

Morgan Lewis

review



U.S. SEC, FINRA and NYSE Regulation:  
Mid-Year Review – Selected Broker-Dealer  
Enforcement Cases and Developments

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## Executive Summary

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This outline highlights selected U.S. Securities and Exchange Commission (“SEC” or the “Commission”), Financial Industry Regulatory Authority (“FINRA”), and NYSE Regulation enforcement actions and developments regarding broker-dealers from January through June 2008.\*

Picking up where it left off last year, in the first six months of 2008 the SEC brought or litigated actions relating to insider trading, on-line account intrusion, Regulation S-P, stock loan, conflicts of interest, and best execution. The Commission also spent time, effort and resources litigating several market timing and late trading cases. Recently, the SEC launched examinations and investigations concerning new topics, such as the malicious creation and spread of rumors intended to manipulate securities prices and showed a renewed interest in auction rate securities following the issues that arose recently in that market. A discussion of SEC enforcement statistics, priorities, actions, and new initiatives, policies, and procedures in the first half of 2008 can be found on pages 3 - 30 of this outline.

This year is the first full year since the merger of NASD Regulation and NYSE Regulation and the resulting creation of FINRA in late July 2007. As we reported in the 2007 Year in Review outline, the number of cases brought by FINRA and the amount of fines in those cases were down from levels that NASD Regulation and NYSE Regulation combined brought in prior years. During the first half of 2008, FINRA brought enforcement actions on various traditional topics, including variable annuities, mutual fund sales practices, disclosures, markups, municipal securities, and form filings. In addition, a sweep action relating to trade volume reporting and a multi-firm OATS case were announced this year. FINRA has also devoted substantial time and energy to creating a single rulebook, examination program, and enforcement arm. Those steps are now well under way or have been completed. A discussion of FINRA’s enforcement statistics, priorities, actions, and new developments between January and June 2008 can be found on pages 31 - 51 of this outline.

Notwithstanding the merger, NYSE Regulation retained oversight and enforcement responsibility for trading violations occurring on the NYSE’s systems and facilities. In

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addition to its own actions in this area, in the first half of 2008, NYSE Regulation released decisions in cases that were in its pipeline prior to the mid-2007 merger. As a result, NYSE Regulation announced a number of enforcement actions in 2008 against broker-dealers and individuals – albeit at substantially reduced levels – on a variety of topics, including order marking, supervision of post-execution changes and odd lot trading. A discussion of NYSE Regulation’s enforcement actions from January through June 2008 can be found on pages 52 - 57 of this outline.

As in the past, we intend to issue our full Year in Review in late January. At that time, we will report on the year’s enforcement activity at the SEC, FINRA and NYSE Regulation, and also describe several key state actions against broker-dealers, as state securities regulators have been active players in recent months.

## Statistics and Enforcement Priorities

### Statistics

By way of background, in the SEC's fiscal year ("FY") 2007, the SEC initiated 656 enforcement actions (262 civil proceedings and 394 administrative proceedings).<sup>1</sup> This was a 14% increase in the number of enforcement actions over FY 2006. The increase in the number of cases initiated in FY 2007 may be explained, in part, by a 57% increase in SEC enforcement actions involving financial disclosure. The Commission also reported a 52% drop in the amount of disgorgement and penalties in its actions in FY 2007 to approximately \$1.6 billion (\$507 million in fines and \$1.1 billion in disgorgement) from \$3.3 billion in FY 2006.

While the Commission has brought some significant actions in the enforcement area earlier this year, there are no statistics of which we are aware that reflect the number of cases brought so far in FY 2008 or the civil penalties and disgorgement obtained. Therefore, it remains to be seen whether the SEC will bring more and bigger cases this year than previously.

### SEC Enforcement Priorities

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

1. Auction rate securities;
2. Valuation of securities;
3. Sales of mortgage-related securities, including suitability, disclosures, and extent of due diligence (coordinated with the SEC's Subprime Task Force, which will address aspects besides enforcement);
4. Insider trading and controls over material, non-public information;

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<sup>1</sup> The SEC's fiscal year begins on October 1st. For example, references to FY 2007 refer to the year that began on October 1, 2006 and ended on September 30, 2007.

5. Trading, including issues involving best execution and short sales;
6. Conflicts of interest;
7. Protection of client assets and information, including Regulation S-P;
8. Internet fraud (led by the SEC's Office of Internet Enforcement); and
9. Fraud in the municipal securities markets.

## Enforcement Actions<sup>2</sup>

### Market Timing/Late Trading

For several years, market timing and late trading had been hot topics in SEC enforcement. It now appears that that pipeline of cases is running dry. Of note, however, is that while most market timing and late trading cases in prior years have been settled, this year saw the issuance of several opinions in litigated cases.

- A. *In the Matter of Trautman Wasserman & Company, Inc* ("TWCO"), *Gregory O. Trautman, Samuel M. Wasserman, Mark Barbera, James A. Wilson, Jr., Jerome Snyder and Forde H. Prigot* (Admin. Proc. File No. 3-12559, Jan. 14, 2008)
  1. In a contested administrative proceeding, the SEC alleged that TWCO, Trautman (TWCO's president, CEO, and majority shareholder), and Wasserman (TWCO's chairman) violated the federal securities laws by engaging in a scheme to defraud mutual funds by market timing and late trading.
  2. Between January 2001 and September 2003, the Commission asserted that TWCO accepted thousands of orders from its hedge fund clients to trade mutual funds after 4 pm EST, but time-stamped the order tickets for those trades as though they had been received prior to 4 pm in order to enable them to occur at the same day's net asset value price.
  3. When the mutual funds attempted to halt market timing transactions by limiting the number of transactions in a client's account, the SEC alleged that the TWCO officers deceived the mutual funds by

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<sup>2</sup> Unless otherwise apparent from the context of the descriptions of the actions, the cases described herein are settlements in which respondents have neither admitted nor denied the allegations against them.

opening new accounts and continuing to trade under the radar for clients after they had received notice prohibiting further trading.

4. TWCO defaulted in the proceedings by not filing an answer. The ALJ determined that even if TWCO had not been in default, it would be liable for violations of Section 17(a)(1) of the Securities Act, Section 10(b) of the Exchange Act, and Exchange Act Rule 10b-5 because the market timing and late trading conduct of senior personnel was imputed to the company. The ALJ revoked TWCO's registration and ordered the firm to disgorge the amount of its assets up to \$9,040,000 and pay a civil monetary penalty of \$500,000.
5. The ALJ did not find Trautman's testimony to be credible and found that he violated Section 17(a)(1) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder, and aided and abetted and caused a mutual fund company's violations of Rule 22c-1 in connection with TWCO's late trading. The ALJ issued a cease-and-desist order and a permanent bar against Trautman and ordered him to disgorge more than \$1.3 million and to pay a civil monetary penalty of \$500,000.
6. The ALJ found Wasserman's testimony credible; she found that Wasserman was not actively involved in the firm's mutual fund trading and did not act with scienter and therefore was not liable for the same violations as Trautman. However, the ALJ found that Wasserman acted negligently and therefore violated Sections 17(a)(2) and 17(a)(3) of the Securities Act. The ALJ barred Wasserman from serving as a supervisor and ordered him to disgorge \$25,000, but rejected the Enforcement staff's requests for a cease-and-desist order, permanent bar, civil monetary penalty, and a larger disgorgement amount. In fashioning a remedy, the ALJ considered that Wasserman was unaware of TWCO's illegal conduct and "suffered substantial financial losses and damage to his professional reputation as a result of his relationship with TWCO."
7. On February 14, 2008, the SEC settled matters involving former TWCO employees Mark Barbera (TWCO's CFO) and Forde Prigot (TWCO's compliance officer) in connection with the firm's market timing and late trading activities. Each consented to a cease-and-desist order and a six-month suspension. In addition, Prigot consented to a \$30,000 civil money penalty.

B. *SEC v. Gann* (N.D. Tex. Mar. 31, 2008)

1. The SEC brought a civil action against Gann, a former Vice-President and stockbroker with Southwest Securities, Inc., alleging that he engaged in a fraudulent scheme to conceal deceptive market timing by his clients, Haidar Capital Management and Capital Advisor (“HCM”).
2. While performing due diligence on HCM, the SEC alleged that Gann became aware that HCM was engaged in market timing and evaded detection by trading through multiple accounts and multiple registered representative numbers. Gann testified that as a result, he contacted mutual fund companies to understand their policies and established policies to only trade for HCM with mutual fund companies that did not prohibit HCM’s trading strategy.
3. However, the Commission asserted that Gann opened multiple accounts for HCM and used multiple registered representative numbers to place HCM’s trades. After receiving several “block notices” from mutual fund companies (in all, 69 block notices from 34 fund families), Gann switched to a different office number (although he had not changed locations), used a different representative number or traded through accounts that had not been blocked.
4. After a three-day trial, the Court held that Gann’s actions were “intentionally geared toward evading detection by the mutual fund managers.” Accordingly, his actions constituted “material misrepresentations made in the course of buying securities.”
5. The Court enjoined further violations, ordered disgorgement of \$54,640.67, and imposed a civil penalty of \$50,000.

C. *In the Matter of Thomas C. Bridge, James D. Edge, and Jeffrey K. Robles* (Admin. Proc. File No. 3-12626, Mar. 10, 2008)

1. In a contested administrative matter, the SEC alleged that market timing by Bridge, an assistant branch manager at A.G. Edwards & Sons, Inc (“AGE”), violated the federal securities laws and that Edge, Bridge’s direct supervisor, and Robles, a manager for a different branch, failed to adequately supervise Bridge and another registered representative to prevent the market timing-related violations.
2. An ALJ found that Bridge violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10-5 promulgated thereunder by continuing to market time mutual funds after the mutual fund companies sent numerous block letters to Bridge

imposing restrictions on such transactions and threatening to cancel transactions. Bridge used multiple account numbers and FC numbers and moved accounts between branch offices to avoid detection.

3. The ALJ found Edge liable for failing to supervise Bridge. Edge was aware of the numerous block letters concerning Bridge's market timing but allowed Bridge to continue to market time and even approved Bridge's efforts to conceal the market timing trading from mutual fund companies. In addition, Edge did not inform his direct supervisor of the block letters or the steps taken to evade detection by mutual fund companies.
4. The ALJ found Robles liable for failing to reasonably supervise Charles Sacco, another AGE financial consultant. After Sacco received hundreds of block letters from mutual funds for market timing, Robles approved thirteen split FC numbers for Sacco and opened hundreds of new accounts to evade detection by the mutual funds. Robles also failed to detect market timing trading on daily trading reports that he was obligated to review as a supervisor and failed to inform his supervisor of block letters concerning Sacco's trading.
5. The ALJ issued a permanent bar and a cease-and-desist order against Bridge and ordered him to disgorge approximately \$40,000 and pay a \$250,000 civil monetary penalty.
6. The ALJ ordered Robles and Edge to each pay \$250,000 in civil penalties and barred them from serving in supervisory capacities for five years.

## **Insider Trading**

In 2007, the U.S. Department of Justice and the SEC prosecuted a number of insider trading cases, many of which involved Wall Street employees. In 2008, further developments occurred in those cases, and the SEC filed several new insider trading-related actions.

- A. *U.S. v. Guttenberg* (S.D.N.Y. Feb. 27, 2008) and *SEC v. Guttenberg, et al.* (S.D.N.Y. Mar. 1, 2007)
  1. The SEC charged fourteen defendants in connection with two related insider trading schemes in which Wall Street professionals allegedly traded after receiving a series of tips from insiders at UBS Securities LLC and Morgan Stanley & Co., Inc. in exchange for cash kickbacks.

2. In one scheme, which occurred between 2001 through 2006, an executive director in the UBS equity research department allegedly tipped material non-public information concerning upcoming UBS analyst upgrades and downgrades to at least two Wall Street traders in exchange for a portion of the profits from the trading. In the second scheme, several of the participants in the first scheme, and others, allegedly traded ahead of corporate acquisition announcements after receiving inside information stolen by an in-house attorney in Morgan Stanley's global compliance department.
3. In a related criminal case, the U.S. Attorney's Office for the Southern District of New York criminally charged thirteen alleged participants in the fraudulent scheme, a number of whom have since pled guilty.
  - (a) In January 2008, Laurence McKeever, an Assent LLC ("Assent") employee pled guilty to charges that he conspired to conceal illegal trading in exchange for \$50,000. On May 20, 2008, he was sentenced to two years probation.
  - (b) In February 2008, Mitchel Guttenberg, a former UBS Securities LLC executive director, pled guilty to 6 counts of conspiracy and securities fraud, in which he allegedly sold material non-public information about prospective upgrades and downgrades generating at least \$15 million in illegal profits for hedge funds with a collaborator and \$10 million for his own account. He faces up to 90 years in prison.
  - (c) In April 2008, Samuel Childs, an Assent registered representative, pled guilty to conspiracy to commit securities fraud, wire fraud, and commercial bribery. Childs had determined that two Assent clients were trading while in possession of material, non-public information. Childs accepted \$100,000 in exchange for agreeing not to report the illegal trading to his superiors. Childs faces a maximum sentence of two years in prison.

