

Morgan Lewis

review



2010 Mid-Year in Review: SEC and SRO
Selected Enforcement Cases and
Developments Regarding Broker-Dealers

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Executive Summary

This Outline highlights selected U.S. Securities and Exchange Commission (the “SEC” or the “Commission”) and Financial Industry Regulatory Authority (“FINRA”) enforcement actions and developments regarding broker-dealers during the first half of 2010.*

The SEC

The SEC appeared to begin FY 2010 (that commenced on October 1, 2009) with the momentum that it had generated in FY 2009 by instituting a number of actions early in the fiscal year. In fact, one study concluded that in the first half of FY 2010, the SEC significantly increased the number of defendants with whom it settled with over the prior year. Anecdotally, however, the volume of cases brought by the SEC appears to have tapered off as the year progressed, perhaps due to the enforcement staff’s continued attention to its major reorganization and the Commission’s focus on the qualitative, rather than solely quantitative, nature of its cases. In terms of penalties this year, the Commission resolved several matters with substantial fines, including settlements with State Street Bank, Bank of America and Goldman Sachs.

The personnel changes that the SEC began in 2009 continued in the first six months of this year. In early 2010, the Commission announced the leaders of its five new specialized enforcement units. Since then, a number of enforcement-related personnel moves have been made, including new senior personnel and promotions in the Atlanta Regional Office, New York Regional Office, and the Home Office.

In January 2010, the SEC announced a series of new measures created to encourage both individuals and companies to cooperate in its investigations. First, the Commission issued a policy statement setting forth formal guidelines to

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evaluate and potentially reward cooperation by individuals. Second, the SEC authorized the use of a number of new “cooperation tools” designed to establish incentives for individuals and companies to cooperate with the Division of Enforcement. These new mechanisms include cooperation agreements, deferred prosecution agreements, and nonprosecution agreements. These changes are expected to significantly alter the SEC’s enforcement program.

In the first half of 2010, the SEC brought actions against broker-dealers and their employees in several areas, including insider trading, the marketing and sales of collateralized debt obligations, short sales, and supervision. Additional actions of note occurred in the municipal securities and net asset valuation arenas. The Commission also is actively engaged in an intensive review of the May 6, 2010 “flash crash.”

These developments and cases are described in more detail at pages 4 through 37 of this Outline.

Dodd-Frank Wall Street Reform and Consumer Protection Act

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”). This landmark legislation contains a number of measures that significantly expand the enforcement authority of the SEC and strengthen its oversight and regulatory authority over the securities markets.

Specifically, the Dodd-Frank Act extends the SEC’s enforcement authority in the aiding and abetting and control person liability areas. The legislation also extends the statute of limitations for securities laws violations and expands the application of the antifraud provisions and the jurisdiction of federal courts in actions brought by the SEC in certain cases. With the new legislation in place, the SEC has several enhanced remedies, including the ability to impose collateral bars and the authority to impose civil penalties in cease-and-desist proceedings against any person found to have violated the securities laws. The incentives and protections afforded to securities whistleblowers have been significantly enhanced by, among other changes, permitting the SEC to pay whistleblowers who voluntarily provide original information between 10% and 30% of monetary sanctions exceeding \$1 million in cases involving any violation of the securities laws.

Finally, the Dodd-Frank Act contains additional procedural enhancements for SEC enforcement actions, including granting the Commission nationwide subpoena power in connection with civil actions filed in federal courts and requiring the agency to file an enforcement action within 180 days of the Wells notice in certain cases or to notify the affected party of the staff’s intent not to file an action.

The Dodd-Frank Act is described in more detail at pages 38 through 45 of this Outline.

FINRA

FINRA also experienced senior personnel changes this year, with the departure of the heads of the Member Regulation Sales Practice area and the Department of Enforcement.

Although FINRA has not yet released official statistics for 2010, the number of cases with significant fines appears to have dropped sharply in the first half of 2010 when compared to the first six months of 2009. However, as the Outline went to press, FINRA announced several significant new actions with substantial fines.

As to process, senior Enforcement staff members have indicated that FINRA will continue to use the on-site enforcement investigation technique that it utilized in 2008 and 2009 in connection with certain auction rate securities investigations more frequently in fraud and other high-profile investigations.

FINRA has identified at least 13 priorities in its enforcement program, including Regulation D offerings, fixed income trading and sales, reverse convertibles, and municipal securities transactions.

In June 2010, FINRA completed the previously announced agreement under which it assumed responsibility for performing the market surveillance and enforcement functions previously conducted by NYSE Regulation. Under the agreement, FINRA took over the regulatory functions for the New York Stock Exchange, NYSE Arca, and NYSE Amex.

In the first half of 2010, FINRA brought enforcement actions on various topics, including auction rate securities, the protection of customer confidential information, day trading, mutual fund operations, Regulation SHO, supervision, and unregistered offerings.

These developments and cases are described in more detail at pages 46 through 77 of this Outline.

Enforcement Statistics

By way of background and to provide context for this year, the SEC's fiscal year 2009 was a busy time for enforcement from a statistical perspective.¹ Among the highlights, in FY 2009, the Commission:

- Brought 664 cases, down slightly from 671 actions that it brought in the prior year (although both FY 2008 and 2009 reflect increases in comparison to the recent past).
- Increased the number of cases brought against broker-dealers to 109 actions from FY 2008's 60 cases, a rise of 82%.
- Filed 154 enforcement actions in FY 2009 in coordination with criminal actions brought by the Department of Justice ("DOJ"), representing more than a 30% increase over FY 2008.
- Started 944 investigations in FY 2009, up 6% from FY 2008, and issued 496 formal orders of investigation, an increase of more than 100% compared to the prior year.
- Moved quickly to halt and punish misconduct by seeking 71 emergency orders in FY 2009 – an 82% increase from the prior year. The Commission also filed 70% of its enforcement actions within two years of starting an investigation or inquiry. That figure represents an 8% increase from the prior year.
- Obtained \$345 million in civil money penalties (up 35%) and \$2.09 billion in disgorgement orders (a 170% increase).²

¹ The SEC's fiscal year begins on October 1st. Accordingly, the most recent official enforcement statistics cover the Commission's fiscal year 2009, which ran from October 1, 2008 through September 30, 2009.

² These statistics were taken from the Commission's Select SEC and Market Data – Fiscal 2009 report, available on the SEC's website at: <http://www.sec.gov/about/secstats2009.pdf>; Mr. Khuzami's Dec. 11, 2009 Congressional testimony, available at

It appears that the SEC began FY 2010 with the momentum that it generated in FY 2009 by bringing a number of enforcement cases early in the fiscal year. Empirically, one study found that in the first half of FY 2010, the SEC settled actions involving 354 defendants, an increase of 22% and 8% when compared with the first half of FY 2009 and the second half of FY 2009, respectively.³

In terms of the number of cases, the pace appears to have tapered off as the year has progressed, perhaps due to the staff's continued attention to instituting "the most profound reorganization in the [Division of Enforcement's] history."⁴ Those changes included flattening the management structure by removing the Branch Chief position and, for the most part, making those individuals frontline investigators and creating five new specialized units. Indeed, Director of Enforcement, Robert Khuzami, analogized running an enforcement program while undertaking these extraordinary changes to changing the tires on a moving car.⁵ As the Enforcement Division now has substantially completed its reorganization and expects to increase its staffing levels and overall budget in the coming years, in part due to the recently enacted Dodd-Frank legislation, the SEC could realize the expected efficiencies and enhanced enforcement capabilities over the next several years.

The Commission's focus on the quality of its cases is perhaps a second reason for the apparent slowdown in the number of such actions. Specifically, Commission officials have expressed an intention to evaluate the Enforcement Division's performance based on qualitative, instead of solely quantitative, metrics going forward.⁶ Indeed, SEC Chairman Mary Schapiro and Mr. Khuzami have emphasized that metrics reflect the number of cases brought but not the effect and impact of those actions.⁷

Turning to penalties, in the first half of FY 2010, the Commission reached large settlements with State Street (including a \$50 million fine and more than \$300 million in total payments) and Bank of America (imposing a \$150 million fine). In addition, in July 2010, the SEC announced a settlement with Goldman Sachs

<http://sec.gov/news/testimony/2009/ts121109rk.htm>; and the SEC's 2009 Performance and Accountability Report, available at <http://sec.gov/about/secpar2009.shtml>.

³ See Jan Larsen with Dr. Elaine Buckberg and Dr. Baruch Lev, *SEC Settlements Trends: 1H10 Update*, May 14, 2010, available at http://www.nera.com/nera-files/PUB_Settlements_Update_H1_0510_final.pdf. Note that unlike other statistics in this Outline, the statistic cited above from NERA's analysis is not based on the number of cases brought by the SEC, but rather the number of defendants involved in those actions.

⁴ See Robert Khuzami, Speech by SEC Staff: Speech to the Society of American Business Editors and Writers (Mar. 19, 2010), available at <http://www.sec.gov/news/speech/2010/spch031910rsk.htm>.

⁵ See *id.*

⁶ See *id.* and Mary Schapiro, Testimony Concerning Oversight of the U.S. Securities and Exchange Commission: Evaluating Present Reforms and Future Challenges (July 20, 2010), available at <http://www.sec.gov/news/testimony/2010/ts072010mls.htm>.

⁷ See *id.*

that involves a civil penalty of \$550 million, a record amount for an SEC settlement with a financial institution.

Personnel Changes and New Specialized Unit Chiefs⁸

In 2009, the SEC underwent significant change. Among those changes was new leadership, including the appointments of Mary Schapiro as the new Chairman and Robert Khuzami as the Director of the SEC's Division of Enforcement. Thereafter, the SEC announced that four former federal prosecutors had joined the Division of Enforcement in the Home Office and various Regional Offices in senior positions. Changes at the top of the Enforcement Division continued in 2010.

By way of background, in August 2009, the SEC announced that it was forming five national specialized units within its Enforcement Division that focus on complex areas of the securities laws to enhance specialization. On January 13, 2010, the Commission announced the leadership of these units:

- **Asset Management** – This unit, focusing on investigations concerning a broad range of asset managers, including investment advisors, mutual funds, hedge funds, and private equity funds, is led by co-Chiefs Bruce Karpati and Robert Kaplan.
- **Market Abuse** – This unit is concentrating on investigations involving broad market abuses and complex market manipulation schemes perpetrated by institutional investors, market professionals, and other traders. The unit is led by Daniel Hawke; the Deputy Chief is Sanjay Wadhwa.
- **Structured and New Products** – Led by Unit Chief Kenneth Lench and Deputy Unit Chief Reed Muoio, this unit is focusing on derivatives and other complex financial products, including credit default swaps, collateralized debt obligations, and securitized investments.
- **Foreign Corrupt Practices** – A unit that focuses on violations of the Foreign Corrupt Practice Act, which bans U.S. companies from bribing foreign officials for government contracts and other business opportunities, is headed by Cheryl Scarboro.
- **Municipal Securities and Public Pensions** – Led by Unit Chief Elaine Greenberg and Deputy Unit Chief Mark Zehner, this unit is concentrating on misconduct in the municipal securities market and several areas in the public pension fund space, including offering and disclosure fraud, tax

⁸ Unless otherwise noted, the information regarding these personnel changes was drawn from SEC press releases available on the Commission's website.

fraud, pay-to-play and public corruption, public pension accounting and disclosure, and valuation and pricing fraud.

At the February 11, 2010 SEC Speaks conference, the newly appointed chiefs reported that their units already had achieved positive results. For example, the Market Abuse Unit noted that it was taking a proactive approach to combating “organized” insider trading among large institutions and associated persons and had penetrated these rings, as reflected in recent enforcement actions and settlements. Other unit chiefs forecast their units’ ability to better recognize, react to, and prevent market abuses.⁹ Indeed, later events confirmed these comments – as noted later in this Outline, the Structured and New Products Unit brought and settled the well-publicized Goldman Sachs collateralized debt obligation case.

In May 2010, Mr. Khuzami stated that 20% of the Division of Enforcement’s personnel have been assigned to the five specialized units.¹⁰

In the first six months of 2010, additional personnel changes relating to the SEC’s enforcement efforts took place. These include the following:

- In January, the SEC appointed Carlo di Florio as the Director of the Office of Compliance Inspections and Examinations (“OCIE”). As the Director of OCIE, Mr. di Florio has responsibility for, among other things, the Commission’s investment advisor, broker-dealer, and investment company examination programs. Mr. di Florio joined the SEC from PricewaterhouseCoopers.
- In February, the SEC announced that Rhea Kemble Dignam had been named Director of the Commission’s Atlanta Regional Office. Although Ms. Dignam joined the SEC from Ernst & Young, earlier in her career, she served in several senior roles in the U.S. Attorney’s Office in the Southern District of New York. Also that month, the Commission appointed William Hicks as the Associate Regional Director of Enforcement in the Atlanta Regional Office. Prior to his promotion, Mr. Hicks had been an SEC staff attorney for more than 25 years.
- In March, Howard Scheck rejoined the SEC as Chief Accountant for the Division of Enforcement. He previously had been a partner at Deloitte Financial Advisory Services and had worked at the SEC for 10 years.

⁹ These comments were reported by Morgan Lewis’ Patrick D. Conner and E. Andrew Southerling in their “The SEC Speaks 2010: Faced Paced Reform Continues,” available at http://www.morganlewis.com/pubs/SecuritiesLF_SECSpeaks2010_11feb10.pdf

¹⁰ Notes of comments made by Mr. Khuzami on May 7, 2010 at the SIFMA Compliance & Legal Society Annual Seminar in Washington, DC.

- In April, the Commission's New York Regional Office appointed Robert Keyes as Associate Regional Director and Chief of Regional Office Operations. In this newly created position, Mr. Keyes assists the Regional Director and other senior officers in managing the enforcement and examination caseload. Mr. Keyes joined the SEC staff in 1996.
- In May, the SEC named Richard Levine as Associate General Counsel for Legal Policy in the Office of the General Counsel. The Commission noted that Mr. Levine will provide legal and policy advice to SEC Commissioners on many matters, with a particular focus on enforcement, corporate disclosure, and accounting. He has worked for the SEC for more than 25 years.
- Also in May, the SEC promoted Gerald Hodgkins to Associate Director of the Division of Enforcement to fill the position previously held by Frederic Firestone. Mr. Hodgkins joined the Commission staff in 1997.
- In July, the Commission announced that its longtime Chief Counsel of the Division of Enforcement, Joan McKown, was leaving the SEC to enter private practice. Ms. McKown spent 24 years working for the SEC. She served as Chief Counsel of the SEC since 1993 and was responsible for creating enforcement policies and reviewing proposed enforcement actions prior to their recommendation to the Commission for approval.

Cooperation Initiatives¹¹

On January 13, 2010, the Commission announced a series of new measures designed to encourage individuals and companies to cooperate in Enforcement Division investigations and enforcement actions. First, the SEC issued a policy statement setting forth for the first time formal guidelines to evaluate and potentially reward cooperation by individuals in investigations and enforcement actions. Second, the Commission authorized the use of a number of new "cooperation tools" designed to establish incentives for individuals and companies to cooperate with the Division. The enforcement staff now is authorized to execute formal written cooperation agreements, deferred prosecution agreements, and nonprosecution agreements with individuals and companies, although a formal witness proffer will be required in most cases before any of these new agreements may be used. These new measures are

¹¹ This section of the Outline was drawn from "The Securities and Exchange Commission Announces New Cooperation Initiative," by Patrick D. Conner and E. Andrew Southerling, published January 2010 available at <http://www.morganlewis.com/index.cfm/publicationID/66edba61-e068-4a7e-8f1a-694da513d7ae/fuseaction/publication.detail>.

codified in a revised version of the Division's Enforcement Manual in Section 6, titled "Fostering Cooperation."¹²

The Commission's new cooperation incentives demonstrate the importance it places on individual and company cooperation in its enforcement efforts. In his public statement announcing these new measures, SEC Enforcement Director Robert Khuzami characterized them as a potential "game changer" for the Commission, and recognized that there is "no substitute for the insider's view into fraud and misconduct that only cooperating witnesses can provide."

Framework for Evaluating Cooperation by Individuals

Rewarding cooperation is not a new concept for the Commission. In the SEC's 2001 "Seaboard Report," it set standards to evaluate cooperation by corporations.¹³ In the January 2010 policy statement, the SEC set forth, for the first time, the way in which it will evaluate whether, how much, and in what manner to credit cooperation by individuals. In the policy statement, the Commission identifies four core factors to determine how to measure and reward cooperation by individuals on a case-by-case basis: (1) the assistance provided by the individual; (2) the importance of the underlying matter; (3) the societal interest in holding the individual accountable for his or her misconduct; and (4) the appropriateness of cooperation credit based upon the personal and professional profile of the cooperating individual. For each of these criteria, the Commission has set forth specific considerations that it and the enforcement staff will take into account.

