

Morgan Lewis

review



2008 Year in Review: SEC and SRO
Selected Enforcement Cases and
Developments Regarding Broker-Dealers

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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 during 2008.*

2008 was a year of dramatic change in the securities industry. The markets were roiled by a number of unprecedented economic events, and the most prominent stock market indices lost significant value, with the Dow Jones Industrial Average declining about 34% and the Nasdaq closing down approximately 41% from the end of 2007. The year also saw the demise of several broker-dealers, the merger of others, unprecedented federal capital infusions, and a move away from the independent investment banking model towards that of commercial banks. Investors and regulators also witnessed several major scandals, and the media, Congress, and others called for significant modifications of the current regulatory regime.

2008 was also an eventful year at the SEC. Perhaps most importantly, in mid-December 2008, President-elect Barack Obama announced his intention to nominate current FINRA CEO, Mary Schapiro, to replace Christopher Cox as the Chairman of the Commission.

On the enforcement front, in the SEC’s fiscal year 2008, the Commission brought 671 enforcement actions, the second-highest number of actions ever, and a slight increase in comparison to the 656 cases initiated in fiscal year 2007. Of note, however, the statistics include more than twice as many cases against public issuers for untimely regulatory filings in fiscal year 2008 versus fiscal year 2007; many of these cases were initiated in the last month of the Commission’s fiscal year. Moreover, in one of its core areas – the regulation of broker-dealers – its case load was down significantly from about 89 cases in fiscal year 2007 to about 60 cases in fiscal year 2008, a decline of approximately 33%.

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The SEC's civil penalties and disgorgement were also significantly lower than in prior years. In fiscal year 2008, the SEC obtained orders imposing \$256 million in civil money penalties, which represents approximately half the amount in fiscal year 2007. The Commission also obtained orders requiring securities law violators to disgorge approximately \$774 million, which is a 29% decline from fiscal year 2007. One of the few statistical bright spots for the SEC occurred in its efforts to close cases. In fiscal year 2008, the Division of Enforcement closed 1,355 cases, a 260% increase from the prior year.

In 2008 the SEC brought actions relating to auction rate securities, insider trading, on-line account intrusion, Regulation S-P, market manipulation, stock loan, and conflicts of interest. The Commission also spent time, effort and resources litigating several market timing and late trading cases that it had initiated in prior years. Moreover, the SEC launched intensive examinations and investigations concerning new topics, such as the malicious creation and spread of rumors intended to manipulate securities prices and began to investigate the alleged Ponzi scheme attributed to Bernard Madoff. In 2008, the Division of Enforcement found itself the subject of several investigations conducted by the Commission's Office of the Inspector General concerning its handling of certain inquiries. The Division of Enforcement also published its Enforcement Manual, which describes its key investigative practices. A discussion of SEC enforcement statistics, priorities, actions, and enforcement developments in 2008 can be found on pages 4 - 58 of this outline.

One of the most important enforcement efforts in 2008 involved the auction rate securities market; state regulators played an active role in these matters. Accordingly, while in the past this outline has focused entirely on SEC and SRO enforcement, this year we include a section devoted entirely to enforcement matters involving auction rate securities at the SEC, FINRA, and state levels, which appears on pages 59 - 83 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. FINRA has confirmed that in calendar year 2008, 946 new cases were initiated, 14 member firms were expelled, 321 individuals were barred from membership, and 300 individuals were suspended. In addition, a total of \$1.2 billion in restitution or reimbursement was agreed to in various settlements executed in 2008. That figure includes the agreements in principle relating to the contemplated "buy backs" of auction rate securities discussed on pages 59 - 83 of this outline. Based upon our review, however, it appears that the number of FINRA enforcement cases with large fines is lower than the number of such cases brought in the recent past by NASD and NYSE Regulation. Indeed, it appears that there were two FINRA settlements in which the fine imposed was greater than \$1 million and one Hearing Panel Decision in which the fine imposed was \$1.53 million.

In 2008, FINRA brought enforcement actions on various traditional topics, including variable annuities, mutual fund sales practices, 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 also brought significant cases in the insider trading and continuing education training areas. As to its regulation and enforcement program, FINRA reported that it completed the creation of a single examination program and enforcement arm; work concerning the consolidation of its rulebook occurred in 2008 and will continue in the coming year. FINRA also published important guidance concerning its views on member firm cooperation. A discussion of FINRA's enforcement statistics, priorities, actions, and new developments in 2008 can be found on pages 84 - 123 of this outline.

Notwithstanding its merger with the NASD, NYSE Regulation retained oversight and enforcement responsibility for trading violations occurring on the NYSE's systems and facilities. NYSE Regulation announced 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, odd lot trading, and Rule 92. A discussion of NYSE Regulation's enforcement actions in 2008 can be found on pages 124 - 134 of this outline.