B. *SEC v. One or More Unknown Purchasers of Call Options for the Common Stock of TXU Corp.* (N.D. Ill. May 4, 2007)

1. In May 2007, the SEC charged Hafiz Naseem, a Credit Suisse investment banker, with misappropriating material, non-public information involving several business deals in which Credit Suisse served as an investment banker or a financial adviser. Naseem allegedly passed the information to Ajaz Rahim, a Pakistani banker employed by Faysal Bank, who was also charged by the SEC.

Rahim traded while in possession of the tips and earned millions of dollars in profits.

2. Federal prosecutors also charged Naseem and Rahim with securities fraud and conspiracy. In February 2008, a jury found Naseem guilty of 28 counts of insider trading and conspiracy to commit securities fraud. In June 2008, he was sentenced to 10 years in prison followed by three years of supervised release and ordered to forfeit \$7.5 million.
3. The SEC's case against Naseem had been on hold pending resolution of the criminal case. The SEC seeks injunctive relief, disgorgement, and a civil penalty against Naseem and Rahim.

C. *SEC v. Chanin Capital LLC* (D.C. Apr. 28, 2008) and *In the Matter of A. Carlos Martinez* (Admin. Proc. File No. 3-13032, May 1, 2008)

1. The SEC filed a civil complaint against Chanin Capital LLC ("Chanin"), a broker dealer, for failing to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of material nonpublic information, as required under Section 15(f) of the 1934 Act.
2. The SEC alleged that between 1999 and September 15, 2003, Chanin had no consistent system for collecting signed acknowledgements or ensuring compliance with the firm's insider trading prevention policies. The firm lacked records evidencing that any employee sought or received pre-clearance to place a single securities trade. Although it had more than 35 employees at the time, Chanin did not collect more than four signed insider trading policy acknowledgements in 1999, 2000, or 2001.
3. The SEC alleged that while Chanin's policies and procedures improved in 2003, they were still insufficient. For example, beginning in 2003, Chanin held mandatory training sessions related to the insider trading policy but did not track which employees attended. As another example, Chanin required employees to disclose their existing personal trading accounts, but it did not compel disclosure of accounts that employees opened subsequently. Finally, Chanin failed to collect signed insider trading policy acknowledgements from all employees, including Chanin's two principals.
4. Chanin consented to judgment against it and a \$75,000 penalty.
5. A. Carlos Martinez, who served as Chanin Capital's CFO and its Chief Compliance Officer, was responsible for implementing and enforcing the firm's insider trading prevention policies and

procedures. In a companion administrative proceeding against him, the SEC alleged that Martinez willfully aided and abetted Chanin's violations by failing to maintain policies and procedures to prevent the misuse of material non-public information.

6. Martinez consented to a cease-and-desist order against future violations, a censure, and a civil penalty of \$25,000.
7. This appears to be the first time that the SEC has brought charges against a Chief Compliance Officer for aiding and abetting violations of 15(f). It also appears to be the first time that the SEC has implied that failing to adopt policies that the SEC staff has said it views as "minimum standards," but not required by the Exchange Act, could result in liability under 15(f).

### **On-Line Account Intrusion**

In last year's outline, we reported on two SEC cases involving on-line account intrusion. In the first half of 2008, the SEC already has brought two additional cases on this topic.

#### **A. *SEC v. Anatoly Russ* (S.D.N.Y. Jan. 16, 2008)**

1. The SEC filed a civil action against Russ, a Russian citizen, alleging that he placed unauthorized orders in online brokerage accounts as part of a fraudulent scheme to control the prices at which he purchased and sold options in ETFs.
2. Russ obtained brokerage firm clients' usernames and passwords and used them to gain unauthorized access to the clients' online brokerage accounts. He then executed purchase and sell orders in those accounts that were opposite from orders he had placed in his own accounts. Because the options were so thinly traded, Russ was able to control the prices for his own purchase and sell orders, earning guaranteed profits in his own accounts.
3. Russ realized illegal profits of at least \$88,465 and caused losses of at least \$339,929 in the accounts to which he gained unauthorized access.
4. The SEC seeks a permanent injunction, disgorgement, prejudgment interest, and civil penalties.
5. As with instances involving similar fraudulent conduct in the past two years, the online brokers housing the accounts made the intruded accountholders whole for their losses.

- B. *SEC v. One or More Unknown Traders in the Common Stock of Certain Issuers a/k/a AWE Trading, Inc. and Andrew Andersen* (E.D.N.Y. Apr. 7, 2008)
1. The SEC filed a complaint alleging unknown traders fraudulently opened brokerage accounts in the names of unsuspecting individuals, gained unauthorized access to trading accounts of other clients of retail brokerage firms and profited by executing unauthorized securities transactions in those accounts.
  2. The unknown traders posted fake job postings on Craigslist. The traders allegedly opened online securities trading accounts in the names of individuals who responded to the job postings without their knowledge using personal identifying information that the applicants provided. The traders also gained unauthorized access to retail client accounts at various brokerage firms. Simultaneously, the traders executed transactions in the same securities in both sets of accounts on opposite sides of the market, causing the accounts that they opened to profit and causing losses in the accounts that they accessed without authorization. By taking advantage of the price and volume movements in the stocks, the traders gained approximately \$66,000.
  3. The SEC seeks an injunction and an order requiring defendants to repatriate any assets that they hold outside the United States, disgorge their gains, and pay civil money penalties.

### **Auction Rate Securities**

Perhaps the topic that received the most media and industry attention in recent months was auction rate securities, as the SEC, FINRA and more than a dozen state securities regulators reportedly launched inquiries in this area. While the media has reported SEC investigations relating to sales practices by broker-dealers, through June 30, 2008, the only action initiated by regulators in this particular area was brought by the Commonwealth of Massachusetts.<sup>3</sup> The only SEC action in 2008 pertains to bidding practices, similar to the Commission's actions in 2006 and 2007.

- A. *In the Matter of First Southwest Company* ("First Southwest") (May 27, 2008 Admin. Proc. File No. 3-13046)
1. The SEC alleged that, between January 2003 and the first half of 2004, First Southwest wrongly intervened in auctions for auction rate securities by placing bids for its proprietary account to prevent failed and all-hold auctions.

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<sup>3</sup> *In the Matter of UBS Securities, LLC & UBS Financial Services, Inc.*, Docket No. 2008-0045 (Mass. Securities Division Admin. Proc. filed on June 26, 2008).

2. The SEC alleged that First Southwest did not adequately disclose that it submitted bids to ensure the auctions would clear and to prevent all-hold auction outcomes, which sometimes affected the clearing rate.
3. First Southwest agreed to entry of a cease-and-desist order, censure, and civil penalty of \$150,000.

## Conflicts Of Interest

In the first half of 2008, the SEC brought cases involving conflicts of interest in a variety of contexts, including gifts and gratuities, the independent selection of recommended mutual funds, research reports, and the awarding of securities business by municipalities.

- A. *In the Matter of Fidelity Management & Research Company and FMR Co., Inc.* (collectively, "Fidelity") (Admin. Proc. File No. 3-12976 Mar. 5, 2008)
  1. The SEC brought a settled action against Fidelity, alleging that certain of its equity traders allowed their receipt of travel, entertainment, gifts and gratuities ("TEGG") from, or their relationships with, brokerage firm employees to influence the mutual fund firm's allocation of order flow to brokers.
  2. The SEC alleged that between January 2002 and October 2004, ten Fidelity traders and two senior executives (Scott DeSano and Bart Grenier) received TEGG worth approximately \$1.6 million from brokerage firms that provided, or sought to provide, brokerage services to Fidelity. During the same period, certain Fidelity equity traders placed fund trades with brokers with whom they had personal or familial relationships.
  3. Fidelity allegedly violated Section 206(2) of the Advisers Act because: (1) its equity traders allowed TEGG and personal relationships to factor into broker selection in violation of the duty to seek best execution, and (2) Fidelity failed to disclose TEGG and personal relationships among its broker selection factors in its Form ADV and the funds' SAs.
  4. The SEC alleged that Fidelity, through DeSano, failed to reasonably supervise the equity traders. DeSano, as head of the equity trading desk, was aware that the equity traders had benefited from lavish TEGG because he attended certain of the trips. DeSano did not monitor their receipt of TEGG "on a systematic basis" for compliance with the firm's gifts and gratuities policy and to prevent the equity traders from receiving compensation in the form of TEGG in exchange for allocated

brokerage. The SEC settlement Order notes that although much of the TEGG violated the firm's gifts and gratuities policy, none of the twelve individuals sought or received an exception to the policy.

5. The SEC also alleged that Peter Lynch (vice chairman and director of Fidelity and formerly a Fidelity portfolio manager) periodically requested and obtained tickets to events from two equity traders, who obtained them from brokers. As a result, Lynch allegedly caused the equity traders to accept compensation in exchange for fund order flow in violation of the Investment Company Act.
6. On the day that the SEC issued the release announcing its settlement with Fidelity, the SEC also released orders: (1) announcing its settlement with Peter Lynch, Bart Grenier, and one equity trader (Marc Beran), and (2) bringing charges against DeSano and the remaining nine equity traders named in Fidelity's order (Tom Bruderman, Tim Burnieika, Robert Burns, David Donovan, Ed Driscoll, Jeffrey Harris, Christopher Horan, Steve Pascucci, and Kirk Smith). The latter cases are in litigation.

**B. *In the Matter of Banc of America Investment Services, Inc. and Columbia Management Advisors, LLC (as successors in interest to Banc of America Capital Management, LLC)* (Admin. Proc. File No. 3-13030, May 1, 2008)**

1. The SEC settled an administrative proceeding against Banc of America Investment Services ("BOA-IS") and Banc of America Capital Management ("BOA-CM") in which it alleged that between July 2002 and December 2004, BOA-IS misled clients and violated its fiduciary duty by recommending funds that BOA-CM advised without evaluating them through the process set forth in its promotional literature.
2. The SEC alleged that beginning in 2002, BOA-IS delegated the task of choosing recommended funds to BOA-CM, its affiliate, in connection with its mutual fund wrap fee program. BOA-CM established a six-step research process, which was intended to provide unbiased recommendations and was summarized in its promotional literature. These steps included screening a "vast universe of available investment managers" on "competitive absolute performance" and "credible length of track record," as well as assessing funds on their competitive returns.
3. BOA-CM did not follow the objective research process and instead favored proprietary funds that paid management fees and other fees to BOA-CM. The recommended funds had lower historical returns and less experienced portfolio managers than those that

would have been recommended if BOA-CM had followed the objective research process.

4. The SEC alleged that the respondents failed to adequately disclose their conflict of interest and that BOA-IS's disclosures were inaccurate and incomplete because they failed to disclose that BOA-CM did not follow the objective research process. As a result, BOA-IS violated Sections 17(a)(2) and (3) of the Securities Act, as well as provisions of the Advisers Act, and BOA-CM aided and abetted BOA-IS's violations of the Advisers Act.
5. Respondents consented to cease-and-desist orders. In addition, BOA-IS consented to pay disgorgement of \$3,310,206 and a civil penalty of \$2,000,000 and to several undertakings (i.e., website disclosures of the settlement and its process for selecting recommended mutual funds for its wrap program, periodic disclosures to clients of mutual funds advised by its affiliates, and a comprehensive review of the firm's process for selecting mutual funds and the adequacy of its related disclosures). BOA-CM consented to pay disgorgement of \$2,143,273 and a civil penalty of \$1,000,000.

C. *In the Matter of the Application of Robert E. Strong* (Admin. Proc. File No. 3-12599 Mar. 4, 2008)

1. The SEC reviewed disciplinary action taken by the National Adjudicatory Counsel ("NAC") of NASD Regulation against Robert E. Strong, Chief Compliance Officer of Jesup & Lamont Securities Corp. ("J&L"). The NAC found, among other things, that Strong failed to supervise the personal securities trading of a J&L research analyst in violation of NASD Conduct Rules.
2. The NAC decision affirmed in part and modified in part an NASD Regulation hearing panel decision imposing a 9-month suspension and a \$15,000 fine. The NAC reduced the fine to \$10,000 and set aside the suspension entirely.
3. As J&L's Chief Compliance Officer, Strong was allegedly responsible for J&L's compliance with an NASD rule that restricted the personal trading of research analysts and mandated the inclusion of certain disclosures in research reports. Strong revised J&L's written supervisory procedures to require prior approval by the Chief Compliance Officer before any research analysts could place a personal securities transaction. According to the new procedures, the Chief Compliance Officer was required to retain evidence of his review of analysts' trading.