Individual Assistance

In evaluating the individual's assistance, the SEC will assess, among other things, the value and nature of the individual's cooperation in its investigation. For example, the Commission will consider the timeliness of the cooperation (whether the individual was the first to report the misconduct to the SEC, and whether the cooperation was provided before he or she had knowledge of the investigation) and whether the cooperation was voluntary. The Commission will

¹² The full text of the Commission's release can be found at <http://www.sec.gov/news/press/2010/2010-6.htm>; the Commission's policy statement is set forth in Release No. 34-61340 (Jan. 13, 2010) at <http://www.sec.gov/rules/policy.shtml>; and the full text of the Division's Enforcement Manual can be found at <http://www.sec.gov/divisions/enforce/enforcementmanual.pdf>.

¹³ Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship and Cooperation to Agency Enforcement Decisions, SEC Release Nos. 34-44969 and AAER-1470 (Oct. 23, 2001) (<http://www.sec.gov/litigation/investreport/34-44969.htm>) (the Seaboard Report). In the Seaboard Report, the Commission set forth four broad measures for evaluating cooperation by companies. These measures are: self-policing, self-reporting, remediation, and cooperation with law enforcement. The factors in the Seaboard Report are now formally incorporated into the Enforcement Manual as Section 6.1.2 (Framework for Evaluating Cooperation by Companies).

also consider whether the individual provided nonprivileged information not requested by the staff or that otherwise might not have been discovered. In addition, the SEC will assess whether the individual encouraged others who might not have otherwise participated to assist the staff in the investigation.

Importance of the Underlying Matter

In evaluating the importance of the underlying matter, the SEC will consider the character of the investigation, including whether the subject matter of the investigation is a Commission priority, the type of securities violations, the age and duration of the misconduct, the repetitive nature of the misconduct, and the amount and type of harm or potential harm to investors. The SEC will view most favorably cooperation in priority investigations that involve serious, ongoing, or widespread violations.

Interest in Holding the Individual Accountable

The Commission also will assess the societal interest in holding the individual fully accountable for his or her misconduct. The SEC will consider the severity of the misconduct within the context of the individual's knowledge, training, experience, and position of responsibility at the time of the violations, whether the individual acted with intent, and any efforts undertaken to remediate the harm caused by the misconduct. The Commission will also evaluate the degree to which the individual tolerated illegal activity, such as whether he or she took steps to prevent the misconduct from occurring or continuing (such as notifying the SEC or other law enforcement agency), or, in the case of a business organization, whether he or she notified management not involved in the misconduct, the board of directors, or the auditors of the company.

Profile of the Individual

Finally, the Commission will consider the cooperating individual's personal and professional risk profile in determining whether it is in the public interest to award cooperation credit. Under this factor, the SEC will consider the individual's history of lawfulness, the individual's acceptance of responsibility for past misconduct, and the opportunity for the individual to commit future transgressions in light of his or her occupation (for example, whether he or she serves as a licensed professional, an associated person of a regulated entity, a fiduciary, officer or director of a public company, or a member of senior management).

New Cooperation Tools for Individuals and Companies

The Commission's cooperation initiative also arms the staff with new tools to encourage individuals and companies to report violations and provide assistance to the agency. These tools, which are in the revised version of the Enforcement Manual, authorize the staff to enter into formal written cooperation agreements,

deferred prosecution agreements, and nonprosecution agreements.¹⁴ The DOJ has regularly used these cooperation tools in criminal investigations and prosecutions; however, they have not been available to the SEC in enforcement matters until now.

Cooperation Agreements

Cooperation agreements are formal written agreements in which the Director of Enforcement agrees to recommend to the Commission that a cooperator receive credit for cooperating in investigations or related enforcement actions. Under certain circumstances, the Enforcement Director may agree to make a specific enforcement recommendation. In exchange, the Division must conclude that the individual or company has provided or is likely to provide substantial assistance to the Commission such as full and truthful testimony and information, including producing all potentially nonprivileged documents and materials to the SEC. If the Division agrees to make a specific enforcement recommendation to the Commission, the cooperation agreement should include the specific recommendation and an agreement by the cooperating individual or company to resolve the matter without admitting or denying the alleged violations.

The Enforcement Manual instructs the staff that, prior to seeking a cooperation agreement, the staff should require a potential cooperating individual or company to execute a proffer agreement and to make a detailed proffer of the information that he or she is prepared to share with the staff.¹⁵ In addition, the enforcement manual instructs the staff to consider the standard cooperation analysis with respect to individuals (Section 6.1.1) and companies (Section 6.1.2, the Seaboard Factors) when assessing whether to recommend that the Division enter into these agreements with an individual or company.

Deferred Prosecution Agreements

Deferred prosecution agreements are formal written agreements in which the Commission agrees to forego an enforcement action against a cooperator. These agreements are executed only if the individual or company agrees, among

¹⁴ The Commission also streamlined its process for obtaining immunity requests when a party is cooperating with the staff. Under its new process, the Commission has delegated authority to the Enforcement Director to make immunity requests directly to the Department of Justice. See <http://www.sec.gov/rules/final/2010/34-61339.pdf>. Previously, the staff was required to file a formal action memorandum with the Commission seeking a formal Commission order to make such a request.

¹⁵ Proffer agreements are not a new tool to the Commission staff. A proffer agreement is a written agreement providing that any statements made by a person, on a specific date, may not be used against that individual in a subsequent proceeding. The Commission may use statements made during the proffer session as a source of leads to discover additional evidence and for impeachment or rebuttal purposes if the person testifies or argues inconsistently in a subsequent proceeding. The Commission may also share the information provided by the proffering individual with appropriate authorities in a prosecution for perjury, making a false statement, or obstruction of justice.

other things, to cooperate fully and truthfully, including producing all potentially relevant nonprivileged documents and materials, and to comply with express prohibitions and undertakings during a period of deferred prosecution, which generally should not exceed five years.

Deferred prosecution agreements may require a cooperator to agree either to admit or not to contest underlying facts that the SEC could assert to establish a violation of the federal securities laws. The Enforcement Manual suggests an admission or agreement not to contest relevant facts underlying the alleged offenses is appropriate for licensed individuals (attorneys, accountants), regulated individuals, fiduciaries, officers and directors of public companies, and repeat offenders.

As with cooperation agreements, the staff should consider the standard cooperation analysis with respect to individuals (Section 6.1.1) and companies (Section 6.1.2, the Seaboard Factors) and require a potential cooperating individual or company to execute a proffer agreement before seeking authority for a deferred prosecution agreement.

Nonprosecution Agreements

Nonprosecution agreements are formal written agreements entered into under “limited and appropriate circumstances,” in which the Commission agrees not to pursue an enforcement action against a cooperator if the individual or company agrees, among other things, to cooperate fully and truthfully in investigations and related enforcement proceedings, including producing all potentially relevant nonprivileged documents and materials, and to comply with express undertakings.

The Enforcement Manual instructs the staff that, in virtually all cases, nonprosecution agreements will not be available for individuals who have previously violated the federal securities laws. Further, nonprosecution agreements should not be executed until the role of the cooperating individual or company and the importance of their cooperation to the staff become clear.

As with cooperation and deferred prosecution agreements, the Enforcement Manual instructs the staff to consider the standard cooperation analysis with respect to individuals (Section 6.1.1) and companies (Section 6.1.2, the Seaboard Factors), and to require a potential cooperating individual or company to execute a proffer agreement prior to seeking authority to enter into a nonprosecution agreement.

Although not part of its public announcement of the cooperation initiatives, the SEC’s revised enforcement manual authorizes Assistant Directors, with approval of a supervisor at or above the Associate Director level, to orally inform an individual or company that the enforcement staff does not anticipate recommending an enforcement action against the individual or company based

upon the evidence known at the time by the staff. The Commission will, however, authorize these oral assurances only when the investigative record is adequately developed.¹⁶

SEC Enforcement Priorities Regarding Broker-Dealers

Based upon our review of currently available information, we believe the following list reflects some of the SEC's top priorities for broker-dealer enforcement:

The marketing and sale of CDOs and other complex derivative products

The valuation of and disclosures relating to subprime securities

Sales of unsuitable securities to retail investors

Municipal securities and political contributions

Insider trading by Wall Street professionals

Failure to supervise registered representatives

The causes of the May 6, 2010 "flash crash"

SEC OIG Report Concerning Robert Allen Stanford

As we reported in last year's Outline, the SEC initiated an action in federal district court in February 2009 alleging that Robert Allen Stanford had carried out an \$8 billion Ponzi scheme. After receiving tips alleging that the SEC's Fort Worth Office ("FWO") had not diligently investigated Stanford in response to concerns that he was perpetrating a Ponzi scheme, the SEC's Office of Inspector General ("OIG") conducted an investigation and released a report on March 31, 2010 detailing its findings.

The OIG concluded that by 1997, the FWO knew that Stanford likely was operating a Ponzi scheme. The FWO staff determined in each of four subsequent examinations that Stanford's CDs could not be legitimate and that it was "highly unlikely" that his stated returns could be achieved using his purported strategy. Despite the urging of the examination staff and complaints from investors and an anonymous Stanford employee, the OIG reported that FWO enforcement staff did not conduct a meaningful investigation into Stanford until late 2005 and, during that investigation, failed to detect facts that uncovered the

¹⁶ See Section 6.2.1 *Proffer Agreements* (Enforcement Manual, Jan. 2010). The revised manual has eliminated a prior provision that permitted the staff in limited circumstance to provide a witness with a written assurance that the Commission does not intend to bring an enforcement action against him or her or an associated entity in exchange for the witness's agreement to testify and provide documents. See Section 3.3.5.3.1 *Witness Assurance Letters* (Enforcement Manual, Oct. 2008).

Ponzi scheme. The OIG found that the FWO enforcement staff did not investigate Stanford more thoroughly, in part, because of pressure from enforcement leadership to bring a high number of cases and to focus on “quick hits,” rather than pursuing cases, such as a possible action against Stanford, that would have taken more time and involved novel legal theories.

In response to the OIG report, Chairman Schapiro issued a short statement emphasizing the significant changes that have occurred within the SEC since the time period at issue in the OIG report and noting that most of the seven recommendations contained within the report were implemented starting in 2005.¹⁷

SEC – CFTC Investigation Regarding the “Flash Crash” of May 6, 2010

On the afternoon of May 6, 2010, the U.S. financial markets experienced a precipitous and unprecedented decline in an extremely short period of time followed by a rebound in prices. The SEC, along with the Commodities Futures Trading Commission (“CFTC”), immediately began an investigation into the causes of what was dubbed the “flash crash.” This effort apparently includes gathering and analyzing trading records from many market participants.

On May 18, 2010, the CFTC and SEC released a report prepared jointly by their staffs for a recently formed body called the Joint Advisory Committee on Emerging Regulatory Issues, which is led by the CFTC and SEC Chairs.¹⁸ The report described the staffs’ preliminary findings concerning the market events of May 6, 2010. The staffs reported that their preliminary findings included potential links between the severe decline in the prices of various stock index products and the simultaneous and later waves of selling in individual securities; a general and large mismatch in liquidity; the extent to which the liquidity mismatch may have been aggravated by different trading conventions used by various exchanges; the need to examine the use of so-called “stub quotes”; the use of certain kinds of orders, including market orders, stop loss market orders, and stop loss limited orders; and the impact on exchange traded funds.

The regulators have indicated that although they have already collected hundreds of millions of trading records totaling approximately 5-10 terabytes of information, a significant amount of additional work needs to be done and that

¹⁷ See Statement from Chairman Schapiro on OIG Report 526: “Investigation of the SEC’s Response to Concerns Regarding Robert Allen Stanford’s Alleged Ponzi Scheme,” Apr. 16, 2010, available at <http://www.sec.gov/news/press/2010/2010-60.htm>.

¹⁸ See SEC-CFTC Release Preliminary Findings in Review of May 6 Market Events, May 18, 2010, available at <http://www.sec.gov/news/press/2010/2010-81.htm>.

they intend to publish additional findings regarding the causes of the flash crash.¹⁹

To date, no disciplinary actions have been taken by either the CFTC or the SEC concerning the events of May 6, 2010.

SEC and IRS Agreement Relating to the Municipal Bond Market

In March 2010, the SEC and the IRS announced that they had entered into a Memorandum of Understanding (“MOU”) in which the two agencies agreed to collaborate more closely in their efforts to monitor and regulate the municipal bond market. Among other things, the SEC and the IRS pledged to work together to identify issues and trends concerning tax-exempt bonds and to create strategies improve the performance of their regulatory responsibilities. Finally, the agencies agreed to share information regarding market risks, practices and the events in the municipal securities arena.²⁰

Cooperation with Foreign Regulators

On June 10, 2010, the SEC entered into an MOU with the Quebec Autorité des Marchés Financiers and Ontario Securities Commission to facilitate “consultation, cooperation, and exchange of information” among these regulators concerning cross-border regulated entities.²¹ By signing this agreement, each regulator has committed to providing the others with the fullest legally permissible cooperation. This MOU follows cooperation agreements that the SEC reached in recent years with regulators in the United Kingdom, Germany, and Australia.

Enforcement Actions

Inflation of Net Asset Value

The below litigation is an example of the SEC’s pursuit of alleged wrongdoing in the asset valuation area. Although not technically a broker-dealer action, this matter is noteworthy, particularly with respect to a decision by an SEC administrative law judge (“ALJ”) concerning the SEC staff’s use of subpoenas.

¹⁹ See “Testimony Concerning Oversight of the U.S. Securities and Exchange Commission: Evaluating Present Reforms and Future Challenges,” Testimony of Mary L. Schapiro before the U.S. House of Representatives Committee on Financial Services Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprise, July 20, 2010.

²⁰ See “SEC and IRS Agree to Work More Closely Regarding Municipal Bond Enforcement,” Mar. 2, 2010, available at www.sec.gov.

²¹ See “SEC, Quebec Autorité des Marchés Financiers and Ontario Securities Commission Sign Regulatory Cooperation Arrangement,” June 14, 2010, available at www.sec.gov.

A. *In the Matter of Morgan Asset Management, Inc.* (“Morgan Asset”); *Morgan Keegan & Company, Inc.* (“Morgan Keegan”); *James C. Kelsoe, Jr.*; and *Joseph Thompson Weller, CPA*, Admin. Proc. File No. 3-13847 (Apr. 7, 2010)

1. The SEC commenced an administrative proceeding against Morgan Asset, Morgan Keegan, Kelsoe and Weller, in which it alleges that the respondents engaged in a fraudulent scheme to materially inflate the net asset value (“NAV”) of certain funds managed by Morgan Asset.
2. Between 2004 and 2008, Morgan Asset managed five funds through Kelsoe, who was a senior Morgan Asset portfolio manager and a Morgan Keegan Managing Director. Each of the funds held securities backed by subprime mortgages. The funds adopted procedures for the internal pricing of these securities using the “fair value” method, which required a valuation committee to be established in order to value the securities in “good faith.” In regulatory filings, the funds stated that Morgan Asset’s valuation committee would determine the “fair value” of securities. However, the funds actually delegated this task to Morgan Keegan, whose employees comprised the majority of the valuation committee.
3. The SEC alleges that Morgan Keegan and the valuation committee violated the funds’ internal pricing procedures by relying on false information provided by Kelsoe. Between January 2007 and July 2008, Kelsoe sent to Morgan Keegan’s fund accounting department approximately 262 “price adjustments” concerning the price of specific portfolio securities. The fund accounting department relied on these inflated price adjustments when calculating the funds’ NAVs. The fund accounting department did not request that Kelsoe provide documentation supporting the price adjustments, did not record which securities had been assigned prices by Kelsoe, and did not record which third-party broker-dealer quotes had been overridden by Kelsoe.
4. The SEC alleges that Kelsoe falsely inflated the dealer quotes obtained from broker-dealers and failed to inform the fund accounting department that certain bonds held by the funds had declined substantially in value. In addition, Kelsoe allegedly fraudulently misrepresented the funds’ performance in letters to investors and regulatory filings

because he knew that the funds' reported performance was based on improperly inflated NAVs.

5. The SEC further alleges that Weller, who was the head of the fund accounting department and a member of the valuation committee, knew or was highly reckless in not knowing about the violations of the funds' internal pricing procedures. In addition, Morgan Keegan, acting through Weller and its fund accounting department, failed to follow reasonable pricing procedures to calculate accurate NAVs.
6. The matter is ongoing.
7. On the same day, FINRA brought an action against Morgan Keegan's broker-dealer affiliate regarding the marketing and sales of certain bond funds. That case is described in the FINRA section below.
8. During the course of this proceeding, an SEC ALJ published an interesting opinion regarding the staff's use of subpoenas after the filing of the action. By way of background, eight days after the SEC issued the order instituting these proceedings, the Associate Regional Director of the Atlanta Regional Office authorized the Enforcement staff to open a second investigation that the respondents asserted was functionally identical to the first action and was opened to gather additional evidence for use in the first action. The ALJ agreed with the respondents and noted that the Division of Enforcement took a risk by asking the Commission to institute proceedings before the Division completed its investigation. Among other determinations, the ALJ refused to permit the SEC staff to introduce in the first action evidence obtained in the second matter.

Insider Trading

The SEC continues to aggressively prosecute insider trading by Wall Street professionals. The first half of this year saw several cases against investment bankers, a surprise turn in the Pequot saga, and a trial concerning alleged insider trading in the credit default swap market.

