conform to the federal securities laws and an investment adviser's fiduciary duties to its clients. The independent Consultant's report shall include, but not be limited to, policies and practices concerning:

(a) The selection of broker/dealers and/or registered representatives to execute clients' brokerage orders, the receipt of services, if any, therefrom, the value of such services, the disclosures made to clients, and review of total costs to clients;

(b) The allocation of new issues among and between Stein Roe clients;

(c) Supervision of Stein Roe's trading desk, procedures for placing brokerage orders and the placing of orders for non-clients;

(d) The purchase of securities for clients that are not on a recommended list;

(e) Maintenance of accurate and current client account records and procedures regarding reconciliations;

(f) Review of clients' account transactions with clients' stated investment objectives.

2. In order for the Consultant to achieve the goals of the aforementioned Report, he, and agents designated by him for such purpose, shall have access to any and all documents in the possession of Stein Roe and may meet with any person, including, but not limited to, any partner, officer, agent and employee of Stein Roe.

3. The Consultant shall receive the full cooperation of Stein Roe and all of its partners, officers, agents and employees in obtaining such access and in making persons available for interviews by the Consultant.
4. The Consultant may communicate with the staff of the Commission in the course of performing his responsibilities.
5. The Consultant shall report to the Commission on his activities as the Commission shall request.
6. The Consultant may engage such assistance, clerical, legal or expert, as necessary and at reasonable cost to carry out his duties.
7. Within 120 days after the date of the Order, the Consultant shall prepare and submit to the Commission and Stein Roe a public Report of his findings and recommendations for any changes in Stein Roe's operations. The Report shall also contain recommendations relating to new procedures and the continuation of existing procedures concerning items (a) to (f) above, to ensure that all such operations and procedures are in accordance with applicable law. The Report shall be provided to Stein Roe's partners.
8. Adopt the recommendations of the independent Consultant within 45 days of the submission of his Report to the Commission, unless otherwise directed by the Commission, within 30 days of its receipt of the Consultant's Report, either as a result of its own review of the recommendations or in response to any request by Stein Roe not to implement any recommendation.
9. Within 60 days of the delivery of the independent Consultant's Report, submit to the New York Regional Office and the Division of Investment Management, an affidavit setting forth the details of its implementation of the recommendations contained therein.

By the Commission.

### **Footnotes**

n1 On July 14, 1986, the Commission instituted related public administrative proceedings against John Giura, George Inserra, John Inserra and Nicholas J. Gentile (Ad. Proc. File No. 3-6691), which arose out of the facts described herein..

n2 Any findings herein are solely for the purpose of these proceedings and are not binding on any other person named as a respondent in any other proceedings, including the proceeding noted in footnote 1 above.

n3 Specifically, New York State Teamsters Conference Pension & Retirement Fund, Upstate New York Teamsters Pension & Retirement Fund, New York State Teamsters Council Health & Hospital Fund, New York State Teamsters Council Legal Benefit Fund.

n4 The actual partner was a professional corporation, John Giura, Inc., wholly-owned by Giura.

n5 Stein Roe is divided into teams comprised of portfolio managers and support personnel. The senior partner in the team is designated the leader. Giura's team consisted of five managers and seven assistants. Its major clients were pension, profit-sharing and tax-exempt accounts.

n6 In addition to being a major partner, Giura served as an interested director of most of the registered investment companies to which Stein Roe acts as investment adviser.

n7 For 1982, 1983, 1984 and the first eight months of 1985, the Inserras were credited with approximately \$1,193,000, \$1,341,000, \$1,050,000, and \$1,166,000, respectively, in gross commissions through the 002 account.

n8 For the last three months of 1982, and the years 1983, 1984 and the first six months of 1985, George Inserra was credited with approximately \$280,00, \$727,000, \$366,800 and \$30,000, respectively, in gross commissions through the 001 account.

n9 Stein Roe's trading desk was instructed that if it selected a certain broker to execute a trade, the broker's trading desk should be told to direct the commission revenue generated to a specific registered representative.

n10 It cannot be determined, based on available documentary evidence, how many requests, if any, were made.

n11 A review of transactions in J. Inserra's bank accounts revealed that on 10 occasions (exclusive of transactions involving the General Account) J. Inserra deposited checks issued by Shearson to his customers in his own bank account. No records exist at Shearson reflecting the customers' authorization that the checks be turned over to him. Although no allegations of wrong-doing were made by any customers against Shearson, this unfettered control by J. Inserra over his customers' funds raises serious questions about Shearson's controls in the Utica office during this period.

n12 "PK" is the Shearson term for trade corrections.