4. The SEC found no evidence that Strong ever reviewed analysts' trading, discussed the pre-approval requirement with employees, or provided training on the procedures so that employees understood and would follow the requirements.
  5. Between July 2, 2002 and September 30, 2003, a J&L research analyst (Davis) executed approximately 178 trades without prior approval from Strong. Of those, 41 transactions were sales of stock that Davis had recently recommended as "buys" or "strong buys." The trades netted Davis a gain of \$116,000.
  6. Strong began reviewing analysts trading in April 2003 and discovered that Davis was trading without pre-approval; however, he did not take action to address the issue with Davis until August 2003 when he told Davis to get prior approval before trades. Strong neither addressed the compliance violations internally nor informed NASD Regulation of Davis' misconduct or the Firm's non-compliance with the NASD rule.
  7. The SEC affirmed the NAC's fine of \$10,000 and imposition of costs against Strong.
- D. *SEC v. Larry P. Langford, William B. Blount, Blount Parrish & Co., Inc, and Albert W. LaPierre* (N.D. Ala. Apr. 30, 2008)
1. The SEC brought charges against Larry Langford, the mayor of Birmingham, Alabama and former president of the Jefferson County commission, and others for allegedly violating federal securities laws in connection with municipal bond and security-based swap transactions.
  2. The SEC alleges that between July 2002 and August 2004, Langford received more than \$156,000 in cash and benefits from his friend, William Blount, chairman of a small Montgomery broker-dealer and municipal securities dealer, in exchange for awarding every county bond offering or swap agreement to Blount's firm, Blount Parrish & Co., resulting in over \$6.7 million in fees to the firm. In the five prior years (before Langford became president of the county commission), Blount Parrish & Co. had not participated in any county bond offerings.
  3. The defendants allegedly failed to disclose to Jefferson County or investors any of the payments or benefits provided by Blount directly or indirectly through a mutual friend Albert LaPierre. The SEC alleges that this course of conduct was fraudulent and deceitful and deprived Jefferson County and investors of objective

and impartial bond underwriting processes and swap agreement negotiations.

4. The SEC seeks a declaratory judgment, a permanent injunction, disgorgement of profits, and civil penalties. All three individual defendants, as well as Blount Parrish & Co. have filed motions to dismiss the Commission's complaint.

## **Stock Loan**

The actions described below represent the most recent in a line of stock loan matters brought by securities regulators in the past few years. Notably, in addition to defending regulatory enforcement matters, several individuals have pled guilty in related cases brought by the Department of Justice.

- A. *In the Matter of Michael McCormack* (Admin. Proc. File No. 3-13041, May 9, 2008)
  1. On August 28, 2007, in a criminal action brought against him by the U.S. Attorney's Office, McCormack, a former A.G. Edwards securities lending representative, pled guilty to one count of conspiracy to commit wire fraud.
  2. The allegations against McCormack included claims that he engaged in inappropriate stock loans through a finder firm that collected fees from other stock loan representatives but did not offer legitimate finder services. Through A.G. Edwards, McCormack entered into stock loan transactions with firms in which the rebates paid were less favorable than those available in the marketplace.
  3. The SEC barred McCormack from association with any broker or dealer. In the criminal action, McCormack was ordered to pay \$900,000 in restitution and sentenced to three years imprisonment.
- B. *SEC v. Robert Durant, Robert Johnson, Lori Caporicci, James Bennett, Tyde, Inc., Bearcat Financial Services, Inc.* (E.D.N.Y. Apr. 15, 2008)
  1. The SEC filed a complaint charging 6 defendants with engaging in a scheme to defraud JP Morgan Chase Bank ("Chase") through sham finder's fees in connection with stock loan transactions.
  2. The complaint alleges that Durant, a Chase stock loan trader, negotiated seven loans of hard-to-borrow Italian stocks to Dresdner Kleinwort Wasserstein Securities LLC ("DKW") without the help of a finder. Durant then falsified records of the loan agreement to state that Bearcat had provided the finding services. As a result, DKW

paid Bearcat \$1.2 million in finder's fees that should have been paid to Chase as interest. These funds were shared by the defendants, who each allegedly participated in the fraudulent scheme.

3. The SEC seeks permanent injunctions, disgorgement, prejudgment interest, and civil penalties.
4. On June 4, 2008, Durant consented to a settlement with the SEC that barred him from association with a broker dealer.

## Rumor Spreading

The following settled administrative proceeding alleging the creation and dissemination of false or misleading rumors to manipulate the price of securities received a significant amount of attention from the media and Wall Street.<sup>4</sup>

- A. *In the Matter of Paul S. Berliner* (Admin. Proc. File No. 3-13035, May 5, 2008)
  1. The SEC settled an administrative proceeding against Berliner, a trader formerly associated with Schottenfeld Group LLC ("Schottenfeld"), for his dissemination of a false rumor involving The Blackstone Group's ("Blackstone") acquisition of Alliance Data Systems ("ADS"). Berliner allegedly started the rumor to cause ADS's stock price to drop, enabling him to profit from his short sales in its stock.
  2. Berliner allegedly sent instant messages to 31 traders and other securities professionals in which he intentionally and falsely claimed that ADS's board of directors was meeting to consider a revised proposal from Blackstone to acquire ADS at a significantly lower price of \$70 per share because ADS was "getting pounded."
  3. The rumor rapidly spread throughout Wall Street and the media, leading to heavy trading in ADS stock and causing its stock price to fall from \$77 per share to \$63.65 in thirty minutes. Minutes earlier, Berliner allegedly sold short thousands of shares of ADS stock, earning approximately \$25,000 in profits.
  4. In announcing this case, Scott Friestad, Associate Director of the SEC's Division of Enforcement, said, "Conduct like this is

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<sup>4</sup> For more information on this topic, we refer you to FINRA News Release, Self-Regulators Warn Against Spreading False Rumors and Other Abusive Market Activity (Mar. 31, 2008); SEC Press Release 2008-140, Securities Regulators to Examine Industry Controls Against Manipulation of Securities Prices Through Intentionally Spreading False Information (Jul. 13, 2008); and NYSE Regulation, NYSE Market Surveillance Sweep Letter on Rumors (Jul. 14, 2008).

particularly insidious because it harms investors by distorting the information they use to make investment decisions.”<sup>5</sup>

5. Berliner consented to findings that he violated Section 17(a) of the Securities Act, Sections 9(a)(4) and 10b of the Exchange Act and Rule 10b-5 promulgated thereunder. Berliner consented to a permanent bar, disgorgement of his trading profits, and a civil penalty of \$130,000.

## Regulation S-P

Regulation S-P prohibits a firm from disclosing non-public personal information to nonaffiliated third parties without first notifying the subject and offering the subject an opportunity to opt out. Below are two litigated cases involving Regulation S-P from the first half of 2008.<sup>6</sup>

- A. *In the Matter of NEXT Financial Group, Inc.* (“NEXT”) (Admin. Proc. File No. 3-12738, June 18, 2008)
  1. The SEC alleged that NEXT violated Regulation S-P by permitting its registered representatives who were leaving the firm to take clients’ personal information with them. The SEC also alleged that NEXT aided and abetted other firms’ violations of Regulation S-P by assisting newly hired registered representatives in taking non-public personal information concerning their clients from their former firm and sending it to NEXT.
  2. An ALJ concluded that NEXT willfully violated Regulation S-P because before representatives ceased to work for NEXT and joined a new firm, they disclosed clients’ social security numbers, dates of birth, and banking information. The ALJ found that NEXT’s privacy notice did not inform customers that the firm permitted departing registered representatives to disclose personal information to third parties and that NEXT did not provide customers with a reasonable opportunity to opt out of this disclosure.
  3. The ALJ further concluded that NEXT knew that registered representatives likely would disclose clients’ personal identifying information to new employers but did not establish policies or

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<sup>5</sup> SEC Press Release 2008-64, SEC Charges Wall Street Short-Seller With Spreading False Rumors (Apr. 24, 2008). We note that in the first half of 2008, Walter Ricciardi and Peter Bresnan, formerly co-Deputy Directors of SEC Enforcement, left the Commission and were replaced by Scott Friestad and George Curtis.

<sup>6</sup> On March 11, 2008, the SEC proposed amendments to Regulation S-P requiring more specific standards under the safeguards rule, amending the scope of the information covered by the safeguards and disposal rules, requiring written records of policies and procedures and compliance with same, and a new exception to the regulation’s notice and opt-out requirements.

procedures until February 2006 for safeguarding this information and was therefore at least negligent.

4. Notably, the ALJ rejected the SEC staff's argument that existing regulations required NEXT to encrypt its emails containing customer data.
5. The ALJ entered a cease-and-desist order and a civil penalty of \$125,000 against NEXT but did not order the more severe penalty of \$325,000 requested by the SEC staff because of mitigating factors, such as no actual harm to customers, no prior violations for the firm and no evidence of unjust enrichment that could be quantified.

B. *SEC v. Sidney Mondschein* (N.D. Cal. Apr. 14, 2008)

1. In a case filed in federal court in 2007, the SEC alleged that between December 2002 and August 2005, Sidney Mondschein, a former WFG Investments Inc. ("WFG") registered representative, illegally profited by selling insurance agents the names and other confidential personal information of over 500 customers. Mondschein sold this confidential information as sales "leads" to enable the insurance agents selling annuities to solicit these customers, many of whom had already purchased fixed or equity-indexed annuity products, to buy additional annuity products. Many of these "leads" were elderly persons.
2. The SEC alleged that in exchange for selling the "leads," Mondschein accepted cash as well as kickbacks. Many of the insurance agents who received the "leads" recommended to their clients that they use Mondschein, instead of their existing broker, to sell securities to fund their annuity purchases, enabling Mondschein to collect additional brokerage commissions and fees.
3. In April, 2008, the case settled. Mondschein consented to a permanent injunction against violating Section 10(b) and Rule 10b-5 of the Exchange Act and aiding and abetting any violations of Rules 4(a) and 5(a) of the Exchange Act and 10(a)(1) of Regulation S-P. Mondschein also consented to disgorgement of \$53,000, a civil penalty of \$45,000 and a five-year bar.

## Best Execution

For years, best execution was a priority among regulatory examiners. Over the past two years, it also has been a focus in the enforcement area, as shown in the two cases discussed below.

- A. *In the Matter of Scottrade, Inc.* (“Scottrade”) (Admin. Proc. File No. 3-13081, June 24, 2008)
  1. The SEC settled an administrative proceeding against Scottrade for allegedly making fraudulent misrepresentations to its clients concerning the firm’s execution of their Nasdaq pre-open orders.
  2. The SEC alleged that between January 1, 2001 and December 31, 2004, Scottrade falsely told clients that it would decide which market center to route their pre-open orders based on, among other factors, liquidity at market opening. At the time, Scottrade allegedly lacked written policies and procedures to assess liquidity at the market opening, which resulted in its failure to consider the availability of potentially superior executions that might have been better than the NBBO, in violation of its implied representation to customers to seek to obtain superior pricing.
  3. The SEC also alleged that Scottrade failed to conduct “a regular and rigorous review” of execution quality that it received from market centers for its NASDAQ pre-open order trades.
  4. In settling the matter, Scottrade consented to a censure, a \$950,000 civil penalty and a cease-and-desist order. The settlement order noted that in agreeing to the settlement, the SEC considered Scottrade’s remedial actions (but did not identify them) in determining the appropriate sanctions.
- B. *SEC v. Kenneth D. Pasternak and John P. Leighton* (D.N.J. June 24, 2008)
  1. In late 2004, the SEC settled an enforcement action against Knight Securities involving best execution for institutional customers. Between January 1999 and November 2000, when Knight’s head institutional sales trader received an institutional “not held” buy order from a customer (*i.e.*, the trader was given discretion as to the price and time of execution), he acquired shares of the requested security for the firm’s proprietary account before filling the customer’s order. He then waited to see how the security performed in the market during the day. If the stock went up in price during the day, he executed the customer’s order from the market, locking in a profit in Knight’s proprietary account. If the stock price dropped during the day, he would fill the customer’s

orders from the firm's proprietary position at prices that nevertheless provided a profit to the firm.