- A. *SEC v. Vinayak S. Gowrish, Adnan S. Zaman, Pascal S. Vaghar, and Sameer N. Khoury* (Defendants) and *Elias N. Khoury* (Relief Defendant), 09-cv-5883 (filed Dec. 16, 2009); *In the Matter of Adnan S. Zaman*, Admin. Proc. File No. 3-13749 (Jan. 14, 2010)

1. The SEC brought a civil action against Vinayak Gowrish (an associate at private equity firm TPG Capital, LLP), Adnan Zaman (a Lazard Freres & Co, LLC investment banker), and two of their friends, Pascal Vaghar and Sameer Khoury, in connection with an alleged insider trading scheme. Three of the four defendants (plus a relief defendant) have settled with the SEC.
2. The SEC alleges that between December 2006 and May 2007, Gowrish and Zaman obtained material, nonpublic information regarding acquisitions involving TPG or Lazard clients. Gowrish and Zaman allegedly tipped this information to Vaghar and Sameer Khoury, who traded based on those tips, ultimately resulting in almost \$500,000 in profits. In return, Sameer Khoury and Vaghar paid Zaman and provided him a residence without charging rent. Gowrish received cash payments from Vaghar.
3. Sameer Khoury also allegedly traded in his brother Elias Khoury's account based on the inside information and split the resulting profits with him. Although Elias Khoury permitted his brother to trade in his account, he did not know that Sameer Khoury traded on the basis of material, nonpublic information.
4. Zaman consented to an injunction and a bar from associating with a broker or dealer and to disgorge \$78,456. In January 2010, Zaman pled guilty to securities fraud and in May 2010 was sentenced to 26 months in prison. Also in January 2010, the SEC filed a separate administrative action against Zaman, which he settled by consenting to a bar from associating with any broker or dealer.
5. Vaghar consented to an injunction and to disgorge \$366,001; the disgorgement amount was reduced to \$33,000, and a civil penalty was waived, based on his inability to pay. Sameer Khoury consented to an injunction and disgorgement of \$198,607; the disgorgement and a civil penalty were waived based on his inability to pay. Relief defendant Elias Khoury consented to disgorge \$5,836.
6. The case against Gowrish is ongoing, and the SEC seeks a permanent injunction, disgorgement and a civil penalty.

B. *SEC v. Phillip Macdonald, Martin Gollan, and Michael Goodman*, 09-Civ-5352 (S.D.N.Y. Jan. 12, 2010)

1. In our 2009 Outline, we reported on a case in which the SEC charged three defendants with insider trading in advance of public announcements of business deals based on information misappropriated from an investment bank.
2. The SEC alleges that, between January and June 2005, Michael Goodman's wife (an administrative assistant at Merrill Lynch Canada, Inc.) informed Goodman about certain potential unannounced business combinations with the expectation that he would keep the information confidential. Goodman instead disclosed the information to his business associates, Macdonald and Gollan, knowing that they would use the information for trading purposes. Macdonald and Gollan purchased securities on U.S. exchanges ahead of the deal announcements. As a result, Macdonald and Gollan earned more than \$900,000 and \$90,000, respectively, in profits.
3. In 2009, one of the defendants, Michael Goodman, settled with the SEC.
4. In January 2010, the SEC settled charges against Martin Gollan, who consented to a permanent injunction and disgorgement of \$91,976.
5. The SEC's case against MacDonald is ongoing.

C. *SEC v. Galleon Management, LP, et al.*, ("Galleon"), 09-Civ-8811 (S.D.N.Y. filed Oct. 16, 2009)

1. The SEC charged Galleon, a hedge fund advisory firm, Raj Rajaratnam, its founder, another hedge fund (New Castle Funds LLC), and five other individuals, including executives at IBM, McKinsey, and Intel with perpetrating an insider trading scheme that involved extensive and recurring insider trading ahead of various corporate announcements. In November 2009, the SEC amended its complaint to include charges against nine additional individuals and four more hedge funds and trading firms.

2. The SEC alleged that the defendants were part of a widespread insider trading ring in which certain participants traded based on material, nonpublic information concerning corporate events, such as acquisitions and earnings announcements involving at least twelve companies (e.g., Polycom, Google, Hilton Hotels, Sun Microsystems, and Sprint Nextel).
3. Some of the defendants allegedly shared material, nonpublic information in exchange for compensation but did not trade. Other defendants allegedly traded in their own accounts, in the accounts of tipplers, and/or on behalf of institutions, such as hedge funds.
4. In January 2010, the SEC again amended its complaint, this time to file additional charges of insider trading against Rajaratnam and Anil Kumar, a friend of Rajaratnam's and former Galleon investor who had been senior partner and director of the global consulting firm, McKinsey & Co. The new allegations raise the total illicit trading profits or losses avoided from the scheme from \$33 million, as alleged in the initial complaint, to more than \$52 million.
5. In the operative complaint, the SEC alleges that, between 2003 and 2009, Rajaratnam paid Kumar \$1.75 million to \$2 million for material, nonpublic information to generate almost \$20 million in illicit profits at Galleon. The SEC also alleges that Kumar reinvested with Galleon the funds he received from Rajaratnam, which resulted in a combined total profit of \$2.6 million for his participation in the scheme.
6. Also in January 2010, the SEC settled charges against defendants Ali Far and Choo-Beng Lee, who were cofounders of Spherix Capital, an unregistered hedge fund investment adviser. The defendants consented to permanent injunctions and to be jointly and severally liable for more than \$1,335,000 in disgorgement and a civil penalty of approximately \$668,000.
7. In April 2010, the SEC settled insider trading charges against another defendant, Schottenfeld Group, LLC ("Schottenfeld"), a registered broker-dealer. The SEC alleged that four Schottenfeld traders used material, nonpublic information to trade in the stocks of three public companies for Schottenfeld's accounts. Schottenfeld

consented to a permanent injunction, to disgorge approximately \$460,000, and to pay a civil penalty of approximately \$230,000. This penalty was reduced to that amount (*i.e.*, fifty percent of disgorgement) in recognition of Schottenfeld's agreement to cooperate in the SEC's investigation.

8. In May 2010, the SEC settled insider trading charges against Kumar, who consented to a permanent injunction, to disgorge \$2,600,000, and to pay a civil penalty in an amount to be set by the court no later than November 2011.
9. The SEC seeks injunctions, disgorgement, civil penalties, and orders barring the remaining defendants from acting as officers or directors of any registered public company.
10. Several of the individuals in these matters have been criminally charged; some of the defendants have pled guilty, while others are contesting the charges.

D. *SEC v. David R. Slaine*, 10-Civ-754 (S.D.N.Y. filed Feb. 2, 2010)

1. In our 2007, 2008 and 2009 Outlines, we reported on the "Guttenberg" case in which the SEC charged fourteen defendants, including DSJ International Resources Ltd. (d/b/a "Chelsey Capital"), in connection with two related insider trading schemes in which Wall Street professionals allegedly traded after receiving tips from insiders at UBS Securities LLC ("UBS") and Morgan Stanley & Co., Inc. ("Morgan Stanley") in exchange for cash kickbacks.
2. In 2010, the SEC filed a related action in federal district court against Slaine (a former portfolio manager for hedge fund Chelsey Capital) in connection with his involvement in the same insider trading scheme. The SEC alleges that Slaine traded in his personal brokerage account on material, nonpublic information regarding upcoming UBS stock analyst recommendations.
3. The SEC seeks injunctive relief, disgorgement of profits, and financial penalties. The case is pending.
4. In February 2010, in a related criminal proceeding, Slaine pled guilty to conspiracy and securities fraud charges.

According to media reports, Slaine, a former Galleon trader, secretly recorded meetings with individuals who have been charged in the Galleon insider trading cases to aid the government's investigation.

E. *SEC v. Igor Poteroba, et al.*, 10-Civ-2667 (S.D.N.Y. Mar. 25, 2010)

1. The SEC filed an injunctive action against Russian citizens Igor Poteroba, Aleksey Koval, and Alexander Vorobiev for insider trading in which they allegedly obtained approximately \$1 million in profits by trading on confidential merger and acquisition information.
2. The complaint alleges that beginning in July 2005, Poteroba served as an investment banker with UBS Securities LLC's Global Healthcare Group in New York. In advance of certain transactions, Poteroba tipped financial professional Koval, who, after trading on the deals, tipped his friend Vorobiev. The group used coded e-mails to tip each other and utilized accounts in their wives' names to conduct additional trades. Both wives have been named as relief defendants.
3. In March 2010, the court issued an emergency order freezing the assets of the defendants and the relief defendants. The SEC seeks permanent injunctions, disgorgement of illicit profits, and financial penalties against Poteroba, Koval, and Vorobiev.

F. *SEC v. Pequot Capital Management, Inc.* ("Pequot") and Arthur J. Samberg, 10-Civ-00831 (D. Conn. May 27, 2010); *In the Matter of Pequot Capital Management, Inc. and Arthur J. Samberg*, Admin. Proc. File No. 3-13928 (June 8, 2010); *In the Matter of David E. Zihlka*, Admin Proc. File No. 3-13913 (May 27, 2010)

1. The SEC filed a settled insider trading action in federal district court against Pequot, a hedge fund adviser, and its chairman, Arthur Samberg, concerning the firm's trading in the common stock of Microsoft.
2. The SEC alleged that in April 2001, Samberg sought information concerning Microsoft's quarterly earnings estimates from David Zihlka, a Microsoft employee who had accepted an offer of employment from Pequot. Zihlka allegedly contacted Microsoft employees and learned that

Microsoft would meet or beat earnings estimates. Zihlka allegedly conveyed the material, nonpublic information that he obtained from the Microsoft employees to Samberg, who traded on the information for funds managed by Pequot and passed the information to a friend. The Pequot funds earned nearly \$14.8 million from the trades.

3. Pequot and Samberg consented to permanent injunctions, to disgorge jointly and severally more than \$15.2 million, and for each to pay \$5 million civil penalties.
4. In a separate administrative proceeding, Pequot agreed to a censure, and Samberg agreed to a bar from association with an investment advisor, except for certain activities aimed solely at winding down Pequot.
5. Also in a separate administrative proceeding, the SEC charged Zilkha with violating federal insider trading laws. That matter is ongoing.
6. This case received significant media attention, in part, because former SEC staff attorney Gary Aguirre attempted to investigate Pequot's trading in 2005, but according to Aguirre, was stymied by senior Enforcement Division personnel from doing so. The SEC terminated Aguirre for insubordination. Aguirre sued the SEC for wrongful termination, a case that settled in June 2010 for \$755,000. In the past few years, the OIG issued two reports related to these issues. In one report, the OIG concluded that SEC Enforcement staff supervisors failed to fulfill their management responsibilities and that their conduct raised serious concerns about the impartiality and fairness of the Pequot investigation. In the second report, the OIG concluded that Enforcement staff supervisors failed to manage Aguirre properly and allowed inappropriate reasons to factor into their decision to terminate him.
7. Interestingly, on July 23, 2010, the SEC announced that it had awarded \$1 million to Glen and Karen Kaiser (Zilkha's ex-wife) for information and documents that the couple provided to the Commission that led to the Pequot and Zilkha cases. The Commission reported that this is the

largest award it had ever paid for information provided relating to an insider trading action.²²

G. *SEC v. Jon-Paul Rorech and Renato Negrin*, 09-Civ-4329
(S.D.N.Y. June 25, 2009)

1. In FY 2009, the SEC filed an action in federal district court against Renato Negrin (a Millennium Partners, L.P. portfolio manager) and Jon-Paul Rorech (a Deutsche Bank Securities, Inc. (“Deutsche Bank”) salesman), charging insider trading in the credit default swaps (“CDS”) of VNU N.V. (“VNU”), the holding company of Nielson Media. This was the first CDS insider trading case brought by the SEC.
2. Deutsche Bank served as lead underwriter for a VNU bond offering. The SEC alleged that Rorech learned about a change in a proposed VNU bond offering that likely would increase the price of CDS on VNU bonds and tipped Negrin about the bond news. After being tipped, Negrin placed orders with Deutsche Bank for €20 million of VNU CDS over two days. Negrin’s trades profited \$1.2 million after the news broke.
3. After a trial in June 2010, the court dismissed the charges, finding that there was no evidence that the defendants violated the insider trading laws and rejecting the SEC’s claim that Negrin and Rorech discussed inside information on two unrecorded telephone calls.
4. Notably, the SEC persuaded the court that the SEC has enforcement authority concerning CDS. On December 10, 2009, the court denied defendants’ motion to dismiss, which was predicated on a jurisdictional argument that CDS are privately negotiated contracts and were not securities-based swap agreements. The court explained that, in passing the Commodity Futures Modernization Act, Congress intended to prohibit in trading securities-based swap agreements what it prohibited in trading securities. In its June 2010 decision, the court confirmed its prior ruling on this issue.

²² See SEC Litigation Release No. 21601 (July 23, 2010).

Marketing and Sales of Collateralized Debt Obligations

The SEC has reportedly been investigating the marketing and sales of a number of complex derivative products since the economic crisis of late 2008. The Commission's lawsuit and subsequent settlement with Goldman Sachs received national and international attention. The matter was initiated by the new Structured and New Products Unit and resulted in the largest civil penalty ever imposed against a Wall Street firm.

A. *SEC v. Goldman Sachs & Co. ("Goldman Sachs") and Fabrice Tourre*, 10-CV-3229 (S.D.N.Y. filed Apr. 16, 2010)

1. The SEC brought an action in federal district court against Goldman Sachs and one of its employees, Fabrice Tourre, alleging fraud in connection with the sale and marketing of a synthetic collateralized debt obligation ("CDO").
2. The SEC alleged that, in 2007, as the U.S. housing market and related securities were beginning to decline, Goldman Sachs created and marketed a synthetic CDO that was connected to the performance of subprime residential mortgage-backed securities. The marketing materials for the CDO, including the offering memorandum and term sheet, stated that the portfolio of residential mortgage-backed securities underlying the CDO was selected by an experienced third party, ACA Management LLC ("ACA").
3. According to the SEC complaint, a hedge fund, Paulson & Co. ("Paulson"), played a major and undisclosed role in the portfolio selection process, despite the fact that its economic interest was adverse to investors. Specifically, Paulson allegedly sold short the securities portfolio after helping to select it by entering into credit default swaps with Goldman Sachs, which provided protection on certain elements of the CDO's structure. Accordingly, Paulson allegedly had an incentive to choose securities for the portfolio that would ultimately decline in credit quality.
4. The SEC also alleged that Tourre was primarily responsible for structuring the relevant CDO and that he prepared the marketing materials and communicated with investors. The complaint alleged that Tourre knew about Paulson's short interest and its participation in selecting the portfolio but did not disclose this information to investors. The SEC further alleged that Tourre was responsible for misleading ACA into

believing that Paulson was an equity investor in the CDO and therefore had interests aligned with ACA Management.

5. Paulson allegedly paid Goldman Sachs approximately \$15 million to create and market the CDO, which was finalized on April 26, 2007. By late October 2007, most of the residential mortgage-backed securities in the portfolio had declined in credit quality, and by the end of January 2008, 99% of the portfolio securities had been downgraded.
6. The SEC alleged that investors in the CDO lost more than \$1 billion, while Paulson's short positions resulted in an approximately \$1 billion profit.
7. Paulson was not charged with any wrongdoing in this matter.
8. The SEC's lawsuit alleged that Goldman Sachs and Tourre's conduct violated Sections 17(a)(1), (2) and (3) of the Securities Act of 1933 ("Securities Act") and Section 10(b) of the Securities Exchange Act ("Exchange Act") of 1934 and Rule 10b-5 thereunder and sought injunctive relief, disgorgement, and penalties.
9. On July 15, 2010, the SEC announced a \$550 million settlement with Goldman Sachs, which, as noted above, is the largest SEC penalty ever assessed against a Wall Street firm. In its settlement, the Commission stated that \$250 million of the penalty will go to harmed investors and \$300 million will be paid to the U.S. Treasury. In addition to the monetary sanction, Goldman Sachs agreed to comply with a number of undertakings for three years, including actions regarding its product review and approval process, the role of both internal and external legal counsel, and the education and training of certain personnel involved in the structuring or marketing of mortgage securities offerings.
10. Although the SEC's complaint charged the firm with violations of Section 10(b) of the 1934 Act and Rule 10b-5 and Section 17(a) of the 1933 Act, the final judgment enjoined Goldman Sachs only from violating Section 17(a) of the 1933 Act.
11. As is typical in such resolutions, Goldman Sachs neither admitted nor denied the SEC's allegations, but as part of the

settlement, it acknowledged that the marketing materials for the CDO product “contained incomplete information,” and that it was a “mistake” not to disclose Paulson’s role in the selection of the portfolio and its adverse economic interest.

12. The SEC’s case against Tourre is ongoing, and on July 19, 2010 Tourre filed his answer to the complaint, denying the SEC’s allegations.

MSRB Rule G-37: Municipal Bonds and Political Contributions

The Commission has called for greater scrutiny of the municipal securities market. The matter below, which reflects, the SEC’s efforts to shine a light on certain practices, was resolved through the issuance of a so-called 21(a) report, rather than a formal enforcement action.