Statistics and Enforcement Priorities

Statistics

In the SEC's fiscal year ("FY") 2008, the Commission brought 671 enforcement actions, a slight increase in comparison to the 656 cases initiated in FY 2007.¹

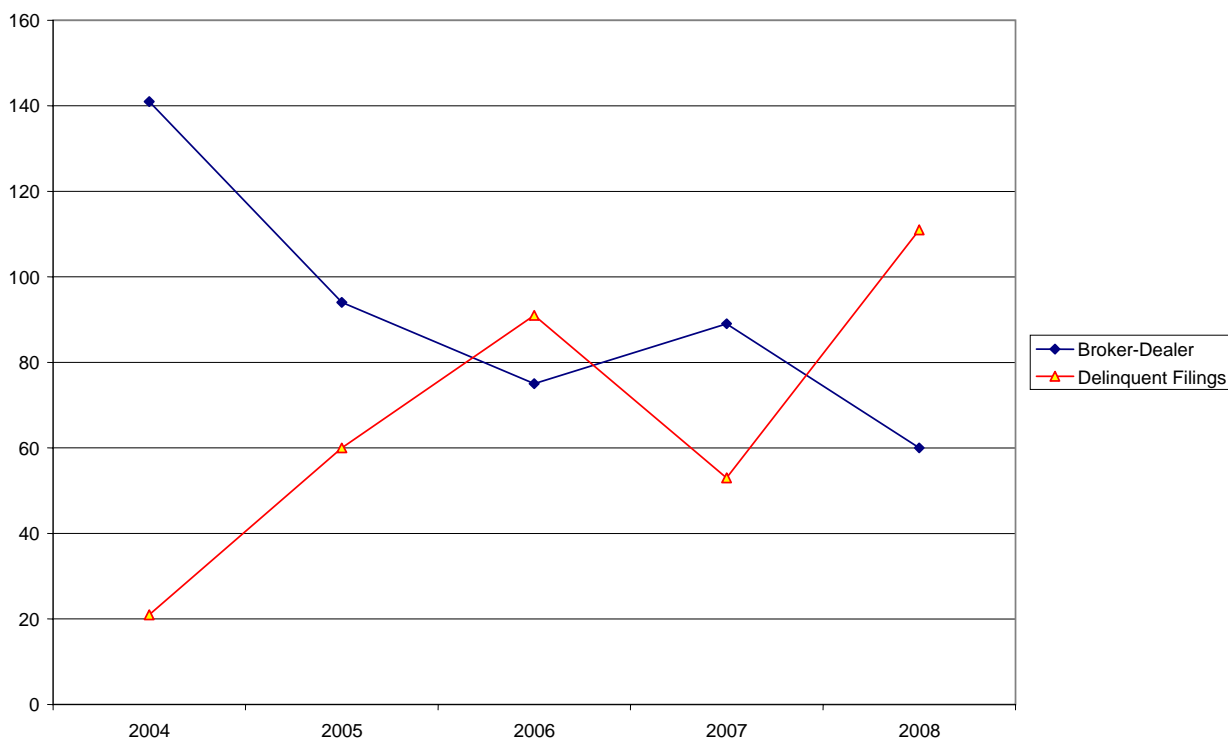
In announcing this year's statistics, the SEC declared that, in FY 2008, the Commission brought the second-highest number of actions ever. That fact does not tell the whole story. For example, it is interesting to note that the SEC brought more than twice as many cases against public issuers for untimely regulatory filings in FY 2008 (111) than in FY 2007 (52). Notably, 47 of the 111 delinquent filing cases were initiated in September 2008, the final month of the SEC's fiscal year. A review of several of those cases showed that the filings had been delinquent for years, suggesting that the Commission could have brought these actions at any time, rather than at the close of this fiscal year.

It also appears that in one of the SEC's core areas – regulation of broker-dealers – its case load was down significantly from about 89 cases in FY 2007 to about 60 cases in FY 2008, a decline of approximately 33%.

Indeed, over the past several years, the number of SEC cases involving delinquent filings generally has trended up while Commission actions against broker-dealers generally have trended down, as shown in the graph below:

¹ The SEC's fiscal year begins on October 1st. References to FY 2008 refer to the year that began on October 1, 2007 and ended on September 30, 2008.

SEC Cases Against Broker-Dealers and Actions for Delinquent Filings 2004 - 2008



In FY 2008, the SEC obtained orders imposing \$256 million in civil money penalties, which represents approximately half the amount in FY 2007. The Commission also obtained orders requiring securities law violators to disgorge approximately \$774 million, which is a 29% decline from FY 2007. The reduced level of penalties and disgorgement continues a generally downward trend in both categories in recent years as shown in the table below:

Fiscal Year	Civil Money Penalties	Disgorgement
2004	\$1.2 billion	\$1.9 billion
2005	\$1.5 billion	\$1.6 billion
2006	\$975 million	\$2.3 billion
2007	\$507 million	\$1.093 billion
2008	\$256 million	\$774 million

In FY 2008, the SEC returned more than \$1 billion of disgorged assets to harmed investors through Fair Funds distributions, the second consecutive year in which

it returned more than \$1.1 billion to investors. However, two cases (against MFS and Bank of America) accounted for nearly half of this amount, and 11 cases accounted for \$739 million. In addition, the Division of Enforcement has negotiated settlements with several large firms concerning auction rate securities sales and marketing. Those settlements, some of which have not yet been approved by the Commission, are not reflected in the FY 2008 statistics. After all of the settlements have been finalized by the Commission, they would be the largest in SEC history, with respondent firms returning more than \$50 billion to investors in exchange for their auction rate securities holdings.

In past years, the Division of Enforcement has been criticized for leaving cases open for extended periods of time. Here, the statistics have greatly improved – the Division of Enforcement closed 1,355 cases in FY 2008, which reflects a 260% increase from FY 2007.

In sum, while the Commission brought (and closed) a relatively high number of cases in FY 2008, actions against broker-dealers, fine levels, and disgorgement were down significantly versus prior years.