2. In March 2005, NASD Regulation filed a complaint against Knight's former CEO, Kenneth Pasternak, and the former head of its institutional sales desk, John Leighton. In April 2007, an NASD Regulation hearing panel found that Pasternak and John Leighton failed to adequately supervise the lead trader on the trading desk (Joseph Leighton, who is John's brother) to prevent that conduct. The panel found that the two executives failed to respond adequately to numerous red flags.
3. Notwithstanding NASD Regulation's case, in August 2005, the SEC also filed an injunctive action against Pasternak and John Leighton. In June 2008, almost three years after the complaint was initially filed and eight years after the last alleged wrongful activity, 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 as described above and dismissed all charges.
4. The SEC alleged that John Leighton and Pasternak participated in the alleged securities fraud committed by Knight's institutional desk by failing to disclose to Knight's institutional customers the significant profits generated by Joseph Leighton's strategy. The court rejected the SEC's argument that earning above-average (or "excessive") profits demonstrated that Joseph Leighton engaged in conduct that violated the securities laws. The court also rejected the SEC's claim that Joseph Leighton charged customers an undisclosed excessive mark-up, finding that he did not charge an identifiable mark-up, and even if he did, the SEC failed to prove he had an obligation to disclose those mark-ups to customers.
5. The SEC also claimed that Pasternak made false and misleading statements by signing the company's 10-K forms in 1999 and 2000, which stated that Knight provided its customers with best execution. The court held that the SEC did not establish that Pasternak knew or should have known that Joseph Leighton did anything improper and noted that Pasternak took the appropriate steps to investigate whether Joseph Leighton was engaging in front-running when the possibility of it was brought to his attention. The court ruled that the SEC failed to establish that Knight did not provide its customers with best execution or, if it did not, that Pasternak knew that the statements in the 10-Ks were false.
6. Finally, the SEC alleged that institutional sales traders at Knight, including Joseph Leighton, misused ACT modifiers causing

inaccurate and untimely reporting of trades to NASDAQ in order to obscure the quality of the execution prices, and that the defendants were aware of the issue. The court held that the SEC failed to prove that any trader misused ACT modifiers, or that such misuse was part of any fraudulent manipulation or a violation of statutory reporting requirements.

7. The court noted that John Leighton regularly reviewed Joseph Leighton's trade runs, that the industry standard in 1999 and 2000 was not to disclose profits earned on a trade, and that John Leighton's knowledge of Joseph Leighton's profits did not trigger any obligation to further investigate his trades.
8. In April 2005, when the SEC first filed a complaint against him, Joseph Leighton consented to a permanent bar from association and to pay over \$1.9 million in disgorgement, \$660,282 in interest, and a penalty of \$750,000 to settle the SEC matter. Joseph Leighton also consented to pay a \$750,000 fine to settle the NASD Regulation action.
9. As noted above, on June 24, 2008, the court ruled for Pasternak and John Leighton, finding that the SEC failed to prove that the defendants had violated any securities laws.

## Front Running

In April 2008, the SEC brought a case against a Fidelity equity trader and a Capital Institutional Services sales trader involving allegations of front running.

- A. *SEC v. David K. Donovan, Jr., and David R. Hinkle* (D. Mass. Apr. 16, 2008)
  1. The SEC filed a civil complaint against Donovan, an FMR Co. ("Fidelity") equity trader, and Hinkle, a Capital Institutional Services, Inc. registered representative, alleging that they were engaged in a scheme to front run Fidelity's mutual funds.
  2. The complaint claims that between July and September 2003, Donovan accessed Fidelity's confidential trading information on approximately 107 occasions and learned that Fidelity's portfolio managers had purchased, and placed additional orders to purchase, common stock shares of Covad Communications Group, Inc. ("Covad").
  3. In violation of his duties to Fidelity and its fund shareholders, Donovan allegedly relayed this confidential information to Hinkle, who in turn purchased thousands of Covad shares. In addition,

Donovan allegedly caused purchases of Covad stock to be made in his mother's account despite the fact that Fidelity had already rejected his requests to purchase Covad stock in his personal account. Upon selling the shares, Donovan's mother and Hinkle made \$89,775 and \$141,035, respectively, in profits.

4. The SEC seeks a permanent injunction, disgorgement, and civil monetary penalties.

### **Fraudulent Trading Scheme**

In our 2007 outline, we reported on SEC cases involving fraudulent trading schemes. In mid-2008, the SEC litigated another such case, this time against broker Jamie Solow.

#### **A. *SEC v. Jamie L. Solow* (S.D. Fla. May 14, 2008)**

1. In November 2006, the SEC brought a civil securities fraud case against Solow, a broker with Archer Alexander Securities Corp., alleging that he engaged in a fraudulent trading scheme involving inverse floater securities and sold inverse floaters to investors with conservative or moderate risk tolerances without advising them of the risk involved. In addition, he made unauthorized purchases of these securities that caused his firm to violate net capital and reporting requirements.
2. On January 31, 2008, a jury found Solow liable. The court entered a permanent injunction against Solow and ordered him to pay a civil penalty of more than \$2.6 million and disgorgement of \$3.4 million.
3. Subsequently, Solow filed a motion for judgment as a matter of law or for a new trial, challenging, in part, the jury instructions. Solow argues that the court relied upon suitability standards from an NASD Notice to Members in the jury instructions. The jury was therefore instructed to weigh the suitability of Solow's recommendations in connection with inverse floaters using NASD standards in an SEC action, which Solow contends was unprecedented.
4. Solow's motion for judgment as a matter of law or for a new trial was denied in March 2008, final judgment was entered against Solow on May 14, 2008. Solow filed a notice of appeal in May 2008, and the matter is pending.
5. Additionally, on June 12, 2008, the SEC issued an Order Instituting Administrative Proceedings against Solow to determine remedial

actions in light of the Division of Enforcement's allegations and the jury decision.<sup>7</sup>

## Sanctions in SRO Proceedings

The case below is an update to a litigated matter that we reported last year concerning a company's response to an NASD Regulation request for information. The firm lost at the NASD Regulation and SEC level and appealed to the D.C. Circuit; the court remanded the matter to the Commission to determine whether the sanctions were excessive. The SEC has now ruled on that issue.

- A. *PAZ Securities et al. v. SEC* (D.C. Cir. July 20, 2007) and *In the Matter of Paz Securities, Inc. and Joseph Mizrachi* (Admin. Proc. File. No. 3-11852 (Apr. 11, 2008))
1. NASD Regulation alleged that in 2003, it began an examination of PAZ Securities, Inc. NASD Regulation allegedly sent three letters seeking information from PAZ and subsequently filed a complaint against PAZ and its president, Joseph Mizrachi, which the respondents did not answer. After NASD Regulation mailed the complaint a second time, the respondents retained an attorney who obtained additional time to respond but never filed an answer. On December 31, 2003, a NASD Regulation Hearing Officer entered a default decision, expelling PAZ from NASD membership and barring Mizrachi from association with a member firm.
  2. PAZ and Mizrachi unsuccessfully sought to vacate the decision and appealed to NASD Regulation's National Adjudicatory Counsel ("NAC") and the SEC. Both the NAC and the SEC affirmed the hearing officer's decision, with the SEC emphasizing that NASD Regulation had the right to the information it had sought and that member firms and associated persons "cannot second-guess NASD's requests."
  3. PAZ and Mizrachi appealed to the D.C. Circuit, arguing that the Commission had abused its discretion by affirming sanctions that were grossly disproportionate to their conduct without considering mitigating factors and without articulating

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<sup>7</sup> SEC Admin. Proc. Rel. No. 34-57960, issued June 12, 2008.

a remedial purpose for the sanctions. The D.C. Circuit agreed with petitioners that the Commission had not addressed all of the mitigating factors.

4. The D.C. Circuit held that federal law authorizes the Commission to order “expulsion not as a penalty but as means of protecting investors.” Therefore, if the Commission orders expulsion, “it must explain why; furthermore, as the circumstances in a case suggesting that a sanction is excessive and inappropriately punitive become more evident, the Commission must provide a detailed explanation linking the penalty imposed to those circumstances if it wishes to uphold the sanction.” Specifically, the Commission “must explain why imposing the most severe, and therefore apparently punitive sanction is, in fact, remedial, particularly in light of the mitigating factors brought to its attention.”
5. On April 11, 2008, the Commission found that because NASD Regulation lacked subpoena power, a member’s compliance with its Rule 8210 requests was essential. Therefore, the continued vitality of the self-regulatory process requires that, absent mitigating circumstances, members and associated persons who do not respond to 8210 requests “present too great a risk to the markets and investors to be permitted to remain in the securities industry.” The Commission therefore concluded that the expulsions of PAZ and Mizrachi were necessary to serve the remedial purpose of protecting public investors and were not excessive under the circumstances.

## **Developments In SEC Enforcement Policy, Procedure And Organization**

### **New SEC Initiatives**

Early in the year, SEC Chairman Cox outlined several new SEC initiatives for 2008, which included the following:<sup>8</sup>

1. Creation of the Office of Collections and Distributions, which will be dedicated to the task of collecting penalties and disgorgements and redistributing them to injured investors through use of the new

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<sup>8</sup> Remarks to the ‘SEC Speaks in 2008’ Program of the Practising Law Institute by Chairman Christopher Cox (Feb. 8, 2008).

Phoenix software system that will track monies owed to the SEC and investors;

2. Creation of a special enforcement working group to address suspected insider trading, securities fraud, and market manipulation by hedge funds and other large, non-public investors;
3. A microcap fraud group will focus its resources on uncovering market manipulators in the OTC markets, such as those running shell company manipulations, pump-and-dump schemes, and Internet spammers;
4. Integration of “The Hub” law enforcement system granting all attorneys and staff in Enforcement Division access to all agency cases; and
5. The Office of Risk Assessment will be expanded to provide resources and analytical support across various SEC divisions and groups.

### **Corporate Penalties, Settlements, and Cooperation**

In two speeches this year, Commissioner Paul S. Atkins<sup>9</sup> stressed the importance of providing predictability with respect to SEC corporate penalties and settlements.

1. Commissioner Atkins opined that the SEC should make corporate penalties more predictable for companies. Commissioner Atkins also stated that penalties that are determined on nothing more than the staff’s feeling of what is “right” do not serve their intended purposes. Commissioner Atkins said that if the goal of large SEC penalties is to deter unlawful conduct, then that purpose is not served when, for instance, a large penalty is issued after a corporation has already paid a substantial amount as a result of private litigation on the same set of facts, particularly if shareholders of a public company are made to suffer for unethical conduct of management. In his view, the SEC penalty is essentially a public relations gesture.
2. Commissioner Atkins proposed ideas to change the current administration of penalties. While rejecting blind application of mathematical formulas as a way of calculating penalties, Commissioner Atkins suggested the creation of an internal SEC Enforcement Manual and adoption of an “open jacket” policy to

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<sup>9</sup> Paul S. Atkins, SEC Commissioner, Remarks to the ‘SEC Speaks in 2008’ Program of the Practising Law Institute (Feb. 8, 2008); Paul S. Atkins, SEC Commissioner, Remarks at the Federalist Society Lawyers’ Chapter of Dallas, Texas (Jan. 8, 2008). Commissioner Atkins recently stepped down. As of August 1, 2008, the Commission is at full strength; Chairman Cox is now joined by Commissioners Casey, Walter, Aguilar and Paredes.

share evidence with companies (which could be beneficial for settlement discussions) would provide greater predictability for companies.

3. Commissioner Atkins also suggested that the need for predictability and transparency should extend beyond enforcement and recommended that OCIE remove from information requests documents that companies are not required to keep and cease requesting information that would require firms to incur unnecessary costs.
4. Commissioner Atkins viewed the practice of granting cooperation credit to companies that waive privilege as tantamount to punishing others for not waiving privilege. He expressed the view that the SEC should resist characterizing companies that waive privilege as cooperative (and non-waiving companies as not cooperative) because these characterizations erode these important rights.
5. Commissioner Atkins noted that the current legislation (H.R. 3013 “Attorney-Client Privilege Protection Act of 2007” and its companion bill, S. 186) intended to guard against erosion of the attorney-client privilege is causing the SEC to re-examine its approach to “cooperation credit” and penalties. This legislation would prohibit federal agents from using a waiver of the attorney-client privilege or the attorney work product protection as a condition for its treatment of individuals or organizations.

### **Protection of Senior Investors**

In February 2008, the SEC, FINRA, and NASAA announced an initiative to identify and publish best practices utilized by financial services firms with senior clients.

1. The SEC, NASAA, and FINRA will solicit input from firms in the areas of: marketing and advertising to seniors; opening of accounts; product and account activity reviews; reviews of relationships with seniors and suitability of products sold to them; satisfying the changing needs of customers as they become older; surveillance and compliance steps; and training.
2. The SEC recognized that differences exist between firms’ business models and clients and emphasized that it did not expect there to be a “one-size-fits-all” approach to serving senior customers. Moreover, the SEC noted that regulators are not seeking to use this initiative to impose new regulations but rather to help firms comply with existing standards.

## Treasury Proposal to Restructure Financial Regulation

In March 2008, the U.S. Treasury Department (“Treasury”) issued recommendations to overhaul the regulatory regimes supervising depository institutions, securities firms, and the insurance industry. The Treasury’s suggestions were contained in its so-called “Blueprint.”