A. *Report of Investigation re JP Morgan Securities Inc., Securities Exchange Act Release No. 61734 (Mar. 18, 2010)*

1. The SEC investigated JP Morgan Securities Inc. (“JPMSI”) for violating MSRB Rule G-37, which prohibits a broker, dealer, or municipal securities dealer from underwriting municipal bonds for an issuer within two years after the broker, dealer, or municipal securities dealer makes a political contribution to an official of that issuer. Although no disciplinary action was taken in this matter, the SEC decided to release the results of its investigation to reaffirm its prior guidance regarding Rule G-37.
2. The SEC’s investigation revealed that between July 2002 and September 2004, the vice chairman of JPMorgan Chase’s global investment banking, asset management, and private wealth businesses supervised, among other things, its U.S. municipal securities. The vice chairman was the lone JPMorgan Chase officer who had responsibility for all of JPMSI’s businesses and actively promoted JPMSI’s activities. He served as CEO of JPMorgan Chase’s investment bank and served on its executive committee.
3. In August 2002, the vice chairman collected \$8,000 in political campaign donations from JPMorgan Chase and some of its senior officials for the California state treasurer (and personally made a \$1,000 personal contribution). In the two years following these contributions, JPMSI participated as senior manager or comanager in more than

50 negotiated underwritings for California state agencies. The underwritten bonds sold in the aggregate for more than \$15.8 billion, and JPMSI received approximately \$37 million in investment banking fees from these deals.

4. Although the vice chairman was not a director, officer, or employee of JPMSI, the SEC concluded that he was “associated” with JPMSI, as the term is defined in the Exchange Act. The Commission issued its report to remind firms that the applicability of Rule G-37 depends on whether a person has a financial incentive to make a contribution in an effort to obtain underwriting business, not merely the person’s title or employment status.

Proxy Disclosures

Early in 2010, the SEC’s proxy cases against Bank of America received judicial approval, ending a long-running and high-profile battle.

- A. *SEC v. Bank of America Corporation* (“B of A”), 09-Civ-6829 (filed S.D.N.Y. Aug. 3, 2009); *SEC v. Bank of America Corporation*, 10-Civ-0215 (S.D.N.Y. Jan. 12, 2010)

1. As we reported in our 2009 Outline, in an action filed on August 3, 2009, the SEC charged B of A with violating federal proxy rules by failing to disclose its prior agreement authorizing Merrill Lynch & Co. (“Merrill Lynch”) to pay year-end bonuses to employees of up to \$5.8 billion. In September 2009, U.S. District Judge Jed Rakoff rejected as “neither fair, nor reasonable, nor adequate” the SEC’s initial proposed settlement with B of A, whereby the firm had agreed to pay a civil penalty of \$33 million.
2. In a second federal court action filed on January 12, 2010, the SEC alleged that B of A failed to disclose prior to the merger vote that Merrill Lynch had incurred a net loss of \$4.5 billion in October 2008 and had billions of dollars in estimated losses in November 2008 that, together, represented one-third of the value of the merger and more than 60 percent of the aggregate losses the firm sustained in the preceding three quarters combined. Judge Rakoff ruled that the charges relating to Merrill Lynch’s losses should be filed in a separate action from the charges relating to the bonus disclosures.

3. Before approving a joint settlement of both actions, Judge Rakoff ordered the parties to submit to the court testimony and other evidence from the New York Attorney General's investigation to reconcile perceived differences in the interpretations of the facts offered by the parties in the SEC case and the NYAG based on its own investigation. After initially refusing to make its transcripts available to the SEC, the NYAG's office agreed to provide them to the court for *in camera* review.
4. Without accepting the SEC's findings over the NYAG's "more sinister interpretation of what happened," Judge Rakoff concluded that the conclusions drawn by the SEC were reasonable and supported by substantial evidence.
5. To settle the matter, B of A consented to paying a \$150 million penalty, an amount that Judge Rakoff labeled "modest" and "paltry" in light of his conclusion that the merger "could have been a Bank-destroying disaster if the U.S. taxpayer had not saved the day." Despite labeling the settlement "far from ideal," "misguided," and "half-baked justice at best," the court, "while shaking its head," approved the settlement based on its conclusion that he owed substantial deference to the SEC's judgment.
6. Unlike the proposed settlement that Judge Rakoff rejected as coming at the expense of victimized shareholders, the \$150 million proposed penalty will be distributed solely to B of A shareholders that were harmed by the Bank's alleged disclosure violations and not to former legacy Merrill Lynch shareholders or B of A officers or directors who had access to the undisclosed information.
7. As part of the proposed settlement, B of A also must implement several remedial initiatives for three years. These protocols include: independent auditing of the firm's internal disclosure controls; certification by the firm's CEO and CFO of all annual and merger proxy statements; retention of disclosure counsel; and steps to improve the transparency of compensation principles and decision making.

Short Sales

The Commission, like FINRA and its predecessors, the NASD and NYSE Regulation, has focused recently on compliance with its short sale rule, referred

to as Regulation SHO. Below is an example of cases in this area brought by both the SEC and NYSE Regulation.

- A. *In the Matter of Goldman Sachs Execution & Clearing, L.P.* (“GSEC”), Admin. Proc. File No. 3-13877 (May 4, 2010)
1. The SEC settled an administrative proceeding against GSEC, alleging that the firm’s response to the SEC’s September 17, 2008 emergency order enacting temporary Rule 204T to Regulation SHO was inadequate.
 2. The emergency order required that firms either deliver securities by a trade’s settlement date or close fail-to-deliver positions by purchasing or borrowing securities by the beginning of the trading day following the settlement.
 3. The SEC alleged that, during a two-month period starting in December 2008, GSEC made erroneous manual calculations, causing the firm to violate the emergency order by failing to timely close out fail-to-deliver positions in approximately 60 securities. The SEC alleged that GSEC’s procedures were inadequate because they “relied too heavily on individuals to perform manual tasks and calculations, without sufficient oversight or verification of accuracy.”
 4. In settling the SEC’s action, GSEC consented to a cease-and-desist order and a censure and agreed to pay a \$225,000 civil penalty. In considering GSEC’s settlement offer, the Commission considered the firm’s remedial acts and cooperation with the SEC Enforcement staff’s investigation.
 5. In accordance with a Hearing Panel Decision issued by NYSE Regulation contemporaneously issued with the SEC’s settlement, GSEC also agreed to pay a \$225,000 fine to NYSE Regulation.

Subprime Mortgage Holdings

Another hot topic for the SEC concerns companies’ subprime holdings and related disclosures to investors. State Street paid a large civil penalty, among other payments, to settle a case in this area.

A. *SEC v. State Street Bank and Trust Company* (“State Street”),
10-Civ-10172 (D. Mass. Feb. 4, 2010)

1. The SEC settled charges against State Street for allegedly misleading investors about the extent to which its actively managed Limited Duration Bond Fund (“the LDB Fund”) was exposed to subprime mortgage investments.
2. The SEC alleged that offering documents and other communications prepared by State Street caused investors and prospective investors to believe that the LDB Fund was sector-diversified and was slightly more aggressive than a money market fund, and that it had virtually no exposure to subprime investments.
3. In contrast, however, the LDB Fund allegedly was entirely concentrated in subprime residential mortgage-backed securities and derivatives and held a lower-than-advertised credit quality. Investors allegedly also were misled about the extent to which the LDB Funds’ performance was tied to its use of leverage.
4. The complaint also alleged that information about the LDB Fund’s exposure to subprime investments was selectively disclosed to certain investors, including clients of State Street’s internal advisory groups that provided advisory services to some of the investors in the LDB Fund and the related funds. In order to meet the redemption demands of the better informed investors, State Street sold the LDB Fund’s most liquid holdings, causing further harm to those investors who were not privy to the selective disclosure and whose investment in the LDB Fund became even more concentrated in subprime securities.
5. State Street consented to a cease-and-desist order, to pay a \$50 million civil penalty, to disgorge more than \$7.3 million, and to pay more than \$255 million to harmed investors (not including more than \$340 million that State Street already paid to harmed investors through settlement of private litigation). State Street also agreed to retain an independent compliance consultant.

Supervision

Similar to several cases last year, in the first half of 2010, the Commission brought supervision actions not only against firms, but also various individual supervisors. In addition, earlier this year, the SEC resolved its long-running case against the former CEO of the American Stock Exchange.

- A. *In the Matter of Axiom Capital Management, Inc.* (“Axiom”), Admin. Proc. File No. 3-13786 (Feb. 22, 2010); *In the Matter of David V. Siegel*, Admin. Proc. File No. 3-13787 (Feb. 22, 2010)
1. The SEC commenced administrative proceedings against Axiom and Siegel, an Axiom branch officer manager, in which it alleges that they failed to reasonably supervise a registered representative who defrauded elderly customers.
 2. In 2003, Axiom assigned Siegel to be the direct supervisor of Gary J. Gross, a registered representative in Axiom’s Boca Raton office. As a result of customer complaints about Gross’ conduct while he was employed by his former firm, the State of Florida required Axiom to place Gross on heightened supervision.
 3. The SEC alleges that, between 2004 and 2006, Gross recommended to elderly customers unsuitable private placements that he described as riskless, , engaged in unauthorized trading, and churned clients’ accounts.
 4. The SEC alleges that the respondents failed to reasonably supervise Gross by failing to follow Axiom’s heightened supervisory procedures. Siegel allegedly failed to monitor Gross’ transactions and did not respond to red flags concerning Gross’ churning activity. Because Siegel’s compensation was partially dependent on the office’s net commissions, Siegel allegedly profited as a result of Gross’ illegal conduct.
 5. Axiom settled the matter by consenting to a censure, to pay a \$60,000 civil penalty, and to retain an independent compliance consultant.
 6. The matter against Siegel is ongoing.

7. In 2008, Gross consented to an injunction, to pay a civil penalty and disgorgement, and to a permanent bar from association with a broker or dealer.

B. *In the Matter of Salvatore F. Sodano*, Admin. Proc. File No. 3-12596 (Feb. 22, 2010)

1. As we reported in our 2007 Outline, in March 2007, the SEC settled an administrative proceeding against the American Stock Exchange LLC (“Amex”), alleging that, from at least 1999 through 2004, the exchange allegedly failed to surveil adequately for its members’ violations of the order-handling rules and also failed to keep and furnish surveillance and other records. At the time, the SEC also initiated a related administrative proceeding against former Amex chairman and CEO Salvatore Sodano.
2. In August 2007, an ALJ granted Sodano’s motion for summary disposition on the grounds that the applicable statute only vests the SEC with jurisdiction to bring charges against current officers and directors of an SRO. Sodano had resigned from those positions with Amex by 2005. In December 2008, the SEC reversed the ALJ’s decision, concluding that the statute permitted the SEC to censure current *and former* SRO officers.
3. In February 2010, the SEC settled its administrative proceeding against Sodano. The SEC alleged that Sodano, as Chairman and CEO of the Amex, was responsible for enforcing compliance with regulatory rules. The SEC further alleged that Sodano failed to ensure that the Amex complied with its own rules and satisfied its regulatory obligations. Specifically, Sodano did not establish procedures to correct deficiencies in the Amex’s surveillance and enforcement systems, and he unreasonably relied on others to address widespread problems.
4. Interestingly, in settling this matter, the SEC did not impose any sanctions or penalties on Sodano.

C. *In the Matter of First Allied Securities, Inc.* (“First Allied”), Admin. Proc. File No. 3-13808 (Mar. 5, 2010)

1. The SEC settled an administrative proceeding against First Allied in which the Commission alleged that firm failed to reasonably supervise one of its registered representatives.
2. Between May 2006 and March 2008, Harold H. Jaschke, a former First Allied registered representative, allegedly engaged in an unauthorized high-risk, short-term trading strategy on behalf of two municipal customers. This strategy, which involved short-term trading in “STRIPS” (Separate Trading of Registered Interest and Principal of Securities) that were financed through the use of repurchase agreements, directly violated the terms of the customers’ investment ordinances.
3. The SEC alleged that Jaschke’s trading strategy was unsuitable for the customers in light of their investment objectives. Jaschke allegedly lied to the customers about the performance and activity of their accounts and failed to disclose unrealized losses. Jaschke also allegedly engaged in unauthorized trading in the customers’ accounts and excessively traded in (or churned) these accounts for his own financial gain.
4. The SEC alleged that First Allied failed to establish reasonable systems designed to detect red flags regarding churning and suitability. The Commission also alleged that First Allied failed to monitor representatives’ use of their personal e-mail accounts to conduct firm business and failed to preserve e-mails for the requisite three-year period.
5. First Allied consented to a censure, to disgorge \$1,224,606, to pay a \$500,000 civil penalty, and to certify to the Commission staff when it implemented improvements recommended by an independent consultant.
6. In the settlement release, the SEC noted the prompt remedial actions taken by First Allied and its cooperation with the Commission staff.
7. In December 2009, the SEC filed a federal court action against Jaschke alleging that he had defrauded two

municipalities. In its complaint, the SEC seeks a permanent injunction, disgorgement, and a civil penalty. This matter is ongoing.

8. Also in December 2009, the Commission settled an administrative proceeding with Jeffrey C. Young, a former vice president of Supervision and Jaschke's supervisor. The SEC alleged that Young failed to respond adequately to red flags raised by Jaschke's conduct and failed to take reasonable steps to assure that First Allied's suitability procedures were followed. Young was suspended in a supervisory capacity for nine months and fined \$25,000.

D. *In the Matter of Prime Capital Services, Inc., et al.*, Admin. Proc. No. 3-13532 (Mar. 16, 2010)

1. The SEC settled an administrative proceeding against Prime Capital Services Inc. ("PCS") and its parent company, Gilman Ciocia, Inc. ("G&C"), in connection with PCS representatives' sale of variable annuities to customers whom they solicited during free-lunch seminars.
2. The SEC alleged that, between 1999 and 2007, PCS representatives sold approximately \$5 million of variable annuities to elderly clients in south Florida using misleading sales pitches, and that, in many cases, the investments were unsuitable based on the customers' ages, liquidity, and investment objectives.
3. PCS representatives allegedly told various customers that the variable annuity was guaranteed not to lose money, the customers would receive a guaranteed rate of return, and/or they would have access to invested funds whenever they needed it. During the time period, at least 23 customers were induced to buy at least 35 variable annuities.
4. The SEC charged PCS with failing to supervise because it did not: implement written supervisory procedures; review and follow up on branch exams; review and approve variable annuity transactions; respond to customer complaints; comply with state regulatory orders; and supervise certain individuals.

5. The SEC alleged that G&C aided and abetted PCS's fraud by arranging free-lunch seminars in and around several senior citizen communities in Florida where the registered representatives recruited senior citizens as customers and induced them into buying variable annuities.
6. In agreeing to settle the matter, PCS and G&C agreed to: (i) censures, (ii) cease-and-desist orders, and (iii) several undertakings, including retaining an independent compliance consultant, placing limitations on the functions that certain employees (including PCS's president and chief compliance officer) could perform, and notifying and making whole affected clients. In addition, PCS agreed to disgorge nearly \$100,000, and G&C agreed to pay a civil penalty of \$450,000.
7. Earlier in FY 2010 (November 2009), the SEC settled related charges against Christine Andersen, a PCS compliance officer, for failing to supervise. Andersen consented to paying a \$10,000 civil penalty, to a one-year suspension, and to cooperate with the SEC staff's investigation.
8. The SEC's case against PCS president Michael Ryan, PCS chief compliance officer Rose Rudden, and PCS representatives Eric Brown, Matthew Collins, Kevin Walsh, and Mark Wells is ongoing.

Unregistered Offerings

Although a stated FINRA priority, the SEC apparently is also interested in unregistered securities offerings, as evidenced by the action described below.

A. *In the Matter of Ronald S. Bloomfield, Robert Gorgia, Victor Labi, John Earl Martin, Sr., and Eugene Miller*, Admin. Proc. File No. 3-13871 (Apr. 27, 2010)

1. The SEC instituted administrative proceedings against the president, chief compliance officer, and three registered representatives of Leeb Brokerage Services, Inc. ("Leeb"), a defunct broker-dealer, for facilitating unregistered sales of penny stocks to investors.
2. The SEC alleged that Leeb's clients routinely delivered large blocks of penny stocks into their Leeb accounts. Leeb's

registered representatives allegedly then sold the stock to the public without conducting a reasonable inquiry to confirm that a registration statement was in effect and also failed to respond to clear red flags that the customers' trades were illegal.

3. The SEC also alleged that Leeb's president and chief compliance officer, who supervised the registered representatives, failed to carry out their supervisory responsibilities. Specifically, the supervisors failed to respond to red flags that allegedly should have caused the supervisors to more closely examine the activities of the registered representatives and their clients.
4. The SEC further alleged that in response to the suspicious trading by Leeb's clients, the firm should have filed suspicious activity reports but did not do so in violation of the Bank Secrecy Act.
5. The case is ongoing.

Dodd-Frank Wall Street Reform and Consumer Protection Act²³

The newly enacted financial reform bill contains several new measures expanding the SEC's enforcement authority and strengthening its oversight and regulatory authority over the nation's securities markets.