SEC Enforcement Priorities

Based upon our review of currently available information, we believe the following list reflects many of the SEC's top priorities for broker-dealer enforcement in FY 2008 and the coming year:

1. The alleged Ponzi scheme attributed to Bernard Madoff, including investigations into the conduct of Mr. Madoff, his family and others at his firm, as well as the role of his firm's auditors and the funds of funds that invested with him;
2. Auction rate securities;
3. Valuation of securities, particularly mortgage-backed securities held by broker-dealers during the subprime crisis;
4. Sales of mortgage-related securities, including suitability, disclosures, and extent of due diligence (coordinated with the SEC's Subprime Task Force, which addresses aspects besides enforcement);
5. Insider trading and controls over material, non-public information;

6. Market manipulation and the collapse of several financial institutions, with a particular focus on short sales, rumors, and the use of credit default swaps;
7. Best execution;
8. Conflicts of interest;
9. Protection of client assets and information, including compliance with Regulation S-P;
10. Internet fraud and on-line account intrusion;
11. Fraud in the municipal securities markets; and
12. Microcap fraud, including efforts to uncover market manipulation in the OTC markets.

Enforcement Actions²

Bernard Madoff's Ponzi Scheme³

Bernard Madoff was arrested and charged with securities fraud on December 11, 2008 after allegedly admitting that he carried out a \$50 billion Ponzi scheme at least in part through an entity that he controlled named Bernard L. Madoff Investment Securities LLC ("BMIS"). According to the charges, Madoff misrepresented to investors that they were receiving gains on their investments when in fact the "gains" consisted of new principal deposits from other investors.

Also on December 11, 2008, the SEC brought an emergency action in the Southern District of New York to halt the ongoing fraud by Madoff and BMIS. On December 12, 2008, Judge Louis Stanton granted the SEC's motion for a temporary restraining order, which, among other actions, appointed Lee Richards, Esq., of Richards Kibbe and Orbe LLP, as receiver for BMIS's assets and directed Madoff and BMIS to retain and prevent any disposal of assets held by Madoff or BMIS.

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

³ These actions were taken after the SEC's FY 2008 closed on September 30th.

On December 15, 2008, Judge Stanton granted an application by the Securities Investor Protection Corporation (“SIPC”) for an order declaring that the customers of BMIS were in need of protection afforded by the Securities Investor Protection Act of 1970. As a result, a trustee, Irving H. Picard, Esq., was appointed for the liquidation of BMIS, and all claims against BMIS will be handled in bankruptcy court. The trustee will begin the claims process by sending claim forms to BMIS’s customers. He then will review filed claims and attempt to satisfy them as completely as possible using SIPC funds (which are reported to be \$1.6 billion) and BMIS assets.

On December 16, 2008, the SEC took the unusual step of issuing a press release stating that it had missed opportunities to discover Madoff’s fraud after receiving “credible and specific allegations regarding Mr. Madoff’s financial wrongdoing”⁴ and announced that it had requested that the SEC’s Inspector General commence an immediate investigation. On December 17, 2008, SEC Chairman Cox softened his tone, emphasizing that “there is no evidence that anyone is aware of at this point that any personnel did anything wrong.”⁵

Since the Madoff scandal erupted, several lawsuits have been filed, including class actions by investors against Madoff and BMIS, and actions by investors against other funds/managers/advisers that, in turn, invested with Madoff or BMIS.

Insider Trading

In 2008, the SEC (and the U.S. Department of Justice) prosecuted a number of insider trading cases, several of which involved Wall Street employees. In total, in FY 2008 the SEC brought 61 insider trading cases against 103 defendants compared to 47 cases against 110 defendants in the prior year, which reflects a 25% increase in the number of cases. Below we report on new civil and criminal insider trading actions and then provide an update on certain settlements from cases initiated in 2007 that were covered in more detail in our prior outlines.

A. *SEC v. Matthew Devlin* (“Devlin”) *et al.* (Dec. 18, 2008 S.D.N.Y.)⁶

1. The SEC brought a civil action against Devlin, a former Lehman Brothers (“Lehman”) registered representative, and six other individuals (including an attorney) for their alleged participation in an insider trading ring that operated between

⁴ SEC Press Release 2008-297, Statement Regarding Madoff Investigation (Dec. 16, 2008).

⁵ Stephen Labaton, *S.E.C. Knew Him as Friend and Foe*, New York Times (Dec. 17, 2008).

⁶ Note that this case was brought after the close of the SEC’s FY 2008.

March 2004 and July 2008 and yielded more than \$4.8 million in illegal profits.

2. In announcing this case, Linda Thomsen, the SEC's Director of Enforcement, stated that "the Commission is unwavering in its determination to pursue illegal insider trading by securities professionals, lawyers, and others."⁷
3. The complaint alleges that Devlin traded on and tipped his clients and friends (three of whom worked in the securities or legal profession) with confidential, non-public information that he secretly obtained from his wife, a public relations executive, who allegedly was unaware of her husband's conduct. The information concerned thirteen pending corporate transactions, including significant acquisitions, which Ms. Devlin was privy to through her representation of the transacting companies.⁸ The SEC noted in its press release that because this information was valuable, some of the defendants called the Devlins the "golden goose."
4. According to the Commission, in exchange for providing inside information to his friends and clients, Devlin received cash and luxury goods, including a widescreen television, a leather jacket, and Porsche driving lessons.
5. Some of the tippees, which included traders, a registered representative, two attorneys, and an investment adviser, attempted to conceal their illicit trading by concentrating the activity in numerous accounts that were not associated with Lehman or Devlin.
6. The SEC seeks injunctive relief, disgorgement, and financial penalties.
7. In related criminal proceedings, the U.S. Attorney's Office for the Southern District of New York charged four individuals with insider trading.