1. The Blueprint contains several short term and intermediate term recommendations to enhance and/or reform the current financial institution regulatory structure.
2. The short term suggestions designed to improve the current efforts at regulatory coordination include:
  - (a) enhancing the President’s Working Group on Financial Markets, which is responsible for acting as an inter-agency coordinator;
  - (b) creating a federal Mortgage Origination Commission, which among other things, would set uniform licensing requirements; and
  - (c) reviewing the current liquidity provisions offered by the Federal Reserve.
3. The intermediate term recommendations made in the Blueprint include the following:
  - (a) federally licensing, chartering, regulating, and supervising insurers and insurance products;
  - (b) merging the SEC and CFTC; and
  - (c) subjecting investment advisers to oversight by an SRO.
4. The Blueprint also suggests a “long-term optimal regulatory structure” under which three new regulators would be created:
  - (a) the Market Stability Regulator, which would be the Federal Reserve, who would have responsibility for overall issues regarding financial market stability;
  - (b) the Prudential Financial Regulator, which would regulate financial institutions with explicit government guarantees and would assume the role of the OCC and OTS; and
  - (c) the Business Conduct Regulator, which would oversee business conduct across all types of financial institutions and

be responsible for licensing, disclosure, sales and marketing practices, and business conduct.

### **Creation of Office of Collections and Distributions<sup>10</sup>**

1. In February 2008, the SEC created the new Office of Collections and Distributions to facilitate the distribution of financial penalties to harmed investors. By creating this office, the SEC intends to cut red tape and lower the administrative costs that arise in such matters.
2. The SEC has already distributed \$3.5 billion to investors since the Sarbanes-Oxley Act authorized the SEC to distribute penalties directly to investors and currently holds \$5 billion in “Fair Funds” that the new office will distribute.

### **Sovereign Wealth Funds and Public Disclosure**

1. In testimony before the U.S.-China Economic and Security Review Commission, SEC Enforcement Director Linda Thomsen commented on the participation of government-owned commercial investment funds in the U.S. capital markets.<sup>11</sup> Ms. Thomsen likened the enforcement issues associated with these funds to the issues associated with hedge funds. Specifically, she addressed the concern that, because the operation of funds is not always transparent, the funds, or persons associated with them, may potentially engage in illegal insider trading or other violations of the federal securities laws.
2. Sovereign wealth funds, like hedge funds, typically have substantial assets and, therefore, substantial power in the U.S. financial markets. Because the funds control large amounts of assets, regulators are concerned about the potential magnitude of any violations.
3. Ms. Thomsen cited the challenges of conducting international enforcement investigations as a regulatory concern associated with sovereign wealth funds. In some cases, the government from which help is being sought may also control the entity under investigation, and therefore may compromise the level of cooperation in the matter. As insider trading cases have become

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<sup>10</sup> SEC Press Release 2008-12, SEC Chairman Cox Announces Creation of New Office, Appointment of Leaders, to Expedite Distribution of Billions to Injured Investors (Feb. 5, 2008).

<sup>11</sup> Linda Chatman Thomsen, Director, SEC Division of Enforcement, Testimony Concerning Sovereign Wealth Funds and Public Disclosure, Before the U.S.-China Economic and Security Review Commission (Feb. 7, 2008).

more international in recent years, investigations have included a growing number of foreign banks, agents and accounts. In FY 2007, the SEC made 556 requests for enforcement assistance to foreign regulators.

## Mutual Recognition

1. In the Winter 2007 edition of the Harvard International Law Journal, the Director and a Senior Counsel in the SEC's Office of International Affairs co-authored an article advocating a new "substituted compliance" framework for providing access to U.S. capital markets for foreign financial service providers without requiring them to register with the SEC.
2. Under the proposed framework, foreign stock exchanges and foreign broker-dealers would be eligible for an exemption from SEC registration requirements "based on their compliance with substantively comparable foreign securities regulation and laws and supervision by a foreign securities regulator with oversight and a regulatory and enforcement philosophy similar to the SEC's."
3. On March 24, 2008, the SEC announced a number of actions that it was contemplating to further mutual recognition for regulatory regimes in foreign countries, including: (1) establishing initial agreements with foreign counterparts; (2) adopting a formal process for reaching out to other countries' regulators; (3) developing a framework to discuss mutual recognition with jurisdictions that have multiple governing bodies; and (4) reforming Rule 15a-6 to improve U.S. investors' access to foreign broker-dealers.<sup>12</sup>

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<sup>12</sup> SEC Press Release 2008-49, SEC Announces Next Steps for Implementation of Mutual Recognition Concept (Mar. 24, 2008).

As we reported last year, FINRA issued a press release announcing the commencement of its operations on July 30, 2007. Much of late 2007 and early 2008 was spent by NASD Regulation and NYSE Regulation personnel in efforts to implement the merger. In March 2008, Mary Schapiro, Chief Executive Officer of FINRA, announced that FINRA had completed its plan to develop a single examination program and to combine the NASD Regulation and NYSE Regulation enforcement arms.<sup>13</sup>

Additional steps remain to fully implement the merger. Over the next year or two, FINRA expects to implement a new technology suite, but the majority of the focus has been, and continues to be, on FINRA's efforts to create a single rulebook to replace the former NASD Regulation and NYSE Regulation rulebooks. FINRA officials have stated that they do not intend to select the better rule (*i.e.*, either the NASD Regulation or NYSE Regulation rule) for the new FINRA rulebook, but the best possible rule. In this regard, FINRA's staff has indicated that it has carefully combed the former NASD Regulation and NYSE Regulation rulebooks to determine which rules should be maintained in their existing format, which NASD rules are duplicative of legacy NYSE Regulation rules (and vice versa), and which rules should be completely rewritten. The rulebook consolidation process is ongoing and we expect to report on these efforts in our year-end review.

### Statistics and Enforcement Priorities

#### Statistics

In early 2008, FINRA released statistics concerning its 2007 enforcement activity.<sup>14</sup> In 2007, FINRA resolved 1,107 formal actions. During that same period, FINRA barred 338 individuals, expelled 16 firms, and suspended 288 individuals and five firms.<sup>15</sup> Fines by FINRA in 2007 totaled approximately \$47.6 million.<sup>16</sup> This number reflects the combined total of NASD Regulation fines for 2007 and NYSE Regulation member

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<sup>13</sup> See Remarks by Mary L. Schapiro, CCO Outreach BD National Seminar (Mar. 7, 2008).

<sup>14</sup> FINRA Annual Report, Shaping the Future of Regulation: 2007 Year in Review and Annual Financial Report (2008).

<sup>15</sup> *Id.* at 3.

<sup>16</sup> *Id.* at 6.

regulation fines for the second half of 2007 and is notably lower than the fines levied in 2006 by NASD Regulation alone, which totaled approximately \$75 million.

FINRA does not release statistics regarding disciplinary actions or fines until the end of the calendar year. As such, it is difficult to determine the number of cases and total fines imposed so far in 2008.

### **FINRA's Enforcement Priorities**

Based on our review of currently available information, we believe the following list reflects several of FINRA's top priorities for enforcement:

1. Sales practices, particularly involving sales of CDOs and sales to senior citizens;
2. Anti-money laundering;
3. Supervision;
4. Variable annuities;
5. Relationships with hedge funds;
6. Auction rate securities;
7. Regulation SHO;
8. Life settlements;
9. Reverse mortgages; and
10. False or misleading rumors.

### **Enforcement Actions**

#### **Senior Investors**

Over the past several years, the SEC, FINRA, and state regulators have focused on senior investors as the baby boomer generation moves toward retirement age. Key issues involve adequate disclosures to clients (particularly with respect to registered representatives' titles and so-called "free lunch" seminars) and suitability.

- A. *John Edward Mullins and Kathleen Mullins* (Feb. 14, 2008)
  1. FINRA filed a complaint alleging that John Mullins, a registered representative, misappropriated nearly \$400,000 from an elderly

customer and her charitable organization and attempted to steal funds from his employer in the form of improper expense submissions. Mullins' wife, a broker, was also charged by FINRA.

2. When Mullins's customer became ill, Mullins allegedly used her checking account and debit cards to pay his and his wife's personal expenses, including paying down \$375,000 on their joint mortgage, ATM withdrawals, and paying for groceries and gas.
3. Mullins also used the customer's charitable organization to buy gift cards which he used himself.
4. Furthermore, FINRA charged that Mullins wrongly submitted \$100,000 in improper expenses to his employer, accepted an unauthorized \$100,000 loan from a customer, and made misstatements on his Form U4 to conceal his officer, trustee and Power of Attorney status for the customer's will and charitable foundation.
5. These charges are still pending.

## **Variable Annuity Sales**

Sales of variable annuities continue to be a priority for FINRA. FINRA's Executive Vice President and Chief of Enforcement Susan Merrill commented in early 2008 that, "[w]hen firms are recommending annuities or annuity exchanges to elderly customers, they must act in the customers' best interests, taking into account all relevant factors - including the customers' ages and liquidity needs, surrender charges, product expenses and investment features."<sup>17</sup> The case that spurred this comment is described below.

### **A. *Banc One Securities Corp.* ("Banc One") (Jan. 29, 2008)**

1. FINRA alleged that, between January 1, 2004 and June 30, 2005, Banc One recommended unsuitable exchanges of deferred variable annuities to clients and had inadequate systems and procedures governing annuity exchanges.
2. FINRA alleged that Banc One representatives made unsuitable recommendations to 23 clients, 21 of whom were over 70 years old, and nine of whom were over 80 years old, to exchange their variable annuities. The clients exchanged out of annuities that were earning a minimum of 3 percent to annuities that earned a maximum of 3 percent. In addition, as a result of the exchanges, the clients ceased to hold annuities that had expired surrender

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<sup>17</sup> FINRA News Release, *FINRA Fines Banc One for Unsuitable Variable Annuity Sales, Inadequate Supervision of Fixed-to-Variable Annuity Exchanges* (Jan. 29, 2008).

periods and acquired annuities that had new three or six year surrender periods during which they would incur penalties for withdrawals.

3. In this matter, FINRA alleged that, considering the customers' ages, investment objectives, financial situations, income needs and the surrender periods of the variable annuities, the recommendations were unsuitable and in violation of NASD Rules 2310 and 2110.
4. Finally, FINRA asserted that the firm violated Conduct Rule 3010(a) because the firm's principals were aware of the customers' circumstances but did not adequately consider the various factors before approving the unsuitable transactions.
5. FINRA also alleged that the firm failed to supervise the exchange transactions in that the firm's supervisory systems and procedures did not require firm supervisors to obtain or consider certain information, such as the costs and benefits of the products being exchanged – information which is critical to conducting the required suitability review of a variable annuity exchange.
6. Banc One consented to a fine of \$225,000, and agreed to pay restitution of \$6,500 to two customers who incurred surrender charges when exchanging annuities. In addition to the fine, Banc One agreed to allow the 23 customers to sell their variable annuities without penalty.

## **Mutual Fund Sales Practices**

In the first half of 2008, FINRA brought cases involving mutual fund sales practices against Royal Alliance Associates, Wells Fargo, Merrill Lynch, UBS Financial Services, Prudential Securities, and Pruco Securities. The last five of these cases were all announced by FINRA on the same day.

- A. *Wells Fargo Investments, LLC* (“Wells Fargo”); *Merrill Lynch, Pierce, Fenner & Smith, Inc.* (“Merrill Lynch”); *UBS Financial Services, Inc.* (“UBS-FS”); *Prudential Securities* (“Prudential”); *Pruco Securities* (“Pruco”) (Feb. 28, 2008)

1. FINRA brought an action against five firms (Wells Fargo, Merrill Lynch, UBS-FS, Pruco and Prudential) for mutual fund sales violations and supervisory failures in connection with the sale of mutual funds.

FINRA alleged that four of the firms, Wells Fargo, Merrill Lynch, UBS-FS, and Prudential Securities, failed to implement adequate supervisory systems to identify customers who were eligible for Net

Asset Value (“NAV”) transfer programs. The NAV transfer programs permitted clients to make new purchases of Class A shares without paying an additional sales charge. As a result of the supervisory failures, customers incurred unnecessary front-end sales charges on their purchase of new Class A shares, in some cases paid higher fees to purchase other share classes, and unnecessarily became subject to contingent deferred sales charges.

2. Prudential Securities, UBS-FS and Merrill Lynch consented to fines of \$250,000 related to the supervisory failures.
3. Although Wells Fargo had failed to implement adequate supervisory systems, FINRA did not impose a fine against Wells Fargo because the firm took proactive remedial actions upon its discovery of the failure before FINRA’s investigation. Upon discovering that some eligible customers were incurring unnecessary charges, Wells Fargo initiated a review of its mutual fund sales and acted promptly and in good faith to repay customers and correct its system and procedures. Wells Fargo paid more than \$612,000 in restitution to investors in Class A shares.
4. The four firms also consented to remediation plans for customers who were eligible for NAV transfer programs. The total remediation is expected to exceed \$25 million.
5. FINRA also alleged that Prudential, UBS-FS, and a fifth firm, Pruco, improperly sold Class B and Class C mutual fund shares to clients. For these violations, FINRA imposed an \$800,000 fine against Prudential, a \$750,000 fine against UBS-FS, and a \$100,000 fine against Pruco. These firms also consented to remediation plans for more than 27,000 fund transactions in the accounts of 5,300 households.