Landmark Legislation Gives SEC New Enforcement Capability

On July 15, the U.S. Senate passed the Dodd-Frank Wall Street Reform and Consumer Protection Act. President Obama signed the bill into law on July 21, 2010. This landmark legislation contains an array of important new measures that significantly expand the enforcement authority of the SEC and strengthen its oversight and regulatory authority over the securities markets.²⁴ These new measures will dramatically improve the SEC's "real-time enforcement" abilities, as it attempts to deliver on its promise to move more swiftly in enforcement actions to restore investors' faith in the markets.²⁵

Many important questions related to the new legislation, such as whether fiduciary duties will be imposed on broker-dealers, whether the SEC will attempt to restrict mandatory predispute arbitration, and whether aiding and abetting liability for securities laws violations will be extended to private civil actions, have yet to be answered. The compromises that were necessary for passage of the Dodd-Frank Act resulted in the authorization of studies and granting of agency rulemaking authority without specific mandates as to any particular outcome. Thus, additional significant changes to the enforcement and regulatory landscape

²³ This section of the Outline was drawn from "Landmark Legislation Gives SEC New Enforcement Capability," by Patrick D. Conner and E. Andrew Southerling, published July 19, 2010 and available at <http://www.morganlewis.com/index.cfm/publicationID/46016ef8-bbc4-41dc-a8fa-18dc8c6df911/fuseaction/publication.detail>.

²⁴ The key provisions within the legislation related to SEC regulation and enforcement are contained principally within Title IX, "Investor Protections and Improvements to the Regulation of Securities"; subtitle A, "Increasing Investor Protection"; subtitle B, "Increasing Regulatory Enforcement and Remedies"; and subtitle H, "Municipal Securities."

²⁵ Morgan Lewis has published several articles about the SEC's reform efforts, including: "SEC Announces New Cooperative Initiatives," available at http://www.morganlewis.com/pubs/WP_SECAnnouncesNewCooperationInitiative_Jan2010.pdf; and "SEC Speaks 2010: Fast-Paced Reform Continues in 2010," available at http://www.morganlewis.com/pubs/SecuritiesLF_SECSpeaks2010_11feb10.pdf.

will continue to be considered and debated for some time while agency study and rulemaking proceeds.

Nevertheless, existing provisions in the Dodd-Frank Act that do not require further consideration before becoming effective, many of which are highlighted below, provide substantially increased enforcement capabilities to the SEC.

Changes to SEC Enforcement and Market Oversight

Extension of Liability and Jurisdictional Regulations

Aiding and Abetting Liability²⁶

Prior to the Dodd-Frank Act's passage, the Exchange Act and the Investment Advisers Act of 1940 ("Advisers Act") permitted the SEC to bring actions for aiding and abetting violations of those statutes in federal civil proceedings. The Dodd-Frank Act extends the SEC's enforcement authority to prosecute those who aid and abet primary violators of the federal securities laws under the Securities Act and the Investment Company Act of 1940 ("Investment Company Act"), and codifies the SEC's authority to impose penalties against aiders and abettors under the Advisers Act. The Dodd-Frank Act therefore brings the SEC's federal civil enforcement authority in line with its existing administrative authority to institute proceedings and seek sanctions against regulated entities and individuals for aiding and abetting violations.²⁷

In addition, the Dodd-Frank Act clarifies the SEC's authority to pursue aiders and abettors for *reckless*, as well as *knowing*, conduct. The preexisting law permitted the SEC to charge individuals who knowingly provided substantial assistance to primary violators. The courts have been split, however, on the question of what constitutes knowing assistance, with some courts holding that "knowingly" meant what it said – actual knowledge, rather than recklessness. The Dodd-Frank Act resolves this issue and makes clear that the knowledge requirement can be satisfied by reckless conduct.

Control Person Liability under the Exchange Act²⁸

The Dodd-Frank Act amends the Exchange Act to permit the SEC to impose joint and several liability on control persons. Under the preexisting statute, control persons were liable, to the same extent as persons they controlled, to any *person* to whom the controlled person was liable.²⁹ Although the SEC routinely brings enforcement actions against individuals based on control person liability, some

²⁶ Dodd-Frank Act §§ 929M, 929N, and 929O.

²⁷ See, e.g., Exchange Act § 15(b)(4)(E); Investment Advisers Act § 203(e)(6).

²⁸ Dodd-Frank Act § 929P(c).

²⁹ Exchange Act § 20(a).

disagreement among the courts existed based on the preexisting language as to whether control person liability is available as an enforcement mechanism to the SEC. In *SEC v. First Jersey*, 101 F.3d 1450 (2d Cir. 1996), the court upheld the SEC's authority to pursue an enforcement action under the Exchange Act control person provision; the court in *SEC v. Coffey*, 493 F.2d 1304 (6th Cir. 1974), however, held that the SEC had no such authority. The Act resolves the issue, giving the SEC authority to pursue such actions.

Extension of Statute of Limitations for Securities Laws Violations³⁰

The Dodd-Frank Act extends the statute of limitations for the prosecution of a "securities fraud offense" from five years to six years following the commission of the offense. The Dodd-Frank Act defines a securities law offense to include criminal securities fraud and willful violations of the Securities Act, the Exchange Act, the Advisers Act, the Investment Company Act, and the Trust Indenture Act of 1939. Previously, the SEC and the federal government were subject to a five-year statute of limitations set forth under 28 U.S.C. § 2462 for enforcement actions seeking civil penalties.

Expansion of the Application of Antifraud Provisions³¹

The Dodd-Frank Act modifies the market manipulation provisions of Section 9 and the short sale provisions of Section 10(a)(1) of the Exchange Act to extend to any security other than a government security, rather than only to securities registered on a national securities exchange. Further, the Dodd-Frank Act extends Section 9(b) of the Exchange Act, which relates to puts, calls, straddles, and options, to expressly cover transactions that do not occur on a national exchange. Additionally, the Dodd-Frank Act modifies Section 9(c) of the Exchange Act, which relates to the endorsement or guarantee of puts, calls, straddles, or options, to specifically cover all broker-dealers, rather than only members of a national securities exchange. The Dodd-Frank Act also amends Section 15(c)(1)(A) of the Exchange Act to bring exchange transactions within its antimanipulation restrictions.

Extraterritorial Jurisdiction³²

The Dodd-Frank Act expands the jurisdiction of federal courts in actions brought by the SEC or the DOJ that allege violations of the antifraud provisions of the Securities Act, the Exchange Act, and the Advisers Act. Congressional leaders have stated that the purpose of this provision is to make clear that in actions or proceedings brought by the SEC or DOJ, the specified provisions of the Securities Act, the Exchange Act, and the Advisers Act may have extraterritorial

³⁰ Dodd-Frank Act § 1079A (Financial Fraud Provision). This provision adds a new Section 3301 to Chapter 213 of Title 18 of the U.S. Code.

³¹ Dodd-Frank Act § 929L.

³² Dodd-Frank Act § 929P(b).

application, and that, for potential Securities Act or Exchange Act violations, extraterritorial application is appropriate regardless of whether the securities are traded on a domestic exchange or the transactions occur in the United States, when the conduct within the United States constitutes “significant steps in furtherance of the violation” or when conduct occurring outside the United States has a “foreseeable substantial effect” within the United States.³³

The Dodd-Frank Act’s provisions concerning extraterritoriality of the federal securities laws are intended to rebut the presumption against extraterritorial application of the federal securities laws that the U.S. Supreme Court announced recently in its decision in *Morrison v. National Australia Bank*, No. 08-1191, wherein the Court ruled that, for purposes of private rights of action, antifraud provision Section 10(b) of the Exchange Act applies only to transactions listed on U.S. stock exchanges and securities transactions within the United States. Thus, while the Dodd-Frank Act does not override the Court’s decision, it prevents the potential extension of the Court’s decision to actions brought by the SEC or DOJ.

Jurisdiction over Formerly Associated Persons³⁴

The Dodd-Frank Act authorizes the SEC to institute proceedings against persons formerly associated with a registered entity (such as the Municipal Securities Rulemaking Board (“MSRB”), broker-dealers, government securities brokers or dealers, investment companies, national securities exchanges, registered securities associations, registered clearing agencies, self-regulatory organizations, and public accounting firms). This authorization is consistent with FINRA rules that permit the agency to bring suits against persons formerly associated with a member within two years after the effective date of the person’s termination or cancellation of registration, or, in the case of a nonregistered person, two years after the date that the person ceased to be associated with the member.³⁵

Enhanced Remedies

Collateral Bars for Securities Laws Violators³⁶

In *Teicher v. SEC*, 177 F.3d 1016 (D.C. Cir. 1999), the court held that the SEC lacked authority to impose “collateral bars” on violators of the securities laws. The new Dodd-Frank Act permits the SEC to impose collateral bars, so that, for example, a person who had violated the Exchange Act provisions relating to broker-dealers could be barred not only from the broker-dealer business, but also the municipal securities dealer business regulated under other provisions of the

³³ Congressional Record, June 30, 2010, at H 5237.

³⁴ Dodd-Frank Act § 929F.

³⁵ FINRA By-laws Article V, Section 4(a).

³⁶ Dodd-Frank Act § 925.

Exchange Act and the investment advisory business regulated by the Advisers Act. The new Dodd-Frank Act permits the SEC, in one stroke, to remove a violator from the financial industry entirely.

Civil Penalties in Cease-and-Desist Proceedings³⁷

The Dodd-Frank Act increases the SEC's existing enforcement authority by permitting the SEC to seek civil penalties in cease-and-desist proceedings against any person found to have violated the securities laws. Under preexisting law, the SEC could impose civil penalties in administrative proceedings only against regulated entities and associated persons. The new Dodd-Frank Act primarily affects public companies, their officers and directors, and their accountants by granting the SEC administrative penalty authority over them.

Securities Whistleblower Incentives and Protections³⁸

The Dodd-Frank Act includes new whistleblower provisions designed to motivate those with inside knowledge to come forward voluntarily and assist the SEC in identifying and prosecuting persons who have violated federal securities laws. Previously, the SEC had the authority to compensate individuals for providing information leading to the recovery of civil penalties in insider trading cases, but the total amount of bounties that could be paid from a civil penalty could not exceed 10% of the collected penalties.³⁹

The Dodd-Frank Act expands the SEC's current bounty program to cover *any* potential violation of the securities laws and requires the SEC to pay whistleblowers who voluntarily provide original information between 10% and 30% of monetary sanctions exceeding \$1 million from a successful judicial or administrative action brought by the SEC, although the SEC would have discretion to set the reward between those points. In determining the amount of the award, the SEC is required to consider a number of factors, such as the significance of the information provided and the degree of assistance provided, along with the programmatic interest of the SEC in deterring securities laws violations.

Moreover, under the Dodd-Frank Act, SEC whistleblowers subject to retaliatory discrimination may directly file suit in federal district court instead of having to first file a complaint with the Department of Labor. Such actions must be filed no more than six years after the date of the alleged violation, or three years after the date when facts material to the right of action are known or reasonably should have been known by the employee alleging the violation. No action, however,

³⁷ Dodd-Frank Act § 929P(a).

³⁸ Dodd-Frank Act §§ 922–924, and 929A.

³⁹ Exchange Act § 21A(e).

may be brought more than 10 years after the date on which the violation occurred.

In addition, the Dodd-Frank Act expands the whistleblower protections already in place under the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”)⁴⁰ to expressly prohibit retaliation against whistleblowing employees of subsidiaries and affiliates of publicly traded companies, extends the current statute of limitations for Sarbanes-Oxley whistleblower claims from 90 days to 180 days, and permits a jury trial. The Dodd-Frank Act also extends whistleblower protections to employees of nationally recognized statistical rating organizations (credit-rating agencies).

The Dodd-Frank Act requires the SEC to promulgate final rules implementing the provisions of its whistleblower program within 270 days after its enactment and requires the SEC to create an office to administer the program.

Regulation of Municipal Securities⁴¹

The Dodd-Frank Act strengthens oversight of municipal securities and enhances municipal investor protections. The Dodd-Frank Act requires municipal advisers who provide advice to a municipal securities issuer with respect to municipal financial products or the issuance of municipal securities, or who undertake a solicitation of a municipal entity, to register with the SEC. The Dodd-Frank Act also grants the SEC authority to regulate and sanction municipal advisers for fraudulent conduct and other violations of the federal securities laws.

The Dodd-Frank Act imposes a fiduciary duty on municipal advisers and associated persons when advising municipal issuers, and instructs the MSRB to adopt rules reasonably designed to prevent conduct inconsistent with this fiduciary duty. The Dodd-Frank Act imposes liability on municipal advisers for breaches of this fiduciary duty and for fraudulent, deceptive, or manipulative acts or practices.⁴²

In addition, the Dodd-Frank Act expands MSRB rulemaking authority over broker-dealers, municipal securities dealers, and municipal advisers and permits the MSRB to regulate *advice* provided by these entities and individuals to issuers (until now the MSRB had the authority to regulate municipal securities

⁴⁰ Sarbanes-Oxley Section 806 creates protections for whistleblowers who report securities fraud and other violations from retaliation by their public company employers.

⁴¹ Dodd-Frank Act §§ 975, 976, and 979.

⁴² The statutory imposition of a fiduciary duty on municipal advisers in this context is consistent with the Supreme Court's ruling in *SEC v. Capital Gains Research Bureau, Inc.*, in which the Court held that investment advisers are deemed to be fiduciaries who owe their clients an affirmative duty of utmost good faith, owe their clients full and fair disclosure of all material facts, and are required to employ all reasonable care to avoid misleading their clients. 375 U.S. 180, 194–99 (1963).

transactions), and requires the MSRB to set professional standards for municipal advisers.⁴³

Further, the Dodd-Frank Act provides for enhanced interaction between the SEC and MSRB. For example, the Dodd-Frank Act authorizes the MSRB to provide guidance and assistance to the SEC (and FINRA) in enforcement actions concerning MSRB rules, and to share fines collected by the SEC and FINRA for MSRB rule violations; the Dodd-Frank Act also establishes an Office of Municipal Securities within the SEC to administer the SEC's rules with respect to municipal securities dealers, advisers, investors, and issuers and to coordinate directly with the MSRB for rulemaking and enforcement actions.

The Dodd-Frank Act also instructs the Government Accountability Office to conduct several studies of the municipal securities markets, including a study of the disclosure required to be made by issuers of municipal securities.⁴⁴ The SEC has demonstrated an acute interest in investor disclosure related to municipal securities. In May 2010, the SEC unanimously approved rule changes designed to improve the quality and timeliness of securities disclosures of municipal issuers.⁴⁵ Among other things, the new rules require a broker, dealer, or municipal underwriter to reasonably determine that an issuer has agreed to provide notice of certain important events – *without regard to materiality* – within 10 days after the event's occurrence. These events include the failure to pay principal and interest, financial difficulties experienced by the issuer such as unscheduled payments by parties backing the issuance, and rating changes.

Additional Procedural Enhancements for Enforcement Actions

Nationwide Service of Subpoenas⁴⁶

The Dodd-Frank Act grants the SEC nationwide subpoena power in connection with civil actions filed in federal courts. The legislation allows the SEC to serve subpoenas "at any place within the United States" in federal civil actions and would remove geographical restrictions imposed by Rule 45(c)(3)(A)(ii) of the Federal Rules of Civil Procedure. The SEC already has authority to serve subpoenas nationwide in administrative proceedings.

⁴³ These provisions become effective October 1, 2010.

⁴⁴ Under the Exchange Act, the SEC and MSRB currently are precluded from requiring disclosure in municipal offerings. See Exchange Act §15B(d) (known as the "Tower Amendment").

⁴⁵ These rule changes amend Exchange Act Rule 15c2-12, which generally prohibits underwriters from purchasing or selling municipal securities unless they reasonably have determined that the municipality or other designated entity has agreed to make certain information available to investors on an ongoing basis, such as annual financial statements, payment defaults, rating changes, and prepayments. The rule changes become effective December 1, 2010 and can be found at <http://www.sec.gov/rules/final/2010/34-62184a.pdf>. The SEC's press release announcing these measures can be found at <http://www.sec.gov/news/press/2010/2010-85.htm>.

⁴⁶ Dodd-Frank Act § 929E.

“Speedy Trial Act” for Commencement of SEC Enforcement Actions⁴⁷

The Dodd-Frank Act also requires that the SEC file an enforcement action within 180 days after notifying a person in writing that it intends to recommend that an enforcement action be instituted against that person, or provide notice to the Director of the Division of Enforcement of its intent to not file an action. However, the SEC may seek an extension of this deadline if the Director of Enforcement determines, upon notice to the Chairman of the SEC, that the investigation is sufficiently complex that the filing of an action cannot be completed within the 180-day deadline.

Protecting Confidentiality of Materials Submitted to the SEC⁴⁸

The Dodd-Frank Act provides limitations on disclosure of certain information that registered persons and entities provide to the SEC pursuant to its examination authority, if such information has been obtained by the SEC for purposes of surveillance, risk assessments, or other regulatory and oversight activities. The Dodd-Frank Act also provides that the SEC shall not be compelled to disclose such information, except in circumstances limited to congressional or other federal agency requests, or a federal court order issued in connection with an action instituted by the DOJ or SEC.

Sharing Privileged and Other Information with Other Authorities⁴⁹

The Dodd-Frank Act allows the SEC and other domestic and foreign law enforcement authorities to share privileged information without waiving any privilege applicable to that information. Further, the Dodd-Frank Act provides that the SEC shall not be compelled to disclose privileged information obtained from a foreign securities or law enforcement authority if the authority represents to the SEC in good faith that the information is privileged.