⁷ SEC Press Release 2008-301, SEC Charges Wall Street Professionals and Others With Widespread Insider Trading (Dec. 18, 2008).

⁸ Ms. Devlin has not been charged with any wrongdoing.

- B. *SEC v. Chanin Capital LLC* (D.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, non-public information, as required under Section 15(f) of the Securities Exchange Act of 1934 (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 at one point in time, 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 in 2003, including Chanin’s two principals.
 4. Chanin consented to pay a \$75,000 penalty.
 5. A. Carlos Martinez, who served as Chanin’s chief financial officer 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 Martinez, the SEC alleged that he 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 money 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 Section 15(f). It also appears to be the first time that the Commission implied that failing to adopt policies that the SEC staff has said it views as “minimum standards,” but not required by the 1934 Act, could result in liability under Section 15(f).

C. *SEC v. Guttenberg, et al.* (S.D.N.Y. Mar. 1, 2007) and *U.S. v. Guttenberg* (S.D.N.Y. Feb. 27, 2008)

1. In 2007, 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 (“UBS Securities”) and Morgan Stanley & Co., Inc. (“Morgan Stanley”) in exchange for cash kickbacks.
2. In one scheme, which occurred between 2001 and 2006, an executive director in the UBS Securities equity research department allegedly tipped material, non-public information concerning upcoming UBS Securities 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 misappropriated by an in-house attorney in Morgan Stanley’s global compliance department.
3. On September 12, 2008, the SEC settled with seven defendants. Laurence McKeever, a former Assent LLC general securities principal, consented to a bar from associating with any broker-dealer or investment advisor but was not required to disgorge any ill-gotten gains. Each of the other defendants consented to a bar from associating with any broker-dealer or investment advisor and an injunction from committing further violations, as well as to disgorge the following amounts:

- (a) Robert Babcock (former Bear, Stearns & Co. registered representative): \$149,041;
 - (b) Mark Lenowitz (former Chelsey Capital portfolio manager): \$337,576;
 - (c) David Glass (former Assent LLC registered representative and owner of Jasper Capital) and Jasper Capital: joint and several liability for \$2,751,336;
 - (d) Randi Collotta (former Morgan Stanley compliance attorney): \$670,014, which was waived based on her demonstrated inability to pay;⁹
 - (e) Christopher Collotta (former attorney in private practice): \$4,500; and
 - (f) Marc Jurman (former registered representative with two broker-dealers in Florida): \$38,685.
4. Mitchel Guttenberg, Erik Franklin, David Tavdy, Ken Okada, Q Investment partners LP and DJS Resources Ltd. (d/b/a Chelsey Capital) remain as defendants in the SEC case.
5. 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 and have been sentenced:
- (a) Ms. Collotta pled guilty to conspiracy and securities fraud for tipping non-public information she stole from Morgan Stanley in exchange for sharing in the illicit trading profits. She was sentenced to sixty days imprisonment, six months of home confinement and four years probation. She was also fined \$3,000 and ordered to forfeit \$4,500.

⁹ Ms. Collotta also was suspended from appearing before the Commission as an attorney.

- (b) Jurman pled guilty to conspiracy and securities fraud for trading on and tipping material, non-public information from Morgan Stanley. He was sentenced to two years probation.
- (c) McKeever pled guilty to charges that he conspired to conceal illegal trading in exchange for \$50,000. He was sentenced to two years probation, fined \$3,000, and ordered to forfeit \$30,000.
- (d) Childs, an Assent LLC registered representative, pled guilty to conspiracy to commit securities fraud, wire fraud, and commercial bribery for accepting \$100,000 in exchange for agreeing not to report illegal trading. He was sentenced to two years probation and fined \$5,000.
- (e) Guttenberg, a former UBS Securities executive director, pled guilty to six counts of conspiracy and securities fraud for selling material, non-public information about prospective upgrades and downgrades. He was sentenced to six and a half years in prison and ordered to forfeit \$15.81 million.
- (f) Glass pled guilty to conspiracy and securities fraud for trading while in possession of material, non-public information. He was sentenced to three years probation, fined \$10,000, and ordered to forfeit \$2,751,366.

D. *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 criminally 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 has been on hold pending resolution of the criminal case. The SEC seeks injunctive relief, disgorgement, and a civil money penalty against Naseem and Rahim.

E. *SEC v. Jennifer Xujia Wang, Ruben Chen, and Zhiling Feng*
(S.D.N.Y. July 3, 2008)

1. This is an update on a case brought by the SEC and Department of Justice in 2007.
2. In July 2008, the SEC settled an administrative proceeding against Wang, then a Vice President of Morgan Stanley and her husband Chen, a former employee of ING Investment Management Services, LLC, for trading based on material, non-public information that she misappropriated from Morgan Stanley. The couple used an on-line brokerage account registered to Wang's mother and allegedly purchased securities of three companies, each of which had approached Morgan Stanley to provide services in connection with future acquisitions.
3. Wang and Chen each consented to pay a civil money penalty of \$50,000 and to disgorge jointly and severally more than \$700,000 in profits. In separate administrative proceedings, Chen consented to a bar from associating with any investment adviser, and Wang consented to a bar from associating with any investment adviser or broker-dealer.
4. As we reported in our 2007 outline, Wang and Chen were also criminally prosecuted by the Department of Justice. On September 5, 2007, Wang and Chen each pled guilty to one count of conspiracy and three counts of insider trading and were each sentenced to 18 months in prison and to disgorge

more than \$600,000 in illegal gains. In addition, Wang and Chen received one year and two years, respectively, of supervised release after serving their prison sentences.