B. *Royal Alliance Associates, Inc.* (Feb. 2008)

1. FINRA alleged that Royal Alliance Associates maintained inadequate controls to identify rapid turnover of mutual funds held by its customers, and failed, among others things, to identify: unsuitable fund switches, failures to exercise rights of accumulation, short term trading of shares, failures to send letters of intent and failures to enforce its procedures regarding switch letters.
2. Royal Alliance consented to a censure, a \$200,000 fine, and was required to review mutual fund “A” share transactions to determine

whether inappropriate fees were charged and provide refunds to customers.

## **Best Execution**

FINRA, like the SEC, brought at least one significant best execution case to date this year.

- A. *GunnAllen Financial, Inc. (“GunnAllen”) and Kelly McMahon (May 8, 2008)*
1. FINRA brought an action against GunnAllen and one of the firm’s principals, Kelly McMahon, relating to the head trader’s trade allocation scheme and the firm’s anti-money laundering, reporting, record-keeping and supervisory deficiencies.
  2. FINRA alleged that Alexis Rivera, the firm’s former head trader, placed client orders in the firm’s proprietary account, “cherry picked” profitable trades and allocated the trades to his wife’s personal account rather than to the accounts of firm clients. Rivera subsequently executed orders, sometimes at a loss, to allocate to the customers’ accounts. Rivera engaged in at least 450 such transactions and made illegal profits in excess of \$270,000. As a result of this scheme, the firm did not provide customers with best execution and failed to maintain accurate times of entry and execution. FINRA found that McMahon, the head of GunnAllen’s trading desk, failed adequately to supervise Rivera because he did not investigate the unusually profitable trades in Rivera’s wife’s personal account.
  3. In addition, FINRA alleged, among other violations, that GunnAllen:
    - (a) provided investment banking services involving certain issuers without placing the issuers’ securities on the firm’s restricted or watch lists or alerting its compliance department of the investment banking services. GunnAllen’s investment banking department also failed to inform its compliance department of its activities, and the firm failed to put in place written procedures to prevent trading while it was in possession of investment banking information;
    - (b) failed to report to FINRA a consulting agreement between its parent company and an individual who had been barred by FINRA;
    - (c) failed to implement an adequate Anti-Money-Laundering program and failed to monitor and report suspicious transactions; and

- (d) failed to ensure that markups and commissions on equity trades were reasonable. Brokers were given discretion to set commissions, and the firm's review consisted primarily of ensuring charges did not exceed 5 percent.
4. GunnAllen consented to a fine of \$750,000, \$25,000 of which was joint and several with McMahon. McMahon consented to a six month suspension and a \$25,000 fine. FINRA previously barred Rivera from association in December 2006.

## **Market Manipulation**

In April 2008, FINRA settled an action against Kensington Capital due to its employees' alleged aiding and abetting market manipulation.

- A. *Kensington Capital Corp. ("Kensington"), Abram Silver and Jeffrey Simon (Apr. 2008)*
  1. FINRA alleged that Kensington, through its employee co-respondent Jeffrey Simon, aided and abetted market manipulation of an over-the-counter bulletin board common stock by an individual barred from the securities industry and that man's brother who had a retail account at Kensington.
  2. Kensington consented to findings that, through its employee co-respondent Abram Silver, the firm failed to establish and implement anti-money laundering procedures to monitor suspicious transactions and to comply with the Bank Secrecy Act. FINRA also concluded that Silver failed to establish written supervisory procedures related to trading and market making and failed to supervise Simon's trading and market making activities, allowing Simon to assist in the stock price manipulation.
  3. The firm consented to a censure and an \$85,000 fine, of which Simon was jointly and severally liable for \$10,000. Kensington also agreed to retain an independent consultant to review the firm's trading and anti-money laundering policies, systems and procedures.
  4. Silver consented to a \$10,000 fine and a 90-day suspension and agreed not to serve as chief compliance officer for an additional six months. Simon consented to a six-month suspension and to re-qualify as a general securities representative by taking the Series 7 examination.

## Overstatement of Trading Volume

In January 2008, FINRA brought actions against a number of broker-dealers for overstating their trade volume in advertisements with service providers. This case is another example of the SRO's sweep actions.

1. On January 8, 2008, FINRA fined 19 broker-dealers for "substantially overstating their advertised trade volume to three private service providers."<sup>18</sup> The private service providers then passed on this false information to market participants in the form of reports and rankings of the firms' volumes in certain securities. FINRA concluded that inaccurate reporting to third-party providers was inconsistent with members' obligations to report true trades to FINRA.
2. FINRA determined that the firms had overstated their trading volume for one or more securities by comparing their advertised trading volume with their executed trade volume in certain securities. FINRA found that the broker-dealers lacked adequate supervisory systems and procedures for communicating trade volumes.
3. Eight firms were fined \$200,000 each (Broadpoint Capital, Inc.; CIBC World Markets Corp.; Lehman Brothers, Inc.; Merrill Lynch, Pierce, Fenner & Smith, Inc.; Needham & Company, LLC; Robert W. Baird & Co.; Thomas Weisel Partners, LLC; and UBS Securities, LLC).
4. Six firms were fined \$150,000 each (Bear, Stearns & Co., Inc.; BMO Capital Markets Corp.; Cowen and Company, LLC; Deutsche Bank Securities, Inc.; Leerink Swann & Company, Inc.; and RBC Capital Markets Corp.).
5. Piper Jaffray was fined \$100,000. This amount was reduced from a higher amount because of the firm's cooperation. The firm conducted its own extensive internal investigation and then voluntarily provided the results to FINRA.
6. Four firms were fined \$50,000 each (Friedman, Billings, Ramsey & Co., Inc.; Jefferies & Company, Inc.; JMP Securities, LLP; and Pacific Crest Securities, Inc.).

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<sup>18</sup> FINRA News Release, FINRA Fines 19 Firms a Total of \$2.8 Million for Inaccurate Advertised Trade Volume Information (Jan. 8, 2008).

7. The amounts of the fines varied between the firms because of “the number of misstatements and the magnitude of the misstatements.”<sup>19</sup>

## **Municipal Securities**

In early 2008, FINRA settled two cases regarding the sale of municipal securities.

- A. *Associated Bond Brokers, Inc.* (Jan. 2008)
  1. FINRA alleged that Associated Bond Brokers (“the firm”), while acting as a municipal securities broker’s broker, had lowered the highest bid to achieve a level close to the cover bid without the bidding broker-dealer’s prior knowledge or consent. In doing so, the firm deprived the selling broker-dealer of the benefit of a higher sale price.
  2. FINRA also found that the firm failed to provide guidance or policies for its employees regarding the communication of competing bid information to bidding broker-dealers, failed to put into place adequate supervisory procedures or systems to monitor communications to broker-dealers, and failed to adequately preserve its electronic communications.
  3. The firm consented to a censure and a fine of \$100,000.
- B. *J.P. Morgan Securities* (“JP Morgan”) (Feb. 2008)
  1. FINRA alleged that JP Morgan failed to disclose its use of consultants to obtain municipal securities offerings to the Municipal Securities Rulemaking Board (“MSRB”).
  2. FINRA alleged that between January 1, 2002 and June 30, 2004, JP Morgan paid \$750,000 to 16 consultants in 70 underwriting transactions. In MSRB filings, JP Morgan incorrectly stated that it had not used consultants to win municipal securities business, and failed to disclose that it had paid these consultants in relation to individual transactions.
  3. In addition to JP Morgan’s failure to disclose these consultant payments, FINRA also alleged that the firm had failed to maintain proper supervisory procedures related to the disclosure of consultants in connection with MSRB rules.

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<sup>19</sup> Paul Gores, *One of 19 Firms Fined, Baird to Pay \$200,000 to Financial Regulator*, Milwaukee Journal Sentinel, Jan. 9, 2008 (quoting from interview of Richard Wallace, Vice President of Market Regulation for FINRA).

4. JP Morgan consented to a \$500,000 fine.
5. In the FINRA press release accompanying the issuance of the case, FINRA Enforcement Chief Susan Merrill said, “[t]he action announced today demonstrates FINRA’s commitment to enforcing rules that are important to the integrity of the municipal securities market. The failure to report payments to consultants for specific municipal business undermined the disclosure scheme in place at the time the reports were made. MSRB rules no longer allow such payments at all.”

### **Forms U-4/U-5 Filings**

In 2004, NASD Regulation concluded a sweep by sanctioning a number of broker-dealers for late form U-4/U-5 filings. Since that time, NASD Regulation, and now FINRA, have brought several additional actions. To date in 2008, FINRA settled several actions in this area including the cases described below; note the relatively high fines FINRA continues to impose in these actions.

#### *A. Hunter Scott Financial LLC and Peter Alex Gouzos (Jan. 2008)*

1. FINRA alleged that the firm, through the actions of one of its principals (Gouzos), failed to timely file amendments to Forms U-4 and Forms U-5 disclosing the receipt of customer complaints or arbitrations.
2. The firm, acting through Gouzos, also allegedly failed to enforce its procedures prohibiting the use of external email accounts, which caused the firm to fail to preserve certain electronic communications as required by Rule 17a-4 under the Exchange Act.
3. The firm, again acting through Gouzos, also allegedly failed to implement written supervisory procedures to achieve compliance with the rules regarding a number of additional issues including the Firm Element of the Continuing Education requirements, internal inspection of its OSJ’s activities, and requirements of Section 220.8(c) under Regulation T.
4. The firm and Gouzos consented to a censure and a joint and several fine of \$125,000.

#### *B. H&R Block Financial Advisors (“H&R Block”) (Feb. 2008)*

1. FINRA alleged that H&R Block had failed to file Forms U-5 termination notices with FINRA in a timely manner and that the firm failed to establish a supervisory system over its registered

representatives and other associated employees to ensure such timely filing.

2. H&R Block consented to a censure and a \$150,000 fine.

## **Regulation T**

In the first half of 2008, FINRA settled a case with Penson Financial Services concerning alleged violations of Regulation T.

### **A. *Penson Financial Services, Inc.* (“Penson”) (Feb. 2008)**

1. FINRA alleged that Penson violated Regulation T, in that, among other things, Penson permitted trading in securities without full cash payment by public customers and that it allowed the use of proceeds from unsettled sale transactions as payment toward subsequent transactions.
2. For each of these transaction types, FINRA alleged that Penson failed to obtain proper Regulation T extension requests for its trading, filed those requests but accepted payment after the extension due date, or obtained a Regulation T extension but allowed the customer to make additional purchases during the 90-day freeze period.
3. Penson consented to a censure, a \$500,000 fine and the retention of an independent consultant charged with assessing the firm’s procedures related to Regulation T.

## **Failure To Submit Fingerprints**

FINRA continues to be active in bringing operational and administrative cases. The matter described below relates to the submission of fingerprints for temporary employees.

### **A. *Pershing LLC* (“Pershing”) (Feb. 26, 2008)**

1. FINRA alleged that Pershing failed to establish and enforce written procedures, including a system of follow-up and review of its business activities, to ensure that temporary employees were fingerprinted and that such fingerprints were submitted to the FBI for background checks.
2. Because of this alleged failure, the firm did not learn that 2 of the 159 temporary workers whose fingerprints were not submitted were

statutorily disqualified from associating with firms in the securities industry.

3. The AWC acknowledged that the firm self-reported the matter to FINRA and retained outside counsel to review the firm's practices surrounding fingerprinting temporary employees and regularly kept FINRA aware of its findings. The firm also enhanced its procedures relating to fingerprinting such employees.
4. Pershing consented to a censure and was fined \$95,000.

### **Electronic Blue Sheet Submissions**

In 2006 and 2007, NYSE Regulation brought cases involving erroneous electronic blue sheet reporting. FINRA has continued this trend with a case against Barclays.

#### **A. *Barclays Capital, Inc.* (Jan. 2008)**

1. FINRA alleged that the firm failed to submit accurate trading data requested by FINRA because blue sheets that were submitted did not include a short sale indicator.
2. FINRA also found that the firm's supervisory system was not reasonably designed to achieve compliance with the securities laws related to the submission of blue sheet data.
3. The firm consented to a censure and a fine of \$125,000.

### **Client Profile Information**

In the recent past, regulatory examiners have been focusing on firms' processes regarding maintaining and updating certain customer information, including changes of address. As described below, FINRA settled a case against Merrill Lynch for failing to maintain updated information for certain client accounts.

#### **A. *Merrill Lynch, Pierce, Fenner & Smith, Inc.* ("Merrill Lynch") (Apr. 2008)**

1. FINRA alleged that Merrill Lynch failed to establish a reasonable supervisory system to update client profiles in its system, failed to monitor proper completion of the entry of profile updates, failed to have adequate written procedures, and failed to ensure changes were made.
2. According to FINRA, between January 2001 and January 2006, when clients switched investment advisors or terminated enrollment in investment advisory or fee-based accounts, Merrill Lynch failed

to consistently update the firm's electronic records with the new account proxy delivery addresses or failed to remove account traits that suppressed trade confirmation delivery. As a result, proxy materials and trade confirmations were either not delivered to clients or were delivered improperly. Approximately 42,626 accounts were affected, a majority of which were dormant, had zero balances, or balances of less than \$100.