The Dodd-Frank Act, however, *does not* include a provision contained in the original House Bill that would have permitted a federal court to grant the SEC access to certain information and materials related to matters occurring before a grand jury otherwise subject to the grand jury secrecy rule.

⁴⁷ Dodd-Frank Act § 929U.

⁴⁸ Dodd-Frank Act § 929I.

⁴⁹ Dodd-Frank Act § 929K.

Personnel Changes

Two significant FINRA personnel changes occurred in early 2010. First, Executive Vice President Robert Errico, Head of the Member Regulation Sales Practice Area, left FINRA at the end of March 2010. Susan Axelrod, a longtime NYSE Regulation/FINRA attorney and a senior official, was appointed to succeed Mr. Errico on July 21, 2010.

Second, on March 18, 2010, FINRA announced that Susan Merrill was resigning from her position as Executive Vice President and Chief of the Department of Enforcement to return to private practice. James Shorris is serving as Acting Director of Enforcement.

Enforcement Statistics

By way of background, in 2009, FINRA resolved 1,090 formal disciplinary actions, an increase of 8.2% from the prior year.⁵⁰ Last year, FINRA expelled 20 firms, barred 383 individuals, and suspended 363 individuals.⁵¹ FINRA levied fines against firms and individuals of almost \$50 million in 2009.⁵² This is an increase of approximately 75% from the amount FINRA collected in 2008.

Although FINRA's 2009 enforcement actions reflected a substantial increase in settlements involving large fines, it did not carry that momentum into 2010, as the number of cases with significant fines dropped sharply in the first half of 2010 when compared to the first six months of 2009, as shown in the following table:

⁵⁰ See <http://www.finra.org/Newsroom/Statistics/> (accurate as of July 16, 2010).

⁵¹ See FINRA's 2009 Year in Review and Annual Financial Report available at www.finra.org. at p. 2.

⁵² *Id.* at p. 2.

Fine Range	2009 (Jan. – June)	2010 (Jan. – June)
\$100,001 to \$250,000	15	14
\$250,001 to \$500,000	12	7
\$500,001 to \$750,000	3	4
\$750,001 to \$1,000,000	2	0
\$1,000,001 to \$1,500,000	2	1
\$1,500,001 or more	5	1

For example, the number of cases involving fines greater than \$250,000 dropped from 24 to 13 (a 46% decline), and the number of actions with fines greater than \$750,000 dropped from 9 to 2.⁵³

As this Outline went to press, FINRA released several significant actions with substantial fines. Because those cases were announced after June 30, 2010, the above analysis and the table do not reflect the \$7.5 million fine levied by FINRA against Deutsche Bank Securities, Inc. on July 21, 2010 or the \$900,000 fine assessed against SunTrust Investment Services on July 22, 2010.

Targeted Examination Letters

In 2009, FINRA stepped up its use of targeted examination letters, canvassing member firms on at least eight topics, ranging from hedge fund advertising and sales literature to retail municipal securities transactions to retail Forex trading.

To date this year, FINRA appears to have significantly slowed its use of this examination/investigative technique, as only one letter has been posted to the FINRA website (on the Targeted Examination Letters page). This letter requests that firms provide information regarding communications relating to noninvestment company exchange traded products (“ETPs”). Among other things, the request seeks copies of advertisements, sales literature and institutional sales material promoting noninvestment company exchange traded products, evidence regarding the written approval by a registered principal of advertisements and sales literature, offering documents, and firms’ written supervisory procedures “concerning the production, approval and distribution of ETP communications” in effect between November 2009 and May 2010.

Current FINRA Enforcement Priorities

At the May 2010 SIFMA Compliance & Legal Annual Seminar, James Shorris, FINRA's Executive Vice President and Acting Chief of the Department of

⁵³ The information in the table was collected based on our review of FINRA’s monthly “Disciplinary and Other FINRA Actions” publications and FINRA news releases issued between January and June 2009 and January and June 2010.

Enforcement, described three “process” issues and listed a “baker’s dozen” of FINRA’s current enforcement priorities.⁵⁴

Process Issues

- **Consistency of staffing models:** The Department of Enforcement now has one consistent staffing model, which includes investigators and lawyers working together on teams.
- **The use of task forces:** FINRA is using task forces, when appropriate, to investigate particular issues and will continue to do so in the future. Examples include teams looking at Regulation D offerings, municipal securities transactions, and day trading.
- **On-site investigations:** According to Mr. Shorris, FINRA’s Enforcement Department effectively used a new technique, on-site enforcement investigations, in numerous auction rate securities investigations in late 2008 and early 2009. FINRA will continue to use this process more frequently in fraud and other high-profile investigations.

Priorities

- **Regulation D offerings:** FINRA is concerned about suitability and potential fraud in these kinds of offerings. In addition to the recent Provident Asset Management case, additional actions will be forthcoming. Firms should consult Regulatory Notice 10-22 regarding obligations to conduct a reasonable inquiry in connection with Regulation D offerings.
- **Illegal distributions of stock and related penny stock scams:** Recently FINRA brought five actions in this area. Previously it had issued Regulatory Notice 09-05.
- **Ponzi schemes and other frauds:** Ponzi schemes and other fraudulent misconduct raise questions for FINRA about the supervisory practices of member firms.
- **Fixed income trading and sales:** Mr. Shorris noted that the sales of bond funds (e.g., the recent FINRA action concerning Morgan Keegan) and markup issues are priorities.
- **Exotic products:** Mr. Shorris discussed leveraged ETFs and Regulatory Notice 09-31 with respect to this topic.

⁵⁴ Notes from Mr. Shorris’s presentation at the SIFMA Seminar.

- **Stock-for-cash programs:** This issue relates to offshore companies that lend money to investors and receive securities as collateral. Issues have been raised regarding the offshore companies' liquidation of collateral rather than the maintenance of such collateral until the end of the loan.
- **Principal protected notes:** Mr. Shorris referenced Regulatory Notice 09-73.
- **Reverse convertibles:** Mr. Shorris expressed concern regarding the qualifications of customers to purchase these products and the use of put options.
- **Equity indexed annuities (“EIAs”) and variable annuities:** FINRA is looking into sales practices (including switching and exchanges) and supervision of EIAs and variable annuities.
- **Auction rate securities:** Enforcement has seemingly cleared its docket of ARS advertising and sales practice cases and is now moving on to “more serious” actions.
- **Day trading**
- **Municipal securities transactions:** FINRA is looking into underwriters who engage in swap transactions that are too costly for municipalities that are unsophisticated. Investigators are also looking at potential conflicts of interest in this area.
- **Life settlements⁵⁵**

Cooperation with Foreign Regulators

In 2009, FINRA signed two Memoranda of Understanding with Canada and France.

On June 18, 2010, FINRA and the Australian Securities and Investments Commission (“ASIC”) entered into a Memorandum of Understanding (“MOU”) to promote and support greater cooperation between the two regulators. The MOU establishes a framework for mutual assistance and the exchange of information between ASIC and FINRA. According to FINRA, the MOU will help the regulators investigate possible instances of cross-border market abuse in a timely manner, exchange information on firms under common supervision of both regulators, and allow more robust collaboration on approaches to risk-based

⁵⁵ Interestingly, on July 22, 2010, the SEC released a staff report that recommends that life settlements be defined as securities and issued an Investor Bulletin to describe the key issues concerning life settlements and several of the risks of such investments. See “SEC Releases Report of the Life Settlements Task Force,” July 22, 2010, available at www.sec.gov.

supervision of firms. This agreement follows a similar agreement that the SEC entered into with ASIC in August 2008.

FINRA Assumption of Market Surveillance and Enforcement Functions Previously Conducted by NYSE Regulation

On June 14, 2010, FINRA and NYSE Euronext announced that they had completed the previously announced agreement under which FINRA assumed responsibility for performing the market surveillance and enforcement functions previously conducted by NYSE Regulation. Under the agreement, FINRA assumed regulatory functions for the New York Stock Exchange, NYSE Arca, and NYSE Amex. Most of the approximately 225 staff members that performed these functions for the three NYSE Euronext exchanges were transferred to FINRA.

In addition to these three exchanges, FINRA also provides regulatory services to six other exchanges: the NASDAQ Stock Market, NASDAQ Options Market, NASDAQ OMX Philadelphia, NASDAQ OMX Boston, The BATS Exchange and The International Securities Exchange.

According to NYSE Euronext and FINRA executives, consolidating surveillance and enforcement functions for the NYSE Euronext exchanges with FINRA will help to create a consistent and integrated approach to regulation and address the fragmented trading environment that erodes regulators' ability to get a more complete picture of market activity across multiple markets and financial products.

NYSE Euronext, through its subsidiary NYSE Regulation, remains ultimately responsible for overseeing FINRA's performance of regulatory services for the NYSE markets and retains its staff associated with rule interpretations and oversight of listed issuers' compliance with the NYSE markets' financial and corporate governance standards.

Dodd-Frank Wall Street Reform and Consumer Protection Act

Of course, the Dodd-Frank Wall Street Reform and Consumer Protection Act mostly focuses on federal issues and federal regulatory issues and agencies. However, one interesting part of the act concerns the SEC's oversight of FINRA. In particular, the new law requires the Comptroller General of the U.S. to submit to Congress a report evaluating the SEC's oversight of FINRA with respect to, among other topics: FINRA's corporate governance, including its identification and management of conflicts of interest; the examinations conducted by FINRA and the expertise of the examination staff; the executive compensation practices of FINRA; the cooperation and assistance provided by FINRA to state regulators; how the funding of FINRA is used to support its mission; the policies regarding the employment of former FINRA staff by member firms; and the effectiveness of

FINRA's rules.⁵⁶ The first report is due by July 2012; thereafter reports are required to be submitted to Congress on a three-year cycle.

FINRA Enforcement Actions

Anti-Money Laundering ("AML")

FINRA has brought many AML cases over the last several years, including a number with significant fines. Two settlements reached in early 2010 and a litigated case are described below.

A. *Penson Financial Services, Inc.* ("Penson") (Feb. 2, 2010)

1. FINRA alleged that Penson failed to establish and implement an adequate AML compliance program during the period October 1, 2003 through May 31, 2008.
2. According to FINRA, Penson's system for detecting, reviewing, and reporting suspicious activity was inadequate. Specifically, FINRA alleged that Penson did not allocate sufficient resources to its AML compliance program, did not use appropriately risk-based criteria to generate AML exception reports, and did not regularly review penny stock deposits and liquidations.
3. FINRA alleged that in 2007, Penson committed additional resources to its AML compliance program, and, in December 2007, implemented a sophisticated automated system to assist its review of potentially suspicious activity. However, FINRA alleged that, despite these improvements, Penson failed to conduct timely investigations of potentially suspicious activity flagged by the automated system on approximately 129 occasions.
4. FINRA also alleged that Penson's AML training program was deficient, that Penson failed to assess AML risks for certain foreign financial institution correspondent accounts, and that the firm's written AML procedures were deficient.
5. FINRA further alleged that, between March 31, 2007 and May 31, 2008, Penson failed to report required information to INSITE accurately and failed to provide certain information to

⁵⁶ Dodd-Frank Act § 964.

its introducing broker-dealers concerning charges required to be taken to the introducing broker-dealers' net capital.

6. Person consented to a censure, a fine of \$450,000, and an undertaking to have all personnel within its AML compliance department complete 16 hours of training.

B. *Pinnacle Capital Markets, LLC* ("Pinnacle") (Feb. 2, 2010)

1. FINRA alleged that between January 2006 and September 2009, Pinnacle failed to establish and implement AML procedures reasonably designed to verify the identity of customers and to detect and report suspicious activity.
2. Pinnacle operates as an on-line business and has a customer base of mostly foreign individuals or firms. FINRA alleged that, although nearly all of Pinnacle's customers reside in jurisdictions that have heightened money laundering risk, Pinnacle relied on AML procedures drafted by a third-party vendor that were not designed to allow the firm to evaluate or monitor AML risk of its foreign customer base. For example, according to FINRA, the firm's suspicious activity review procedures contained a list of 18 red flags taken directly from a FINRA notice, most of which did not apply to Pinnacle's business model.
3. FINRA further alleged that Pinnacle's customer identification procedures were inadequate and impractical given Pinnacle's customer base and that Pinnacle failed to detect, investigate, or file suspicious activity reports on potentially suspicious activity within customer accounts.
4. One of Pinnacle's foreign financial institutional customers domiciled in Latvia had an account with Pinnacle with 55 subaccounts, some of which had additional subaccounts. According to FINRA, Pinnacle failed to obtain the required customer identification information for these subaccounts and failed to detect irregular trading patterns in these subaccounts. In March 2007, the SEC filed a complaint for injunctive relief against this foreign financial institution and certain unknown traders alleging an international on-line "pump and dump" scheme involving Pinnacle and other broker-dealers, although Pinnacle was not named as a defendant in that action.

5. Pinnacle consented to a censure and a fine of \$300,000, and undertook to: (1) have its registered personnel complete three hours of AML training, and (2) hire an independent consultant to review its AML program.

C. *Department of Enforcement v. Sterne, Agee & Leach, Inc.* (“Sterne Agee”) (Mar. 5, 2010)

1. In this contested matter, FINRA alleged that, between April 2002 and July 2005, Sterne Agee failed to develop and implement an adequate AML program because its systems were not sufficiently automated. FINRA also alleged that, from July 2006 to April 2007, Sterne Agee’s AML program was deficient because, among other reasons, it did not have adequate procedures for reviewing physical securities certificates, monitoring journal transfers, or identifying direct foreign financial institution accounts. FINRA further alleged that the firm failed to have written procedures to comply with enhanced due diligence requirements of the USA PATRIOT Act, failed to identify certain accounts as foreign bank accounts, and failed to implement certain customer identification procedures.
2. The Hearing Panel determined that, with respect to the Department of Enforcement’s allegations that Sterne Agee’s AML systems were not sufficiently automated, the Department of Enforcement failed to demonstrate that it was unreasonable for Sterne Agee to have relied on a system with a substantial manual component to fulfill its AML detection requirements. Specifically, the Hearing Panel found that Sterne Agee’s system could be reasonably expected to detect and cause the reporting of suspicious activity and transactions.
3. The Hearing Panel concluded that, during the time period of the alleged violations, FINRA provided firms with little guidance on the degree of system automation required to maintain a reasonable AML program. The Hearing Panel also found that Sterne Agee’s written procedures for identifying and reviewing transactions, as well as its training program, were adequate.
4. Notwithstanding the foregoing, the Hearing Panel concluded that Sterne Agee’s program failed to detect and obtain certifications for foreign banks, did not have written due

diligence procedures to comply with the USA PATRIOT Act, and failed to implement certain customer identification procedures for delivery versus payment accounts.

5. The Hearing Panel imposed a \$40,000 fine on Sterne Agee.

Auction Rate Securities (“ARS”)

FINRA settled two ARS cases earlier this year and, reportedly, after failing to reach an amicable resolution, filed a complaint in a third matter. These cases add to the more than dozen actions brought by FINRA in this space to date.

A. *US Bancorp Investments, Inc.* (“US Bancorp”) (Apr. 22, 2010)

1. FINRA settled a matter with US Bancorp in which it alleged that the firm engaged in certain violations relating to the sale and marketing of ARS.
2. FINRA alleged that the firm used internal marketing materials prepared by other securities firms that did not provide a balanced or adequate disclosure of risks of ARS, describing ARS as a “great place for short-term money” and a “cash alternative,” but failing to disclose the liquidity risks of ARS. Other materials allegedly compared ARS yields to those of money market securities but failed to disclose the material differences between the investments, including differences in liquidity, safety and potential fluctuation of return.
3. FINRA alleged that US Bancorp failed to maintain procedures reasonably designed to ensure that the firm marketed and sold ARS in accordance with applicable laws and rules.
4. FINRA further alleged that ARS were added to US Bancorp’s approved product list without first being subjected to the firm’s usual due diligence process.
5. US Bancorp consented to a censure and a \$275,000 fine.
6. In setting the sanction, FINRA took into account that, in September 2008, US Bancorp voluntarily offered to repurchase at par all ARS held in its customer accounts.

B. *HSBC Securities, Inc.* (“HSI”) (Apr. 22, 2010)

1. FINRA settled a matter with HSI in which it alleged that the firm engaged in certain violations relating to the sale and marketing of ARS and failed to retain certain e-mails and instant messages.
2. FINRA alleged that, between May 2006 and February 2008, HSI made negligent misrepresentations and omissions of material facts to customers concerning the safety and liquidity of ARS and used advertising and marketing materials that were not fair and balanced and did not provide a sound basis for evaluating the facts about purchasing ARS.
3. HSI also allegedly sold restricted, and therefore unsuitable, ARS to certain nonqualified customers.
4. FINRA further alleged that HSI failed to retain certain e-mails and internal instant messages and failed to maintain adequate supervisory procedures concerning its ARS sales and marketing activities and its retention of certain e-mails and instant messages. (The AWC noted that HSBC had previously been fined by the NYSE for e-mail retention issues.)
5. HSI consented to a censure, a \$1.5 million fine, and an undertaking to repurchase ARS from certain current customers who had not accepted HSI’s voluntary offer to repurchase the ARS in 2008, as described below, and certain former customers.
6. In setting the sanction, FINRA took into account HSI’s voluntary remediation to customers prior to the entry of the AWC, which included HSI’s voluntary offer to repurchase ARS from its customers in 2008. As of July 2008, HSI had repurchased more than 90% of its then-current customers’ ARS holdings and, in October 2008, offered to repurchase all of the remaining ARS held in those customers’ accounts.