On-Line Account Intrusion

In last year's outline, we reported on two SEC cases involving on-line account intrusion.¹⁰ In 2008, the SEC brought at least 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 on-line 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' on-line 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 allegedly 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. On July 24, 2008, the court entered a default judgment against Russ. The court issued a permanent injunction against Russ and ordered him to disgorge \$88,465 and pay a civil money penalty of \$130,000.
5. As with instances involving similar fraudulent conduct in the past two years, the on-line brokers housing the accounts made the intruded accountholders whole for their losses.

¹⁰ One of the cases that we reported in last year's outline was *SEC v. Jaisankar Marimuthu, Chockalingam Ramanathan and Thirugnanam Ramanathan*. In September 2008, a district court judge sentenced Ramanathan to 2 years in prison, 3 years of supervised release and ordered him to pay restitution of \$362,247. In November 2008, Thirugnanam Ramanathan settled charges with the SEC by consenting to a permanent injunction.

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 Craig's List. The traders allegedly opened on-line 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. On December 30, 2008, the SEC filed a motion for a default judgment against AWE Trading, Inc. and Andrew Andersen and voluntarily dismissed its case against relief defendant Interactive Brokers, LLC.

Regulation S-P

Regulation S-P prohibits a firm from disclosing non-public personal information to non-affiliated third parties without first notifying the subject and offering the subject an opportunity to opt out. Below are two litigated cases and one settled proceeding involving Regulation S-P from 2008.¹¹

¹¹ 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 establishing a new exception to the regulation's notice and opt-out requirements. The comment period ended in May 2008.

A. *In the Matter of NEXT Financial Group, Inc.* (“NEXT”) (Admin. Proc. File No. 3-12738, June 18, 2008)

1. In a litigated case, 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 administrative law judge (“ALJ”) concluded that NEXT violated Regulation S-P because before representatives ceased to work for NEXT and joined new firms, they disclosed to their new firms 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 acted negligently because the firm knew that registered representatives likely would disclose clients’ personal identifying information to new employers but did not establish policies or procedures until February 2006 for safeguarding this information.
4. Notably, the ALJ rejected the SEC staff’s argument that existing regulations required NEXT to encrypt its e-mails containing customer data.
5. The ALJ entered a cease-and-desist order and imposed a civil money penalty of \$125,000 against NEXT but did not order the more severe penalty of \$325,000 requested by the SEC staff. The ALJ believed that the lesser penalty amount was appropriate in light 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. *In the Matter of LPL Financial Corporation, formerly known as Linsco/Private Ledger Corp. ("LPL") (Admin. Proc. File No. 3-13181, Sept. 11, 2008)*

1. The SEC settled an administrative proceeding against LPL, a registered broker-dealer, investment adviser, and transfer agent, for failing to adopt policies and procedures reasonably designed to safeguard customer information as required under Regulation S-P.
2. The SEC alleged that between 2005 and mid-2006, LPL's security policies and procedures for safeguarding customer information were deficient, and that LPL failed to reasonably evaluate the security controls over the on-line trading platform the firm provided to its brokers.
3. The SEC further alleged that between July and September 2006, LPL conducted an internal audit of its on-line trading platform, which revealed system security deficiencies with respect to password complexity and session inactivity parameters. The audit report also specifically identified a risk for account intrusions.
4. Despite the audit findings, LPL failed to take timely corrective action and did not implement adequate controls and security measures to protect customers' personal information. Between July 2007 and February 2008, LPL's on-line trading platform experienced multiple "hacking" incidents, whereby unauthorized person(s) placed, or attempted to place, unauthorized trades in customer accounts. The hacking incidents left vulnerable the personal information of at least 10,000 customers.
5. LPL detected all of the breaches and either blocked the unauthorized trades or absorbed all losses to customer accounts caused by unauthorized trades.
6. LPL consented to a censure, a \$275,000 civil money penalty, a cease-and-desist order, and an undertaking related to its policies and procedures for training its employees on safeguarding customer records and information, and agreed to retain an independent consultant

to review and make recommendations regarding LPL's Regulation S-P policies and procedures.

7. This case marked the first time that the Commission brought an enforcement matter under Regulation S-P against a firm for failing to protect adequately unauthorized access to clients' non-public personal information.

C. *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 to 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 to buy annuity products. Many of these "leads" were elderly persons who already held fixed or equity-indexed annuity products.
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 Section 10(a)(1) of Regulation S-P. Mondschein also consented to a five-year bar and to pay disgorgement of \$53,000 and a civil money penalty of \$45,000.

Anti-Money Laundering

Since 2006, the SEC has been active in the anti-money laundering and suspicious activity report areas. In 2008, the Commission brought the following anti-money laundering related action.

- A. *In the Matter of E*Trade Clearing LLC and E*Trade Securities LLC* (collectively, "E*Trade") (Admin. Proc. File No. 3-13106, July 30, 2008)
1. The SEC settled an administrative proceeding against E*Trade for failing to comply with recordkeeping requirements of the Bank Secrecy Act that obligate broker-dealers to identify and verify all customers identities through a customer identification program ("CIP").
 2. E*Trade's CIP procedures required that it verify all clients' identities primarily by comparing information with that of a third-party vendor. During a 20-month period beginning in October 2003, E*Trade allegedly did not follow this procedure because its systems did not submit the names of 65,000 secondary holders of jointly held accounts when new accounts were opened.
 3. In the summer of 2004, nine months after the CIP compliance deadline, E*Trade's risk operations group discovered the vetting gap and reported it to the firm's three highest ranking compliance officers and senior management. The SEC found that despite being aware of the issue, and its re-emergence four and eleven months later, E*Trade did not remedy the problem.
 4. The SEC further alleged that the inconsistency between E*Trade's actual verification process during this period and the process described in its written procedures violated the firm's books and records requirements.
 5. E*Trade consented to a censure, a cease-and-desist order, and civil money penalties totaling \$1 million. It also agreed to retain a consultant to conduct a comprehensive regulatory review of the CIP and develop a written plan to achieve compliance with regulatory requirements.