3. FINRA also alleged that prior to 2006, Merrill Lynch's system was manual and the firm did not have adequate written procedures for the service team making the changes.
4. Merrill Lynch automated the process in January 2006, and as a result, discovered the problems. Merrill Lynch self-reported and conducted an internal review to confirm that the new system had effectively corrected the issue.
5. Merrill Lynch consented to a censure and a fine of \$175,000.

### **Soft-Dollar Payments**

The topic of broker-dealer relationships with hedge funds has been, and is likely to remain, a significant area of interest in regulatory examinations and enforcement.

A. *SMH Capital Inc. ("SMH"), Michael S. Rosen, Jack D. Seibald, Anthony M. Gallo (Jan. 9, 2008)*

1. FINRA charged SMH with supervisory failures because although its procedures covered the firm's traditional brokerage business, they were not tailored to issues facing a prime brokerage business that the firm had acquired.
2. SMH entered into soft dollar arrangements with certain hedge funds. Under the arrangement, SMH paid for some of the hedge funds' expenses despite the presence of red flags suggesting that the expenses may not have been allowable for soft dollar treatment under the safe harbor provision of Section 28(e) of the Exchange Act.
3. FINRA also found that compensation for two managers of SMH's prime brokerage business unit was tied to the profitability of the business unit. The two managers also simultaneously served as managers and investment advisors for four separate hedge funds. The agreement created a financial incentive for the managers to direct trades to SMH, while the managers also had a duty as investment advisors to direct trades to the brokerage firm that could achieve best execution. FINRA found that this conflict was not

adequately disclosed and, in fact, was contrary to representations to investors that managers would not be compensated based on the profitability of SMH's prime brokerage business. The two SMH employees consented to fines of \$100,000 each and were suspended for 20 days.

4. SMH drafted and distributed summaries for its clients concerning hedge funds and helped fund managers prepare and disseminate sales materials. FINRA found that these materials constituted sales literature for hedge funds, and therefore, the materials violated NASD Advertising Rules because they did not contain the required specific risk disclosures. FINRA found that SMH's written supervisory and compliance procedures failed to address how sales materials should be prepared, approved, disseminated and filed.
5. In addition, FINRA found that SMH failed to retain e-mails and instant messages and that one of its employees sold and/or marketed SMH's services without being registered. The employee consented to a suspension of ten days, a \$15,000 fine, and an order that he pass the Series 7 examination before performing tasks that require the license.
6. SMH consented to a censure, a \$450,000 fine and agreed to retain an independent consultant to conduct a comprehensive review of the adequacy of the firm's hedge fund policies, procedures and systems.

### **Order Audit Trail Systems ("OATS") Reporting**

So far in 2008, FINRA has picked up where NASD Regulation left off with respect to bringing cases against broker-dealers for inaccurate OATS reporting. The actions below came with hefty fines.

A. *TradeStation Securities, Inc.* ("TradeStation"), *E\*Trade Securities, LLC* ("E\*Trade") and *CIBC World Markets Corp.* ("CIBC") (May 15, 2008)

1. FINRA fined TradeStation, E\*Trade and CIBC a total of \$1.6 million for violations of the OATS rules, which require firms to report to FINRA order handling and execution information related to customer orders and proprietary trading for Nasdaq and OTC Equity securities. The 3 firms all consented to FINRA's actions.
2. FINRA fined TradeStation \$200,000 for failing to report approximately 23.5 million Reportable Order Events ("ROEs") relating to orders received during 2000 through 2004 and \$550,000 for failing to have adequate written supervisory procedures. The

firm's procedures did not identify a person responsible for supervising the firm's compliance with the OATS rules and did not identify steps for that person to comply with the rules. FINRA also found that TradeStation failed to conduct supervisory reviews for OATS compliance even though the ROEs significantly increased during the relevant period.

3. FINRA fined CIBC \$150,000 for failure to report approximately 28 million ROEs that were generated between 2003 and 2006 by its affiliate, Canadian Imperial Holdings, Inc. ("CIHI"), to which CIBC provided sponsored market access. It also fined CIBC \$200,000 for failing to supervise the reporting of trades. FINRA noted in the case that it had found that CIBC falsely represented to FINRA's Market Regulation staff that all of its businesses were properly reporting OATS information. In determining these fines, FINRA took into consideration the fact that CIBC, upon discovery of the failures, self-reported and immediately took actions to correct the issues.
4. FINRA fined E\*Trade \$200,000 for failing to accurately report the order receipt time of customer orders received after the market close and for not accurately reporting that the orders were routed through its affiliate. It also fined E\*Trade \$300,000 for failing to have written supervisory procedures that identified a person responsible for supervising the firm's compliance with OATS rules and that identify steps for that person to take to comply with the rules.

### **Directed Brokerage**

In our outline that addressed selected 2006 enforcement cases, we reported on a litigated matter in which an NASD Regulation hearing officer imposed a \$5 million fine against American Funds Distributors for directing \$98 million in brokerage business to broker-dealers to reward them for being top sellers of its funds. Below is a summary of the NAC's decision on appeal.

- A. *In the Matter of Department of Enforcement v. American Fund Distributors, Inc.* ("AFD") (Apr. 30, 2008)
  1. FINRA's National Adjudicatory Council ("NAC") affirmed the decision of a FINRA Hearing Panel, which found that AFD violated FINRA's Anti-Reciprocal Rule intended to prevent "conflicts of interest that might cause retail firms to recommend investment company shares based upon the receipt of commissions from that investment company."

2. The NAC held that AFD violated the rule by arranging for its subsidiary to direct over \$98 million brokerage in commissions to 46 retail securities firms between 2001 and 2003 based on those firms' sales of American Funds.
3. Notably, the NAC disagreed with the hearing panel's conclusion that AFD's violations were negligent. Rather, the NAC found that AFD's violations were intentional. The NAC also found additional aggravating factors that the Hearing Panel did not find, including that AFD's reciprocal arrangements undermined fair competition in the industry and could have harmed the brokerage firm's clients.
4. The NAC rejected certain mitigating factors that the Hearing Panel accepted, such as that directed brokerage was widespread in the industry. The NAC found no evidence in the record to support that conclusion and, in any event, found that it would not excuse the failure to follow FINRA's rules. The NAC also rejected the Hearing Panel's determination that FINRA's subsequent modification of its directed brokerage rules was a mitigating factor. The NAC determined that subsequent rule modifications did not affect AFD's obligations to follow rules that were in effect during the relevant period.
5. In the case below, FINRA had sought a \$98 million fine, but the Hearing Panel imposed only a \$5 million fine and a censure. The NAC upheld the Hearing Panel's sanctions. Based upon media reports, AFD is considering whether to appeal this case to the SEC.

## **Continuing Education Training**

In March, FINRA brought actions against sixteen State Farm representatives concerning misconduct in connection with continuing education training.<sup>20</sup>

1. Sixteen State Farm registered representatives settled FINRA charges in connection with testing misconduct by either taking tests for superiors or directing subordinates to take tests for registered State Farm employees.
2. FINRA requires a mandatory two-part training program consisting of regulatory and firm elements. The "firm" element is administered by firms to registered representatives who have direct customer contact and their immediate supervisors. State Farm designed a computerized system of testing for the firm element, and in this

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<sup>20</sup> See *Sixteen From State Farm Entity Agree to Sanctions Over Test-Taking*, Broker/Dealer Compliance Report, Vol. 10 No. 10, Mar. 12, 2008.

case, computer IDs of superiors were used by subordinates to take the test.

3. In one instance, a supervisor, Rebecca Sappington, directed a subordinate, Karen Curtis, to obtain user IDs and passwords of four other State Farm registered representatives who worked on Sappington's team. Sappington directed Curtis to access the computerized testing system and complete the tests for the four individuals. When Curtis failed to complete the task, Sappington directed her to delegate the task to another employee. That individual, an unregistered new hire to the firm, then completed the tests.
4. Nine of the State Farm employees who were sanctioned were supervisors who either ordered or allowed subordinates to complete the test for them. Two of these supervisors were Series 26 registered principals. These two individuals consented to a \$10,000 penalty, a six month suspension as a principal and a 90-day suspension in all other capacities. The other seven supervisors, all Series 6 registered, each consented to \$5,000 penalties and 60-day suspensions.
5. For her actions ordering subordinates to complete the tests of other employees, Ms. Sappington, also Series 26 registered, consented to a \$10,000 penalty, a bar as a principal and a six month suspension in all other capacities.
6. Six additional employees, all Series 6 registered, were subordinates who completed the test for superiors. Each of these employees consented to a \$5,000 penalty and a 30-day suspension.
7. State Farm discovered this conduct in one region initially through an employee tip and self-reported the information to FINRA. After expanding its internal review nationwide, State Farm provided its findings to FINRA.
8. Notably, FINRA did not bring a case against the firm.

### **Suitability**

Over the last few years, FINRA and H&R Block litigated a case concerning allegations that H&R Block representatives made misrepresentations to clients in connection with the trading of Enron bonds. In April, a decision was issued in the case clearing the company of all charges.

- A. *Department of Enforcement v. H & R Block Financial Advisors, Inc.* (“H&R Block”) (Apr. 25, 2008)
1. In this contested matter, FINRA alleged that during the one-month time period prior to Enron Corporation’s bankruptcy filing on December 2, 2001, H&R Block financial advisors misrepresented or omitted material facts in connection with the sale of Enron bonds to more than 800 customers, and that the firm’s supervisory systems and procedures were inadequate. A Hearing Panel dismissed all of the causes of action.
  2. The Hearing Panel held that the Department of Enforcement failed to present any evidence to support its allegations that H&R Block’s Fixed Income Department inflated the gross sales credits for the bonds, created a high-pressure sales campaign to sell the bonds, and caused registered representatives to make misstatements or omissions when recommending the bonds to customers.
  3. The Panel found that the H&R Block corporate bond trader set the gross sales credits for bond sales in accordance with widely employed industry practice, taking into account various factors, such as volatility and trading spread. Enforcement presented no evidence that the sales credits were set as motivation to focus on selling Enron bonds, nor was there evidence that registered representatives actually recommended the bonds because of the size of the sales credit payouts. Instead, the evidence showed that “the sales were driven by the anomalous yields then available on these investment-grade bonds.”
  4. H&R Block’s internal policy restricted its fixed-income offerings to securities that were rated “investment grade” by two recognized rating agencies. During the relevant time period, the Enron bonds were rated investment grade by both Moody’s and Standard & Poor’s, and therefore the sales force’s reliance on these ratings at the time did not violate the firm’s policy.
  5. The Hearing Panel also found that H&R Block’s recommendations were suitable. Enforcement also did not support its allegation that H&R Block’s registered representatives should have informed customers “that the risk of default was higher than what the bonds’ investment-grade rating signified.”

## Mark-Ups

In 2007, FINRA's first settled enforcement action involved allegedly excessive mark-ups on corporate bonds.<sup>21</sup> In 2008, FINRA brought a similar case, this time against Jefferies.

- A. *Jefferies & Company, Inc.* ("Jefferies") (Jun. 2008)
1. FINRA found that Jefferies sold a distressed corporate debt security from its proprietary account to a client at a price that was not fair under the circumstances.
  2. FINRA also found that Jefferies failed to create and maintain accurate records of brokerage orders and executions and found inaccuracies in Jefferies' reporting of transactions in TRACE-eligible securities.
  3. FINRA also found that Jefferies failed to provide customers, prior to or contemporaneous with the purchase of some debt securities, notice that the particular securities could be redeemed before maturity and that redemption could affect yield.
  4. Jefferies consented to a censure, a fine of \$500,000, restitution of approximately \$450,000, and to revise its procedures regarding recordkeeping, trade confirmations to customers, fair pricing and FINRA's markup policy.

## Research Disclosures

Over the past year or so, regulators have brought several research disclosure cases. In mid 2008, FINRA brought a case against SG Americas concerning the adequacy of disclosures in its research reports.

- A. *SG Americas Securities, LLC* ("SG Americas") (May 2008)
1. FINRA alleged that SG Americas distributed research reports and updates to its customers that its non-member foreign affiliates had authored without first determining whether disclosures were required. No principal reviewed the reports, and the reports bore the firm logo, which represented that the U.S. member affiliate had produced the materials.

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<sup>21</sup> On August 2, 2007, FINRA settled an action against Morgan Stanley & Co. and a corporate bond trader, in which FINRA alleged that, during a five month period in 2001, Morgan Stanley charged mark-ups in excess of the 5% industry guideline on more than 2,800 sales of notes.

2. FINRA alleged that SG Americas failed to correct these disclosure issues in a timely manner and failed to establish adequate supervision to comply with FINRA disclosure rules.
3. The firm consented to a censure and \$175,000 fine.