C. *Thomas Weisel Partners* (“Weisel”) (May 18, 2010)

1. FINRA filed a contested action against Weisel and Stephen “Henry” Brinck, Jr., the former head of its fixed income and

corporate cash management, in connection with the firm's sales of ARS.

2. FINRA alleges that Brinck faced pressure from more senior Weisel managers to raise \$25 million that would be used to pay employee bonuses. Brinck purportedly sold \$15.7 million of ARS from the firm's proprietary account into the accounts of three customers whose accounts the firm managed without the customers' approval, even though he and the firm had recommended that all corporate cash clients sell their ARS.
3. FINRA alleges that, at the time of the sales, the firm was concerned about the ARS market, which crashed weeks later.
4. FINRA further alleges that the firm made false and misleading statements to two of the customers to induce them to provide retroactive consent, made false statements to FINRA concerning the transactions, and failed to maintain and implement adequate supervisory procedures and an adequate supervisory system.
5. Weisel has repurchased the ARS from the affected customers.
6. The case is ongoing.

Branch Office Examinations

The case below generally involves standard branch office examination issues, but also includes allegations concerning the interaction between certain individuals and NYSE Regulation examiners.

- A. *Merrill Lynch, Pierce, Fenner & Smith Incorporated* ("MLPFS") (Apr. 2010)
 1. FINRA settled a matter with MLPFS in which it alleged several findings related to branch office examinations over a three-year period from 2005-2008.
 2. FINRA alleged that, in 2005, MLPFS, through several branch office employees and employees of an affiliate in the Office of General Counsel, made material misstatements to NYSE

Regulation examiners relating to an on-site examination concerning nonregistered cold-callers by:

- (a) providing inaccurate and sometimes deceptive information in response to various exam requests, including information about the use of nonregistered cold-callers;
 - (b) instructing staff that an unapproved facsimile machine be hidden or removed; and
 - (c) providing an inaccurate written statement in response to requests for information during an ongoing investigation.
- 3. FINRA also alleged that MLPFS failed to properly supervise a registered person who held himself out as an attorney on firm stationery and business cards, even though he was not licensed by any federal or state bar.
 - 4. FINRA further alleged that, between 2005 and 2008, the firm failed to follow certain operations policies and procedures in a number of its branch offices.
 - 5. MLPFS consented to a \$300,000 fine.

Credit Default Swaps

Last year, our Outline reported on a FINRA case against ICAP Corporates in which the company settled allegations that it and a manager improperly attempted to influence other interdealer brokerage firms in setting customers' brokerage rates in the wholesale credit default swaps ("CDS") market. The below case is another in this arena; in announcing the case, FINRA stated that it continues to investigate matters in this space.

- A. *Phoenix Derivatives Group, LLC ("Phoenix"), Marcos Moises Brodsky, John Richard Lines, and Wesley Wang* (June 24, 2010)
 - 1. FINRA settled a matter with Phoenix in which it alleged that the firm, acting through Brodsky, Lines, and Wang, Phoenix desk coheads and managing directors of the firm, improperly attempted to influence other interdealer brokerage firms in setting customers' brokerage rates in the wholesale CDS market.

2. Interdealer brokerage firms receive fees for matching counterparties in wholesale CDS transactions. FINRA alleged that Brodsky, Lines, and Wang repeatedly communicated with other interdealer brokers in connection with setting brokerage fees. These discussions typically took place after dealers' customers proposed reductions in the brokerage rates to a number of interdealer brokers. Brodsky, Lines, and Wang discussed, among other topics, actual or proposed reactions to such reductions, including the preparation of similar responses to customers.
3. FINRA further alleged that this conduct violated its rules because the respondents attempted to influence improperly another member or person associated with a member.
4. FINRA also alleged that Phoenix's supervisory systems, including its written supervisory procedures, were not reasonably designed to detect such inappropriate activity. In particular, FINRA alleged that the procedures did not include supervisory reviews for anticompetitive activity or more generally for regulatory compliance.
5. The Firm also allegedly failed to conduct supervisory reviews of electronic communications and did not maintain any non-Bloomberg instant messages for two periods comprising approximately 10 months in 2005 and 2006.
6. FINRA further alleged that Phoenix's productions of e-mail communications during the course of FINRA's investigation were untimely and incomplete.
7. Phoenix consented to a censure and a \$3 million fine, of which \$900,000 is joint and several with the individual respondents (\$350,000 with Brodsky, \$100,000 with Lines, and \$450,000 with Wang). Brodsky, Wang, and Lines also consented to suspensions from acting in all capacities of one month, two months, and three months, respectively.
8. FINRA contemporaneously settled cases with five CDS brokers at other interdealer firms: Thomas J. Lewis and Matthew A. Somers, formerly of Chapdelaine Corporate Securities & Co.; John P. Thompkins, formerly of CreditTrade (US) Corp.; Michael B. Jessop, formerly of Tullett Liberty Inc.; and Eric Ridder, formerly of Creditex Group, Inc. The assessed fines equaled \$1.3 million, and

the brokers were suspended from the industry for various periods.

Customer Confidential Information

FINRA and its member firms have been keenly focused on protecting confidential customer information. In the matter below, FINRA apparently took into account a number of positive steps taken by the firm after it learned that a hacker had broken into its systems.

A. *D.A. Davidson & Co.* (“D.A. Davidson”) (Apr. 12, 2010)

1. FINRA settled a matter with D.A. Davidson in which it alleged that the firm failed to employ adequate safeguards to protect confidential customer information against hackers.
2. The firm maintained its customer records, including account numbers, social security numbers, names, addresses, dates of birth, and other confidential information, on an unprotected web server with a constant internet connection.
3. On December 25 and 26, 2007, an unidentified hacker downloaded confidential information concerning approximately 192,000 customers.
4. FINRA alleged that the database was not encrypted and that the firm never changed the default password for the database. The firm also allegedly failed to review the web server logs, which showed evidence of the system breach.
5. D.A. Davidson learned of the breach when it received an e-mail from the hacker threatening to blackmail the firm. Upon receipt of the threat, D.A. Davidson took remedial measures by disabling the website, reporting the incident to law enforcement officials, and assisting them in identifying the hackers. The firm took additional remedial steps, including: hiring an outside consultant to advise on electronic security, removing sensitive customer information from the database, adding a firewall, deploying additional intrusion prevention software, and installing a repository for server logs and procedures for review of the logs.
6. D.A. Davidson consented to a censure and a \$375,000 fine.

7. In setting the sanction, FINRA credited D.A. Davidson for its remedial measures and its significant cooperation with criminal authorities. In addition to the remedial steps outlined above, the firm also: (i) issued a press release about the incident, (ii) provided written notice to customers and established call centers to respond to customer inquiries, (iii) offered a credit-monitoring service to affected customers for two years at a cost to the firm of \$1.3 million, and (iv) resolved a class action litigation with affected customers, which included providing loss reimbursement for potential victims of the hacking of up to an aggregate of \$1 million. FINRA also considered that, as of the date of the settlement, no customer had suffered any instance of identity theft or other actual damages.

Day Trading

This year FINRA brought a case involving day trading and SEC Regulation T. This case appears to coincide with FINRA's determination to make day trading an enforcement priority.

A. *Scottrade, Inc.* (Feb. 8, 2010)

1. FINRA settled a case with Scottrade related to customer day trading activities and cash accounts.
2. NASD Conduct Rule 2520 governs day trading margin rules and defines "day trading" as buying and selling, or vice versa, the same security in a day in a margin account. A "pattern" day trader is a trader who executes four or more day trades within five business days.
3. FINRA alleged that, between February 2006 and October 2007, Scottrade allowed customers who were pattern day traders to day trade in margin accounts in which the equity was less than \$25,000, in violation of Rule 2520. FINRA alleged that the firm allowed pattern day traders to execute 171,190 day trades in 11,708 margin accounts that did not meet the \$25,000 minimum.
4. Scottrade monitored the accounts of pattern day trader customers and sent written notification to customers whose accounts fell below \$25,000. FINRA alleged, however, that the firm did not adequately restrict the trading of those

customers if the account balance was not properly restored to the \$25,000 level.

5. FINRA also alleged that, between February 2006 and January 2007, Scottrade did not obtain payment from customers or cancel or liquidate transactions in 65 instances when a customer did not have sufficient funds in a cash account to meet the costs of the transactions. Scottrade's practice in such situations was to send the customer a sellout letter on the date payment for the transaction was due, which instructed the customer to pay Scottrade within 2 business days. As such, the customer was allowed more days to make payment than permitted under SEC Regulation T.
6. Scottrade consented to a censure and \$200,000 fine.

E-mail Retention

The case below is yet another example of FINRA's enforcement efforts in the e-mail retention arena. Of note, the settling firm was also criticized for failing to timely report its deficiencies to FINRA.

A. *Piper Jaffray & Co.* ("Piper Jaffray") (May 24, 2010)

1. FINRA settled a case against Piper Jaffray in which it alleged that the firm failed to retain millions of e-mails between November 2002 and December 2008.
2. FINRA alleged that, due to several operational failures, Piper Jaffray did not retain approximately 4.3 million e-mails. This allegedly affected the firm's ability to comply with e-mail requests from FINRA and possibly other regulatory and civil litigation requests.
3. FINRA also alleged that, although the firm's compliance and IT departments were aware of the e-mail issues as early as April 2003, Piper Jaffray did not report the deficiencies to FINRA until FINRA noted an e-mail was missing in a separate inquiry in 2007. Piper Jaffray informed FINRA of additional e-mail preservation issues in 2008 during the course of FINRA's inquiry into the e-mail retention issues.

4. Piper Jaffray also allegedly committed a number of supervisory violations, including:
 - (a) failure to design systems and procedures reasonably designed to detect e-mail retention deficiencies;
 - (b) failure to review and supervise electronic communications; and
 - (c) failure to ensure that it promptly reported violations of the securities laws, regulations, and rules.
5. Piper Jaffray had been disciplined previously in connection with e-mail preservation issues. In 2002, it settled cases with the NYSE, NASD and SEC, in which it consented to a censure, a \$1,650,000 fine, and an undertaking to certify that it had systems and procedures in place with respect to the retention of electronic communications.
6. In connection with the case settled in 2010, Piper Jaffray submitted a Statement of Corrective Action with the Letter of Acceptance, Waiver and Consent, which stated that the firm had made changes to its archival process and other procedures and had retained a third-party consultant in 2009 to perform an audit of the firm's e-mail retention systems and procedures. The Statement noted that the consultant had determined that the firm was in compliance with its internal policies and FINRA's rules and regulations.
7. Piper Jaffray consented to a censure and a \$700,000 fine.

Misappropriation

Not surprisingly, FINRA, as well as the criminal authorities, move aggressively in cases of alleged thefts from customers. In the case below, FINRA sanctioned a firm for allegedly failing to respond to several red flags regarding a broker's activities.

A. *Citigroup Global Markets, Inc.* ("CGMI") (May 26, 2010)

1. FINRA settled a case against CGMI in which it alleged that, between September 2004 and October 2006, CGMI failed to adequately supervise a registered representative, Mark Andrew Singer, who, assisted two firm customers,

"Customer B" and "Customer S," in allegedly misappropriating approximately \$60 million in cemetery trust funds.

2. After the scheme was discovered, Singer, Customer S, and others unrelated to CGMI were criminally charged in various states with an apparent scheme to misappropriate cemetery trust funds and improperly transferring some of those funds to various third parties.
3. Prior to his CGMI employment, Singer's clients at another broker-dealer included Customer B, who owned cemeteries in Michigan. Singer opened trust accounts for the cemeteries and other entities controlled by Customer B, including Summerfield LLC. The funds in the Summerfield account, which FINRA alleged belonged to the cemetery trusts, were invested in a hedge fund.
4. In August 2004, Customer C, another Singer customer, purchased the cemeteries from Customer B, allegedly using the cemeteries' trust funds to do so. Among other things, FINRA alleged that Customer S used the hedge fund investment as a part of the collateral for a \$24 million personal line of credit from Citigroup Private Bank.
5. When CGMI hired Singer in September 2004, Customer B transferred his assets, including the cemeteries and Summerfield, to CGMI, and Customer S opened accounts for the cemeteries and Summerfield with Singer. According to FINRA, the accounts opened by Singer on behalf of Customers B, S and others were thereafter used as conduits for improper transfers of cemetery trust funds to various third parties.
6. FINRA alleges that the firm failed to respond adequately to the following red flags:
 - (a) Singer's prior firm informed CGMI that it had stopped doing business with Customer B because of concerns regarding the movement of funds in his accounts. Although CGMI added Customer B, Summerfield, and the cemeteries to an internal alert system and examined some transactions, FINRA alleged that CGMI's follow-up to the information was inadequate.

- (b) Shortly after Singer joined CGMI, numerous rapid transfers of trust funds occurred, which generated alerts from the CGMI system. CGMI conducted a review of these movements and related issues and decided to terminate its relationship with Customer S in February 2005 solely because it concluded that he may have engaged in some unethical self-dealing. However, FINRA alleged that CGMI did not memorialize its decision and failed to ensure that it was carried out. As such, the scheme went undetected until at least October 2006.
 - (c) Finally, FINRA alleged that CGMI received a letter from a third party that alleged that Singer had improperly handled the cemetery trust accounts, but CGMI failed to conduct a sufficient inquiry into the allegations.
- 7. CGMI agreed to a censure, to pay a \$750,000 fine, and to disgorge \$750,000 in commissions to be paid to the cemetery trusts as partial restitution.
- 8. FINRA settled a separate disciplinary action against Singer in 2009 for failing to cooperate with its investigation. A criminal case against Singer in Tennessee resulted in a mistrial, and criminal charges against him in Indiana are still pending.

Mutual Fund Operations

In prior years, FINRA has focused on mutual fund sales practice cases. The below action is an example of a case in the mutual fund operational space.

- A. *AXA Advisors, LLC* (“AXA”) (Jan. 2010)
 - 1. FINRA settled a matter with AXA in which it alleged that AXA failed to keep accurate and complete records relating to its direct mutual fund business.
 - 2. Between 2001 through 2006, AXA created a trade blotter for its direct mutual fund business by matching the data feeds containing records from networking vendors with client information contained in AXA’s systems. Records from networking vendors that did not match AXA’s information

were not reflected on AXA's trade blotter or processed through AXA's internal compliance and supervisory systems.

3. While the unmatched information varied over the years, FINRA alleged that 9% of all direct mutual fund transactions were not reported on AXA's books and records. Most of the transactions that did not appear on the trade blotter were not large.
4. FINRA also alleged that no AXA employee was responsible for monitoring the level of unmatched records and that AXA did not have written procedures that addressed the supervision of the matching process.
5. As early as 2000, AXA was aware of the issue and took certain steps to address it. AXA notified FINRA of its recordkeeping deficiencies in 2007, undertook an internal review, and reported its conclusions to FINRA. As part of the review, AXA hired an independent consultant to conduct a retrospective analysis of the transactions that had not been reflected on the trade blotter. The review concluded that the overall level of harm to AXA's clients was small.
6. During its 2007 review, AXA discovered that certain mutual fund families did not appear on its networking vendors' data feeds. The excluded records were not of a sufficient volume to materially change AXA's analysis.
7. AXA consented to a censure and \$250,000 fine.
8. In setting the sanction, FINRA took into account the work done by AXA and the independent consultant.

Regulation SHO

Continuing its efforts in the Reg. SHO short selling area, FINRA announced two settlements in May.

A. *Deutsche Bank Securities, Inc.* (May 13, 2010)

1. FINRA settled a matter with Deutsche Bank in which it primarily alleged that the firm violated rules relating to short sale locates, marking, close-outs, and buy-ins.

2. FINRA alleged that, between January 3, 2005 and September 30, 2009, the firm implemented customer Direct Market Access (“DMA”) trading systems that were designed to block the execution of short sale orders unless a locate had been obtained and documented. However, the firm disabled its system in certain instances, resulting in an unquantified number of short sales without locates. FINRA further alleged that Deutsche Bank’s “Easy To Borrow” list was not properly constructed between January 2005 and approximately April 2007 because it sometimes included hard-to-borrow securities.
3. Between January 3, 2005 and approximately December 2008, the firm allegedly marked client orders long without reasonable grounds and used borrowed shares to make delivery or had fails to deliver. For example, FINRA alleged that, during a sample month of July 2007, Deutsche Bank impermissibly utilized borrowed shares to settle approximately 2,500 long sales (out of approximately six million long sale transactions).
4. Between January 3, 2005 and December 30, 2007, the firm allegedly failed to monitor for Archipelago Exchange threshold securities and thus failed to timely close out fails to deliver in such securities. FINRA further alleged that, between January 2005 and approximately December 2008, the firm did not monitor, effect buy-ins, or obtain a valid extension for long sales in certain prime brokerage accounts in which Deutsche Bank had not obtained timely possession of the securities after settlement.
5. Finally, FINRA alleged that the firm failed to maintain proper books and records, submitted inaccurate blue sheets, and failed to supervise reasonably with respect to the activities described above.
6. Deutsche Bank consented to a censure and a \$575,000 fine.
7. In setting the sanction, FINRA considered that the firm implemented numerous information technology improvements that minimize the need to lift the automated block and improved the firm’s Easy-to-Borrow list process.