Market Timing/Late Trading

For several years, market timing and late trading were hot topics in SEC enforcement. It now appears that that pipeline of cases is running dry. Of note, however, while most market timing and late trading cases in prior years have been settled, the first six months of 2008 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 4:00 p.m. EST but time-stamped the order tickets for those trades as though they had been received prior to 4:00 p.m. EST in order to enable them to occur at the same day’s net asset value price.
 3. The SEC alleged that when the mutual funds attempted to halt market timing transactions by limiting the number of trades in a client’s account and prohibiting violators from further trading, the TWCO officers deceived the mutual funds by opening new accounts.
 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 money 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 money penalty of \$500,000. Trautman is challenging the ruling.
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 money 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 Scott Gann, a former Southwest Securities, Inc. vice-president and stockbroker, alleging that he engaged in a fraudulent scheme to conceal deceptive market timing by his clients, Haidar Capital Management, LLC and Haidar Capital Advisors, LLC (collectively, "HCM").

2. The SEC alleged that while performing due diligence on HCM, 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 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 and 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 money 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 of 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 broker numbers and moved accounts between branch offices to avoid detection.

3. The ALJ found Edge liable for failing reasonably 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 reasonably to supervise Charles Sacco, another AGE financial consultant. After Sacco received hundreds of block letters from mutual funds for market timing, Robles approved thirteen split broker 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 money penalty.
6. The ALJ ordered Robles and Edge each to pay \$250,000 in civil money penalties and barred them from serving in supervisory capacities for five years.

D. *In the Matter of Pritchard Capital Partners, LLC, Thomas Ward Pritchard, Joseph John VanCook, and Elizabeth Ann McMahon* (Admin. Proc. File No. 3-12753, July 10, 2008)

1. The SEC brought an action against Pritchard Capital Partners, LLC (“Pritchard”) and three of its employees, alleging that they allowed several hedge fund clients to late trade mutual funds. All respondents except Joseph John VanCook (“VanCook”), a Pritchard sales representative, settled with the SEC.
2. The SEC alleged that VanCook facilitated clients’ late trading, aided and abetted Pritchard Capital’s clearing broker when he entered trades after 4:00 p.m., and aided and abetted Pritchard’s books and records violations by failing to enter accurately trade times.
3. Pritchard cleared its trades through Banc of America Securities, LLC (“Banc of America”), which required that all trades that received the same day’s net asset value (“NAV”) pricing be received by Pritchard by 4:00 p.m. However, Banc of America permitted Pritchard to enter mutual fund trades until 5:30 p.m. for error correction purposes.
4. VanCook allegedly told hedge fund clients that he could place trades after 4:00 p.m. He requested that clients send trade sheets to him by 4:00 p.m., but he permitted them to call him until 5:30 p.m. to inform him which trades on the trade sheets should be entered and which should be discarded (and often permitted changes to the post-4:00 p.m. additions to the trade sheets). When Pritchard’s senior management questioned VanCook following industry-wide regulatory investigations concerning market-timing and late trading, VanCook allegedly represented that he did not place trades after 4:00 p.m.
5. The ALJ concluded that VanCook orchestrated a fraudulent scheme to permit late trading and that VanCook acted with scienter based on the testimony of his hedge fund customers. The ALJ found unpersuasive VanCook’s testimony that he was not aware that late trading was unlawful, in light of VanCook’s experience in the securities

industry, access to information regarding the practice, and deception of Pritchard's senior management.

6. Finding that VanCook's conduct was "egregious," the ALJ issued a cease-and-desist order, barred him from associating with a broker, dealer, or investment company, and ordered him to disgorge \$538,565 (his compensation from the late trading) and to pay a civil money penalty of \$100,000.

E. *In the Matter of Michael Sassano, Dogan Baruh, Robert Okin, and R. Scott Abry* (Admin. Proc. File No. 3-12554, July 11, 2008, July 17, 2008)

1. In 2007, the SEC charged four individuals affiliated with CIBC World Markets Corp. ("CIBC") and/or Fahnestock & Co., Inc. with market timing-related violations. The SEC initiated proceedings, but all four settled before a hearing on the merits in the matter.
2. In July, the SEC settled an administrative proceeding against brokers Michael Sassano and Dogan Baruh for their alleged collaboration with hedge fund customers to deceptively market time mutual funds between June 1998 and September 2003.
3. As we reported in last year's outline, despite hundreds of complaints by mutual fund families concerning the market timing activities, Sassano and Baruh allegedly employed an array of strategies designed to help their hedge fund clients avoid detection by the mutual fund companies' internal market timing monitors by: (1) the use of multiple accounts, registered representative numbers, and branch numbers; (2) trading in smaller dollar amounts; (3) moving accounts to other broker-dealers to continue market timing funds that had blocked their customers trading through CIBC; and (4) market timing variable annuities.
4. During the approximately five-year period, Baruh and other CIBC brokers allegedly market timed 80 different mutual funds through 217,000 trades involving a total of

approximately \$90 billion dollars in purchases. The median holding period of these trades was two days.