## FINRA Developments

### New Case Review Process<sup>22</sup>

- A. FINRA has instituted a case enforcement review process to ensure consistency in the way it handles enforcement cases.
  1. This internal review process was previously used by NYSE Regulation under Susan Merrill, who moved from NYSE Regulation to become FINRA's Chief of Enforcement.
  2. To carry out this review, FINRA created an advisory committee, which includes, among others, the chief counsels to FINRA's seven investigative groups and the chief counsels to FINRA's five regional groups of lawyers.
  3. The committee reviews approximately 10-20 percent of FINRA's cases, focusing on "especially significant" matters. The committee's goal is to ensure that FINRA's cases are thoroughly investigated, well-pled and settling within an appropriate range, without slowing down the enforcement process.

### Rulebook Consolidation

- A. On May 14, 2008, FINRA issued four proposals for comment to consolidate certain key legacy NYSE and NASD rules into one rule book.<sup>23</sup> The proposals cover the following areas: financial responsibility, supervision and supervisory controls, books and records, and investor education and protection.
- B. FINRA also issued guidance to firms in the first half of 2008 concerning a variety of topics, including: the protection of senior investors, false rumors

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<sup>22</sup> See *FINRA Launches New Process to Review Cases; Overall Penalty Levels Not Affected*, Broker/Dealer Compliance Report, Vol. 10 No. 05, Feb. 6, 2008.

<sup>23</sup> FINRA Regulatory Notices 08-23, 08-24, 08-25, and 08-26.

and other similar market manipulation activity, and detecting and preventing “rogue” trading.<sup>24</sup>

## Penalties Enforcement

Review of SEC orders and SRO sanctions is an area receiving some attention following the case litigated last year, *PAZ Securities, Inc. v. SEC*, No. 05-1467 (D.C. Cir. July 20, 2007), discussed above in the SEC section. In the following case, a court ruled on the issue of state court jurisdiction to enforce regulatory sanctions.

A. *FINRA v. Fiero, et al.*, 853 N.Y.S.2d 267 (Feb. 7, 2008)

1. In 2000, an NASD Regulation hearing panel found that an NASD registered broker, John Fiero, and his one-man firm, Fiero Brothers, had violated NASD rules by carrying out a “bear raid” to drive down the price of securities underwritten by another NASD member. The panel, *inter alia*, expelled Fiero from NASD membership, fined him and his company \$1 million, and imposed hearing costs of \$10,809.25.
2. Fiero did not appeal but also did not pay the fine. NASD Regulation commenced an action in New York state court to collect the fine. The New York Supreme Court enforced the NASD Regulation fine against Fiero, and the Appellate Division affirmed.
3. Fiero appealed, and the New York Court of Appeals reversed, holding that New York courts do not have subject-matter jurisdiction to enforce NASD Regulation penalties. The court concluded that because NASD Regulation had imposed the fine pursuant to the federal Exchange Act, state courts lacked authority to adjudicate any resulting disputes.

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<sup>24</sup> FINRA Regulatory Notice 08-18; FINRA News Release, Self-Regulators Warn Against Spreading False Rumors and Other Abusive Market Activity (Mar. 31, 2008); FINRA News Release, SEC, NASAA and FINRA Announce New Steps to Help Protect Senior Investors (Feb. 8, 2008).

NYSE Regulation has not released any statistics concerning its enforcement activity in the first half of 2008. Such statistics, even if published, would be of limited utility, because after the merger in July 2007 between NASD Regulation and NYSE Regulation, FINRA began handling a significant portion of the enforcement actions that historically would have been brought by NYSE Regulation. Accordingly, a year-over-year statistical analysis of NYSE Regulation's enforcement statistics would not be meaningful. Some of the cases below appear to be matters still working their way through the old NYSE Regulation regime.

### Enforcement Actions

#### Suitability

Suitability cases have long been a standard part of NYSE Regulation's enforcement docket; the action below is an example of a litigated case in this area.

- A. *Luis Miguel Cespedes*, Hearing Board Decision 07-24 (Jan. 30, 2008)
1. NYSE Regulation alleged that Cespedes, a former registered representative and top branch performer of A.G. Edwards & Sons, Inc. ("AGE"), had recommended unsuitable technology-sector Unit Investment Trusts ("UITs") in a one-sized-fits-all approach to 20 AGE clients.
  2. The Hearing Panel found that the UITs were unsuitable for many of the clients, some of whom were elderly, retired, unsophisticated or did not have significant investment assets. In addition, many of the trades were on margin, which increases the risk associated with the trades. AGE had reported complaints against Cespedes to NYSE Regulation and settled with 15 customers for approximately \$1.08 million, of which Cespedes contributed \$20,000.
  3. NYSE Regulation also alleged that Cespedes engaged in unauthorized trading, but the Hearing Panel determined that Enforcement failed to meet its burden with respect to that charge.

4. Although NYSE Enforcement recommended a five-year ban and restitution payments to clients totaling \$195,000, the Hearing Panel did not impose restitution, finding that the loss measure was unreliable. However, the Panel imposed a ten-year bar – twice that sought by Enforcement – because of: (1) the number of harmed clients; (2) Cespedes’s attempt to collude with a client to blame AGE for his losses, instead of Cespedes, and file an arbitration claim against the firm; (3) his attempts to hide customer complaints, and (4) his attempts to intimidate witnesses to testify favorably for him.

### **Dissemination of Material, Non-Public Information**

Securities regulators have been paying close attention to firm’s policies, procedures, and conduct relating to the receipt of material, non-public information.

- A. *Adam Galeon*, Hearing Board Decision 07-162 (Dec. 20, 2007)<sup>25</sup>
  1. Adam Galeon, a research analyst with Credit Suisse First Boston LLC, consented to a finding that he violated just and equitable principles of trade by obtaining information from the CEO of a NYSE-listed public company that the company was reducing its estimated EPS the day before the news was publicly disseminated and then selectively passing along the information to certain firm employees and clients.
  2. NYSE Regulation alleged that Galeon approached the CEO at an annual conference the day before the company’s scheduled analyst meeting. During a brief conversation, Galeon asked the CEO whether the company’s earnings would go below \$2.00. According to Galeon, the CEO responded “that’s the number I’m shooting for, give or take a penny.” The CEO also mentioned that the company had recently made several acquisitions that were increasing its spending. Galeon immediately called his research team and sent 23 emails to colleagues and clients, each time disclosing what he had learned. In all but one email, Galeon warned the recipient to keep the information quiet.
  3. After speaking with Galeon, a research associate on Galeon’s team conveyed the information to a firm healthcare trader, who then sold short 50,000 shares of the company stock. The trader also executed sell orders from firm clients who had communicated with the sales personnel who received Galeon’s email. Later that night,

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<sup>25</sup> This action was decided on Dec. 20, 2007, although it was posted on the NYSE website on Feb. 13, 2008. This case was therefore not included in our 2007 outline.

the firm published a note from Galeon's research associate, which included the information Galeon had learned from the CEO.

4. Galeon consented to a censure, a fine of \$50,000 and a four-month bar from membership.

## Odd Lot Trading

Enforcement of the odd lot trading rules continue to be the subject of enforcement actions.

- A. *Merrill Lynch, Pierce, Fenner & Smith, Inc.* ("Merrill"), Hearing Board Decision 07-163 (Dec. 20, 2007)<sup>26</sup>
  1. NYSE Regulation alleged that Merrill violated Exchange rules by failing to comply with NYSE rules concerning odd-lot transactions and by failing to supervise.
  2. Merrill provided broker/dealer "ABC" with access to its SuperDOT system. ABC submitted nearly 50,000 odd-lot trades prior to the opening of trading without ensuring that they were aggregated into round lots. After NYSE Regulation commenced its investigation, ABC and Merrill agreed that ABC would aggregate odd-lots and report trading activity to Merrill for review.
  3. NYSE Regulation found that Merrill failed to supervise reasonably because it did not conduct surveillance of ABC's trading activity. ABC used its own proprietary system to submit trades through Merrill's SuperDot lines and therefore was outside Merrill's electronic surveillance process.
  4. Merrill consented to a censure and a penalty of \$160,000.

## Order Marking

In early 2008, NYSE Regulation issued a case against Goldman Sachs related to marking of proprietary orders.

- A. *Goldman Sachs & Co.* ("Goldman"), Hearing Board Decision 08-8 (Feb. 26, 2008)
  1. NYSE Regulation alleged that Goldman's Fixed Income, Currencies and Commodities Division ("FICC") Traders inadvertently mislabeled certain proprietary orders.

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<sup>26</sup> This action was decided on Dec. 20, 2007, although it was posted on the NYSE website on Feb. 13, 2008. This case was therefore not included in our 2007 outline.

2. Federal securities laws require that certain proprietary orders, known as “G” orders, yield to orders placed by non-member customers on the NYSE Floor. Rather than marking the orders “G,” FICC traders marked the relevant orders “P,” mistakenly believing that “P” identified the orders as “proprietary.” Between January 2002 and June 2005, approximately 20% of the total orders entered by the FICC traders were improperly marked. 42% of the improperly marked orders were executed by a floor broker without yielding priority to non-member customer orders. NYSE Regulation found that, during the first relevant period, the firm did not have adequate systems or procedures to review whether orders had been marked properly and the FICC traders had not been trained on how to enter the orders properly.
3. Additionally, between January 2006 and August 2007, a computer programming problem at the firm caused approximately 1.3% of the total orders entered by the FICC traders not to be marked as “G” orders. 12% of the improperly marked orders were executed without yielding priority to non-member orders.
4. Notably, the original referral from Market Surveillance to Enforcement had uncovered only one instance in which an order had not been marked properly. The firm self-reported the larger problems, hired a law firm to conduct a review of the order entry system, and took action to correct the issues identified.
5. Goldman consented to a fine of \$225,000.

### **Failure to Supervise Post-Execution Changes**

Supervision is always a hot enforcement topic. In the case below, NYSE Regulation alleged a failure to supervise post-execution changes to trades.

- A. *Merrill Lynch, Pierce, Fenner & Smith, Inc.* (“Merrill”), Hearing Board Decision 08-006 (Feb. 20, 2008)
  1. NYSE Regulation alleged that Merrill failed to supervise post-execution account name and designation changes by not enforcing its policies and procedures, which required supervisory review and written approval before an employee could make such changes.
  2. On approximately 1,000 occasions between January and August 2003, a Merrill Lynch trader transferred executed orders from one client to another without obtaining supervisory approval. By moving the trades, he was able to favor a client by diverting the losses caused by stock price movements from that client to another client.

3. As a result of the inaccurate customer information entered on its orders, the trader caused the firm to fail to keep accurate books and records. Additionally, during the relevant time period, the firm did not have policies or procedures for reviewing employees' instant messages, a practice which could have alerted the firm to the trader's misconduct.
4. Merrill Lynch took remedial action by requiring traders to send an email to their supervisors requesting approval of any post-execution account name and designation changes. The firm also reported to NYSE Regulation that it regularly reviews instant messages as part of its review of electronic communications.
5. Merrill Lynch consented to a censure and a \$300,000 fine.

### **Electronic Blue Sheets**

In 2006, NYSE Regulation settled investigations of 20 firms relating to electronic blue sheet reporting. Two firms did not initially resolve their investigations. We reported on one litigated case in our 2007 outline. The remaining case is discussed below.

- A. *In the Matter of Wedbush Morgan Securities, Inc.* ("Wedbush"), Review of Hearing Board Decision 06-196 (Mar. 12, 2008)
  1. Wedbush and NYSE Regulation Enforcement ("Enforcement") sought a review of an NYSE Hearing Panel decision involving Wedbush's alleged failure to submit accurate Electronic Blue Sheet ("EBS") information. Wedbush appealed the penalty of a censure, a \$300,000 fine, and an undertaking to review the firm's legal and compliance functions. Enforcement sought a review of the Hearing Panel's dismissal of charges that Wedbush made material misstatements to, and failed to cooperate with, the NYSE Regulation.
  2. The Board affirmed the Hearing Panel's findings that Wedbush submitted inaccurate EBS information to NYSE Regulation and failed to adequately supervise and control its EBS reporting process. The Board found "ample evidence supporting the Hearing Panel's findings that Wedbush's responses to requests for Blue Sheet information were inexcusably inadequate, inept, dilatory and systematically deficient."
  3. The Board affirmed the Hearing Panel's finding that Wedbush did not make a material misstatement to NYSE Regulation because Wedbush believed that the information that it provided to NYSE Regulation was accurate. Moreover, the Board affirmed the Hearing Panel's finding that Wedbush did not fail to cooperate

satisfactorily with an NYSE Regulation investigation by failing to submit requested information concerning the firm's review because the information was not available at the time.

4. The Board affirmed the censure of Wedbush, reduced the fine from \$300,000 to \$200,000, and modified the scope of the outside consultant review. In determining the appropriate remedy, the Board took into account "the seriousness of the violations, the potential for repetition, and the deterrent value to Wedbush and others" and stated that the penalty will "specifically serve[] the goal of protecting investors from further lapses in Wedbush's compliance mechanisms."