B. *National Financial Services LLC ("NFS")* (May 13, 2010)

1. FINRA settled a matter with NFS in which it primarily alleged that the firm failed to obtain locates for certain short sales.
2. FINRA alleged that, between June 2005 and approximately August 2008, NFS customers traded through direct market access trading systems that were designed to block the execution of short sale orders without locates. However, the firm utilized a separate manual request and approval process for approximately 12 prime brokerage customers that did not block an unquantified number of short sale orders that did not have locates.
3. According to FINRA, requests for, and approvals of, the locates for these prime brokerage clients were transmitted via e-mail with NFS prime brokerage personnel and were not required to be entered into NFS's stock loan system at the time of approval. FINRA further alleged that, because the e-mailed locates were not documented in a central location, the firm could not accurately assess its remaining availability in each security during a trading day.
4. FINRA alleged that the firm represented that it had terminated these practices effective February 1, 2008, but that the practices continued thereafter with respect to at least one prime brokerage client.
5. The firm allegedly failed to perform a meaningful post-trade-date review of short sale orders to identify orders executed without a valid locate.
6. Between January 2005 and December 2006, NFS allegedly failed to maintain accurate books and records in that locate request records for approximately 100,000 locates were inaccurately maintained due to a programming error.
7. Finally, FINRA alleged that the firm failed to have an adequate supervisory system for confirming reasonable compliance with the locate requirement.
8. NFS consented to a censure and a \$350,000 fine.

Sales Materials

FINRA and the SEC have focused their recent efforts on issues arising from the 2007 and 2008 financial downturn. This case is an example of a litigated matter regarding the marketing and sale of certain bond funds.

A. *FINRA Department of Enforcement v. Morgan Keegan & Company, Inc.* (filed Apr. 7, 2010)

1. FINRA filed a disciplinary complaint against Morgan Keegan, alleging that it marketed and sold certain affiliated bond funds from January 1, 2006 to December 31, 2007 using false and misleading sales materials. Investors in the bond funds allegedly lost over \$1 billion.
2. FINRA alleges that Morgan Keegan did not adequately disclose the risks associated with the bond funds and that its marketing materials misled investors. The complaint alleges that Morgan Keegan marketed the Intermediate Fund and the Short Term Fund as fairly conservative, diversified investments, when in fact, the funds were invested in a number of higher-risk products, including asset-backed and mortgage-backed securities and were not as diversified as represented.
3. The complaint also alleges that, in connection with the Intermediate Fund, Morgan Keegan did not adequately disclose the risks and suitability information to its registered representatives and did not provide adequate training regarding the fund.
4. FINRA also alleges that each of the bond funds had substantial investments in structured products, including subordinated tranches, that were not disclosed in Morgan Keegan's 2007 marketing materials. In 2007, a downturn in the mortgage-backed securities market had a significant negative impact on the performance and value of bond funds.
5. Finally, FINRA's complaint alleges that Morgan Keegan failed to establish, maintain, and enforce a system, including written supervisory procedures, reasonably designed to comply with NASD's advertising rules in connection with the bond funds and, with respect to the Intermediate Fund, to ensure the adequacy of its training and internal guidance.

6. FINRA seeks monetary sanctions. This matter is ongoing.

Securities Lending

FINRA has been active in the stock loan area for several years. Below is a case that settled earlier in 2010.

A. *Ramius Securities LLC* (“Ramius”) (Feb. 22, 2010)

1. FINRA settled a matter with Ramius regarding supervisory violations concerning its securities lending business.
2. FINRA alleged that, between January 2003 and October 2008, a comanager of Ramius’ securities lending department, who was responsible for hard-to-borrow securities, used a finder to locate stock for the firm’s lending transactions. The finder, who had previously been barred by the SEC from the industry, was used for approximately 200 of the firm’s lending transactions in 2003 and 2004. Ramius’ use of the finder was never disclosed in the firm’s books and records because the transaction counterparties paid the finder.
3. Ramius did not have written procedures regarding the use of finders and did not provide oral guidance to its registered representatives. FINRA alleged that, because of the lack of guidance, employees, including those in supervisory positions, had different and conflicting understandings regarding what was a permissible use of finders in stock lending transactions. As a result, the firm did not adequately supervise its use of finders.
4. FINRA also alleged that, between January and May 2004, the firm did not archive Bloomberg e-mails and instant messages sent or received by firm employees.
5. Ramius consented to a censure and \$200,000 fine.

Supervision

Supervision provides a steady stream of cases for FINRA each year. The cases below reflect recent settlements in this area and an important decision in a litigated matter.

A. *H&R Block Financial Advisors, Inc. ("H&R Block") and Andrew MacGill* (Feb. 16, 2010)

1. FINRA settled a matter with H&R Block in which it alleged that the firm failed to establish adequate supervisory systems and written procedures for supervising retail sales of reverse convertible notes ("RCNs").
2. An RCN is a structured product that consists of a high-yield, short-term note of an issuer and a put option that is linked to the performance of a "linked" asset. Upon maturity of an RCN, the investor receives either the full principal of his investment plus interest, or a predetermined number of shares of the linked asset. In addition to the ordinary fixed income product risks, RCNs carry the additional risk of the underlying linked asset, which, depending on performance, could be worth less than the principal investment.
3. FINRA alleged that, between January 2004 and December 2007, H&R Block sold RCNs without having in place an adequate surveillance system to monitor for overconcentration in RCNs. As a result, the firm failed to detect and address such overconcentrations in customer accounts.
4. FINRA alleged that H&R Block failed to provide guidance to its supervising managers to enable them to effectively assess suitability related to RCNs.
5. FINRA alleged that, between May 2007 and November 2007, H&R Block broker Andrew MacGill made unsuitable sales of RCNs to a retired couple who invested nearly 40 percent of their total liquid net worth in nine RCNs.
6. H&R Block consented to a censure and to pay a \$200,000 fine and \$75,000 in restitution.
7. MacGill consented to a fine and disgorgement totaling \$12,023 and a 15-day suspension from associating with any FINRA member firm in any capacity.

B. *Kenneth D. Pasternak and John P. Leighton v. FINRA* (Mar. 4, 2010)

1. The National Adjudicatory Council (“NAC”) issued a decision dismissing charges that Kenneth Pasternak, former CEO of Knight Securities, L.P. (“Knight”), and John Leighton, former head of the firm’s Institutional Sales Desk, failed to reasonably supervise the firm’s leading institutional sales trader, Joseph Leighton (John Leighton’s brother), in connection with alleged fraudulent sales to institutional customers. The decision brought to a close more than five years of proceedings relating to the alleged conduct.
2. The NAC reversed an April 2007 FINRA Hearing Panel decision, which found that Pasternak and John Leighton had violated FINRA’s supervision rule. That ruling fined each respondent \$100,000, barred John Leighton in all supervisory capacities, and suspended Pasternak in all supervisory capacities for two years. Those sanctions were vacated by the NAC’s decision.
3. The NAC concluded that FINRA (then NASD) failed to satisfy its burden of proof concerning allegations set forth in its March 4, 2005 complaint that Pasternak and John Leighton did not take reasonable steps to confirm that Joseph Leighton adhered to “industry standards” when executing orders for institutional customers. The NAC found that FINRA staff did not establish that the trader contravened any market or regulatory standards when providing execution services to institutional customers. The NAC further found that the preponderance of the evidence did not support the allegation that Pasternak and John Leighton failed to reasonably supervise the sales trader’s practices.
4. Finally, the NAC decided that the evidence did not support allegations that Pasternak failed to respond appropriately to certain “red flags” that were raised concerning the manner in which the trader executed institutional customer orders.
5. In August 2005, the SEC filed a separate injunctive action against Pasternak and John Leighton relating to the same issues. In June 2008, a federal judge held that the SEC failed to prove that Pasternak or John Leighton violated the federal securities laws in connection with the firm’s alleged failure to seek best execution and dismissed all charges.

6. In April 2005, Joseph Leighton consented to a permanent bar from association with a broker or dealer and to pay over \$1.9 million in disgorgement, \$660,000 in prejudgment interest, and a \$750,000 civil money penalty to settle the SEC enforcement action, as well as a \$750,000 fine to settle an NASD action.
7. In December 2004, the NASD and SEC settled enforcement actions against Knight under which Knight consented to pay a \$12.5 million fine to NASD, a \$12.5 million civil penalty to the SEC, and pay \$41 million in ill-gotten profits and \$13 million in prejudgment interest into a Fair Fund established by the SEC for compensating harmed investors.

C. *Citigroup Global Markets, Inc.*, FINRA Case No. 20080149558-01 (Apr. 6, 2010)

1. FINRA settled a matter with CGMI in which it alleged that the firm failed to adequately supervise its Direct Borrowing Program (“DBP”) because CGMI implemented no supervisory system and inadequate written procedures tailored to the DBP, and failed to disclose material facts to customers who participated in it.
2. FINRA found that, between January 1, 2005 and November 30, 2008, CGMI operated its DBP, through which it borrowed fully paid securities owned in large part by the firm’s retail customers. The borrowed securities were pooled and used to facilitate other CGMI clients’ short-selling activities. During the relevant time period, CGMI arranged through its DBP for over 4,000 loans, involving over 770 different securities borrowed from over 2,300 customers.
3. FINRA found that CGMI failed to disclose to customers who participated in the DBP certain material information, including that:
 - (a) the securities were hard-to-borrow due to short selling;
 - (b) the interest rates could be reduced by the firm;

- (c) the brokers received commissions based upon the number of shares loaned for the duration of the loan period;
 - (d) while the securities were on loan, dividends were paid as “cash-in-lieu” of dividends and were therefore subject to higher tax rates; and
 - (e) shares on loan could be sold by the customers at any time.
- 4. Branch managers and supervisors were not aware that clients of the brokers they supervised were participating in the DBP. FINRA alleged that the firm’s supervisory tools were compromised because securities that were loaned out of the accounts were not reflected in customers’ positions; exception reports did not properly detect concentration levels; and supervisors could not ascertain the ongoing suitability of loan transactions.
 - 5. FINRA alleged that three versions of CGMI’s publicly distributed marketing materials failed to adequately disclose the risks of the DBP.
 - 6. CGMI consented to a censure, to pay a \$650,000 fine, and to comply with an undertaking that, before it reinstitutes the DBP, the firm must establish a supervisory system to monitor the activities of each registered person relating to the DBP.

D. *J.J.B. Hilliard, W.L. Lyons, LLC* (“J.J.B. Hilliard”) (Apr. 12, 2010)

- 1. FINRA settled a matter with J.J.B.Hilliard in which it alleged that the firm failed to have adequate procedures for identifying customer checks deposited from an affiliated introducing broker from April 21, 1999 through December 31, 2005.
- 2. J.J.B. Hilliard utilized a manual process that occasionally failed to capture certain customer-identifying information from check deposits received.
- 3. As a result of its failure to have adequate procedures in place, J.J.B. Hilliard was unable to identify the proper

customer accounts to post deposits received from the introducing broker. After 60 days, J.J.B. Hilliard transferred the funds to an account designated for abandoned property and eventual escheatment to the Commonwealth of Kentucky.

4. FINRA alleged that more than 8,900 deposits, totaling \$133,000 of customer funds, were never properly identified or credited to the appropriate customer accounts and therefore escheated to the Commonwealth of Kentucky.
5. As a result of its failure, J.J.B. Hilliard was unable to maintain proper books and records, prepare accurate customer account statements, maintain possession and control of customer excess margin securities, and properly service customer cash and margin accounts.
6. FINRA alleged that the firm failed to properly account for the unidentified funds through required reconciliations that should also have been included in the firm's computation of net capital and customer reserves.
7. FINRA alleged that the firm also failed to implement adequate procedures in 2004 and 2005 related to employee public appearances, disclosures to the media and the issuance of research reports.
8. FINRA further alleged that the firm failed to comply with rules governing analyst certifications and required disclosures in certain research reports issued between January and June 2005.
9. J.J.B. Hilliard consented to a censure and to pay a \$200,000 fine. The firm was also required to set aside \$133,817 in an interest-bearing account for five years to reimburse clients who can prove that their funds were not properly deposited.

Unregistered Securities

Unregistered securities offerings, particularly those regarding affiliated offerings, have attracted regulatory scrutiny. The cases below, instituted by both FINRA and the SEC, highlight this issue.

A. *FINRA Department of Enforcement v. McGinn, Smith & Co., Inc., et al.* (filed Apr. 5, 2010); *SEC v. McGinn, Smith & Co., Inc., et al.*, 10-Civ-457 (N.D.N.Y Apr. 20, 2010)

1. FINRA and the SEC brought separate actions against McGinn, Smith & Co. Inc. and related entities for conducting fraudulent unregistered securities offerings involving millions in income notes owed to investors.
2. FINRA alleged that, between September 2003 and November 2006, the firm and its affiliates relied on an exemption provided by Regulation D to issue offerings for four unregistered limited liability companies managed and controlled by David Smith, a principal at the firm. However, the exemption was not available because the four offerings involved more than 35 nonaccredited investors. Further, both Smith and another principal, Timothy McGinn, misused the offering proceeds for their own personal needs or to benefit entities that they owned, controlled or in which they maintained a financial interest. Smith and McGinn did not disclose these transactions to investors and misrepresented to investors exactly the amount of the firm's underwriting/commission fees.
3. FINRA seeks disciplinary sanctions for misuse of proceeds, misrepresentations and omissions, sale of unregistered securities, supervisory violations, and providing false documents to FINRA. FINRA also seeks disgorgement of ill-gotten profits and restitution to investors.
4. The SEC's action relates to more than 20 unregistered debt offerings that raised approximately \$136 million from investors, including the four fund offerings that FINRA cited and numerous trust entities.
5. The SEC alleges that, beginning in 2003, Smith and McGinn funneled investors' money to entities that they owned or controlled in order to provide liquidity to these entities as well as to support Smith's and McGinn's luxurious lifestyles. As of September 2009, investors were owed at least \$84 million, and the four funds had less than \$500,000 in cash on hand, while the trusts had a negative equity of approximately \$18 million and never had the ability to pay the interest rates promised to investors. McGinn and Smith continued to drain the funds of cash into 2010.

6. The SEC obtained an emergency asset freeze and seeks sanctions related to antifraud violations, violations of public offering rules in accordance with the Investment Company Act, and violations of securities offerings rules in accordance with Regulation D. Further, the SEC seeks disgorgement of ill-gotten gains from the defendants as well as civil penalties, disgorgement from relief defendant Lynn A. Smith, and an order prohibiting McGinn from acting as an officer or director of any issuer of certain registered securities.
7. These actions are ongoing.

B. *Fagenson & Co., Inc.* ("Fagenson") (Apr. 9, 2010); *RBC Capital Markets Corporation* ("RBC") (Jan. 4, 2010); *Alpine Securities Corp.* ("Alpine") (Jan. 11, 2010); *Equity Station, Inc.* ("Equity Station") (Jan. 20, 2010); *Olympus Securities, LLC* ("Olympus") (Jan. 29, 2010)

1. FINRA settled actions against five broker-dealer firms in which it alleged that they unlawfully sold shares of unregistered stock into the market on behalf of clients.
2. FINRA alleged that the firms permitted their customers to deposit millions or billions of shares of USXP securities in certificate form and immediately liquidate those positions. The firms failed to conduct proper inquiries, and four of the firms (all except Equity Station) failed to maintain an adequate supervisory system, to determine the registration status of securities of Universal Express, Inc. (USXP) before permitting the shares to be sold into the market. Instead of conducting their own inquiries, the firms relied on transfer agents, clearing brokers, or customer questionnaires to satisfy their obligation to perform a reasonable inquiry. As a result, the firms allegedly missed red flags indicating that their clients' sales constituted illegal distributions.
3. FINRA alleged that an appropriate inquiry would have revealed that, prior to these sales, the SEC brought an injunctive action against USXP and certain of its executives relating to their issuance and promotion of hundreds of millions of shares of unregistered stock for public distribution, which led USXP to disgorge approximately \$12 million in gains and pay a civil penalty of approximately \$10 million.

4. The actions filed against Alpine, Equity Station, and Olympus solely involved USXP securities. FINRA alleged that Fagenson and RBC permitted their customers to sell shares of unregistered stock of nine and seven other issuers besides USXP, respectively.
5. FINRA also alleged that Fagenson failed to establish adequate anti-money laundering policies and failed to comply with its then-existing anti-money laundering policy by missing red flag alerts referenced in the policy and by failing to file suspicious activity reports required by the Bank Secrecy Act.
6. Each of the firms consented to a censure and to pay the following fine:

Firm	Fine
Fagenson	\$165,000
RBC	\$135,000
Alpine	\$40,000
Equity Station	\$25,000
Olympus	\$20,000