5. In addition, Baruh allegedly accepted mutual fund orders after 4:00 p.m. and processed them as though they had been placed prior to 4:00 p.m., so that they received the same day's NAV pricing. In many instances, clients faxed trade orders to Baruh before 4:00 p.m. but called after 4:00 p.m. and told Baruh which trades to execute.
6. Robert Okin and Scott Abry supervised Sassano and Baruh and purportedly knew of, and assisted, Sassano and Baruh's deceptive market timing practices. Earlier this year, Okin consented to a 12-month suspension from acting in a supervisory capacity with any broker or dealer and agreed to pay a civil money penalty of \$150,000. Abry consented to the same suspension and agreed to pay a civil money penalty of \$125,000.
7. Baruh agreed to cooperate with the SEC's investigation. He also consented to a cease-and-desist order, payment of a \$325,000 penalty, and a bar from associating with any broker, dealer, or investment advisor and from serving in specified roles for a registered investment company. Sassano consented to a cease-and-desist order and the same bar and agreed to pay a civil money penalty of \$1,000,000.

F. *SEC v. Tambone* (1st Cir. Dec. 5, 2008)¹²

1. In a litigated case, the First Circuit reversed a dismissal by a district court of SEC charges against two Columbia Funds Distributor Inc. ("CFD") executives for their roles in permitting certain investors to market time the Columbia Funds.
2. In 2005, the SEC settled an administrative proceeding against Columbia Management Advisors, Inc. ("CMA"), CFD, and three executives for permitting certain investors to engage in short-term trading in the Columbia Funds while maintaining prospectus disclosures that stated that market

¹² This opinion was published after the SEC's FY 2008 closed on September 30th.

timing was prohibited. To settle that matter, the respondents consented, in part, to pay a \$70 million fine and disgorging \$70 million.

3. Subsequently in 2005, the SEC initiated a federal district court action against James Tambone and Robert Hussey, two CFD executives, for entering into or approving at least eight agreements for investors to market time the Columbia Funds. The SEC alleged that in light of their knowledge of these agreements, Tambone and Hussey violated the law by distributing misleading prospectuses and/or participating in the process of reviewing and revising prospectus disclosures. The SEC charged the defendants as primary violators of the federal securities laws and for aiding and abetting CMA's and CFD's violations.
4. A Massachusetts district court dismissed the primary liability claims because the complaint failed to allege that either defendant personally made any untrue statement or material omission. The court also dismissed the aiding and abetting claims because the complaint did not sufficiently allege that the defendants "threw in their lot with the primary violators."
5. In a 2-1 decision, the First Circuit reversed the dismissal of the primary and secondary liability claims and remanded the case to the district court, holding that the defendants made implied statements to investors by disseminating prospectuses that contained information that they knew was false.
6. Notably, the First Circuit also opined that a defendant could violate Section 17(a)(2) even if he or she did not actually make a false or misleading statement if he or she obtained property "by means of" an untrue statement made by another person. The court distinguished this Section 17(a)(2) standard from the more narrow Section 10(b) and Rule 10b-5 standard, which requires that the defendant "make" an untrue statement.

Conflicts Of Interest

In 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)¹³

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) it failed to disclose TEGG and personal relationships among its broker selection factors in its Form ADV and its SAs.
4. The SEC alleged that Fidelity, through DeSano, failed reasonably to 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

¹³ Although the Commission did not sanction any broker-dealer in this case, the matter involves Fidelity’s relationships with such firms. Moreover, the SEC and NASD brought actions against certain broker-dealers related to this matter. See, e.g., the case involving Lazard Capital Markets described below.

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 (a 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).

7. On December 11, 2008, seven equity traders named in Fidelity's order settled with the SEC by consenting to charges relating to their acceptance of travel and gifts from brokers who placed trades for Fidelity. Each of the seven equity traders agreed to cease-and-desist orders, censures, and the following additional sanctions:

RESPONDENT	SANCTION
Burnieika	Disgorgement of \$39,000 and a civil penalty of \$30,000
Donovan	Disgorgement of \$120,816 and a civil penalty of \$45,000
Driscoll	Disgorgement of \$39,000 and a civil penalty of \$30,000
Harris	Disgorgement of \$45,000 and a civil penalty of \$30,000
Horan	Disgorgement of \$63,000 and a civil penalty of \$30,000
Pascucci	Disgorgement of \$44,339 and a civil penalty of \$30,000
Smith	Disgorgement of \$56,690 and a civil penalty of \$30,000

8. DeSano also settled with the SEC consenting to charges that he violated, and caused Fidelity to violate, several provisions of the Advisers Act by failing reasonably to supervise, failing to seek best execution of Fidelity's clients' securities transactions, and failing to disclose to Fidelity and its clients material conflicts of interest arising from the receipt of TEGG. DeSano consented to a cease-and-desist order, a bar from association with any investment advisor (with right to reapply for association after one year), disgorgement of \$106,000, and a civil money penalty of \$125,000.
9. The SEC's charges against equity traders Robert Burns and Thomas Bruderman have not been resolved.