n13 Of the 176 PKs generated by the Utica office between June 1982 and May 1983, 85 related to Inserra customer accounts.

n14 Employee-related accounts begin with the digit "8" so that they can be easily identified as such.

n15 This is in conformity with the New York Stock Exchange rules which require that the authorizer of an account change be apprised of the essential facts relating to the change.

n16 As part of the settlement of a claim by the Customer, Shearson and J. Inserra compensated the Customer.

n17 In the Matter of Smith Barney, Harris Upham & Co., Inc., Exchange Act Release No. 21813 (March 5, 1985).

n18 Reynolds & Co., 39 SEC 902 (1960); Richard J. Buck & Co., 43 S.E.C. 998 (1968); Shearson, Hammill & Co., 42 S.E.C. 811 (1965); Sutro Bros. & Co., 41 S.E.C. 463 (1963); In the Matter of Michael E. Tennenbaum, Exchange Act Release No. 18429 (January 19, 1982); Smith Barney, Harris Upham & Co., Inc., supra.

n19 Smith Barney, Harris Upham & Co., Inc. supra.

n20 "[i]f a firm's established procedures for preventing and detecting fraud by employees come down in the last analysis to taking the employee's word on explanations when questionable events are looked into, then the procedures cannot be very effective." In the Matter of Charles Schwab & Co., Inc., [1983-1984 Transfer Binder] Fed. Sec. Law Rpt. (CCH) P83,469 at 86,504 (December 28, 1983).

n21 Gentile also sent the incorrect letters as a result of the monthly activity runs which automatically flag active accounts. Although the responses to these letters were to go to Compliance, there is no indication that Compliance's failure to receive any communication caused it to look further. Had it been pursued, Compliance would have known that the wrong letters were sent.

n22 See, Shearson, Hamill & Co., supra; In the Matter of Prudential-Bache Securities, Inc., Exchange Act Release No. 22755 (January 2, 1986).

n23 Prudential-Bache Securities, Inc., supra.

n24 Especially troublesome was the failure to pursue the branch manager's failure to respond to the branch audit report, as he was required to do by Shearson's internal procedures. In order for a system of internal controls to be adequate and effective, those in authority must "exercise utmost vigilance whenever even a remote indication of irregularity reaches their attention." Michael E. Tennenbaum, supra.

n25 We note that this is the first action that the Commission has brought since the 1970 amendments to the Advisers Act when failure to supervise was made a ground upon which to discipline advisers. This amendment to the Advisers Act sought to strengthen existing disciplinary controls over advisers by making the controls more comparable to the provisions of the Exchange Act. 116 Cong. Rec. 33,280 (daily ed. September 23, 1970).

n26 SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963).

n27 Hot issues are new issues that trade at a premium immediately after the distribution process.

n28 Usually, syndicate managers allocate the offering among the syndicate members who in turn accept indications of interest from both institutional and individual clients. If those resold in the aftermarket. If allotments to institutions do not approximate the number of shares requested, the institution will be forced to purchase additional shares in the aftermarket, sometimes at a higher price than the initial offering.

n29 Stein Roe has recompensed six of seven clients who lost a profit opportunity. The seventh client declined compensation. The total amount of the lost opportunity was less than \$100,000.

n30 The Employee Retirement Income Security Act of 1974, 18 U.S.C. § 1953, precludes, among others, administrators, officers, trustees, custodians, counsels, agents or employees of any employee welfare or pension benefit plan from receiving, agreeing to receive, soliciting any fee, kickback, commission, gift, loan, money, or thing of value because of or with intent to be influenced with respect to any of his actions, decisions or other duties relating to any question or matter concerning a plan. Equally liable is any person who, directly or indirectly, gives, offers or promises to give or offer any fee, kickback, commission, gift, loan, money or thing of value as prohibited.

n31 "Special" clients were individuals who did not have advisory agreements with Stein Roe and did not pay an advisory fee for Giura's services.

n32 The records department reported to a committee of which Giura was a member.

n33 See footnote 29, supra.

n34 A third benefit is the potential advantage to Stein Roe clients of buying a large block of stock and thus obtaining a better price.

n35 As was explained supra, Giura often by-passed Stein Roe's trading desk, placing orders directly with brokers or obtaining new issues directly from the managing underwriter.

n36 During the course of the investigation, and as a result thereof, Stein Roe revised its procedures with the assistance of Arthur Andersen & Co., its auditors, and has instituted changes designed to strengthen its control procedures in light of the issues raised herein.

n37 An allocation account for this purpose is defined as an account established to facilitate the assignment of bulk orders to the appropriate account prior to settlement date.