B. *In the Matter of Lazard Capital Markets* ("Lazard") (Admin. Proc. File No. 3-13281, Oct. 30, 2008); *In the Matter of Louis Gregory Rice* (Admin. Proc. File No. 3-13282, Oct. 30, 2008); *In the Matter of Robert A. Ward* (Admin Proc. File No. 3-13283, Oct. 30, 2008); *In the Matter of David L. Tashjian* (Admin. Proc. File No. 3-13284, Oct. 30, 2008); *In the Matter of W. Daniel Williams* (Admin Proc. File No. 3-13285, Oct. 30, 2008).¹⁴

1. The SEC settled administrative proceedings against Lazard and four of its employees for allegedly providing more than \$600,000 in gifts, travel, and entertainment to Fidelity equity traders, who traded on behalf of the Fidelity mutual funds.
2. The SEC alleged that between 2000 and 2004, Robert A. Ward and W. Daniel Williams, two Lazard traders, and David L. Tashjian, a managing director, provided private jet travel, lavish meals and lodging, adult entertainment, illegal drugs, and extravagant gifts to Fidelity equity traders who directed Fidelity orders to Lazard. During that period, Lazard placed trades for Fidelity, which generated more than \$20 million in commissions for Lazard.
3. The SEC further alleged that Lazard, Tashjian, and Gregory Rice, a managing director, failed to supervise Ward and Williams. Lazard's policies and NASD rules prohibited employees from providing gifts greater than \$100 to an employee of a financial institution in any year. Rice allegedly

¹⁴ Note that this case was brought after the close of the SEC's FY 2008.

was aware of the nature and frequency of the gifts, did nothing to stop the conduct, and encouraged Lazard employees to use Lazard's expense account to increase the firm's brokerage business from Fidelity.

4. Lazard, Rice and Tashjian were charged with failure to supervise, and all four respondents were charged with aiding and abetting Fidelity traders' violations of Section 17(e)(1) of the Investment Company Act, which prohibits the receipt of compensation (e.g., gifts and entertainment) in exchange for fund property (e.g., trading commissions).
5. Lazard consented to a censure, disgorgement of \$1.8 million, and a civil money penalty of \$600,000. Rice agreed to a six-month suspension from supervising any broker or dealer and a civil money penalty of \$60,000. Ward and Williams consented to cease-and-desist orders, a six-month and a three-month industry suspension, respectively, and civil money penalties of \$50,000 and \$25,000, respectively. Tashjian agreed to a cease-and-desist order, a 9-month industry suspension and a civil money penalty of \$75,000.
6. In accepting Lazard's offer of settlement, the SEC noted the firm's "extraordinary cooperation" afforded to the staff in the investigation.

C. *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 adequately to 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 money 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 money penalty of \$1,000,000.

D. *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”). Among other findings, the

NAC concluded 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 hearing panel decision imposing a nine month suspension and a \$15,000 fine. The NAC reduced the fine to \$10,000 and set aside the suspension entirely because it did not find Strong's conduct to be as egregious as the hearing officer did. The NAC found significant that: Strong was the lone compliance employee in a forty-person firm that historically had neglected compliance responsibilities, the violations occurred shortly after Strong began working for the firm, and Strong did not personally benefit from the infractions.
3. As J&L's chief compliance officer, Strong allegedly was 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 revised 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 Gary Davis ("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.

E. *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 money penalties. All three individual defendants, as well as Blount Parrish & Co. have filed motions to dismiss the Commission's complaint.

5. On December 1, 2008, federal prosecutors in Alabama brought criminal charges against Langford, Blount, and LaPierre in a 101-count indictment based on the same facts as the SEC's charges.

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 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 six 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 money penalties.
4. On June 4, 2008, Durant consented to a settlement with the SEC that barred him from association with a broker-dealer.

C. *SEC v. Kenneth Suarez, Kevin King, Ronald Garcia, Gilbert Beital, Independent Investor Services, Inc., and Gilcar Securities of Florida, Inc.* (“Gilcar Securities”) (E.D.N.Y. Sept. 24, 2008)

1. The SEC filed a complaint charging six defendants with engaging in a scheme to defraud Schonfeld Securities, LLC (“Schonfeld”) out of at least \$1.66 million through sham finder’s fees and undisclosed kickbacks in connection with stock loan transactions.
2. The complaint alleges that over a period of almost four years, Suarez, the head of Schonfeld’s stock loan trading desk, caused Schonfeld to enter into stock loan transactions on terms deliberately unfavorable to Schonfeld in order to generate finder’s fees and kickback payments for all of the defendants at Schonfeld’s expense.
3. King, a stock loan trader employed by Van der Moolen Specialists USA, LLC (“VDM”), arranged the loans with Suarez, causing VDM to pay sham finder’s fees to Garcia, operator of Independent Investor Services, and Beital, operator of Gilcar Securities. King then received kickbacks from Garcia, and Suarez received kickbacks from King and Beital.

4. The SEC seeks permanent injunctions, disgorgement, prejudgment interest, and civil money penalties.
- D. *SEC v. Melvyn Nathanson, Eric Nathanson, Charles Peterein, and Ganis Company, Inc.* (S.D.N.Y. Sept. 24, 2008)
1. The SEC filed a complaint charging four defendants with engaging in a scheme to defraud two securities brokerage firms out of at least \$1.16 million through the payment of sham finder fees and undisclosed kickbacks in connection with stock loan transactions.
 2. The complaint alleges that Melvyn and Eric Nathanson were consultants whose duties involved arranging stock loans for Kellner, Dileo & Co. (“Kellner”), a registered broker-dealer. They participated in a scheme in which Peterein, a stock loan trader for PAX Clearing Corp. (“PAX”), caused PAX to engage in over 4,000 stock-loan transactions with Kellner on terms that were intentionally unfavorable to PAX, which increased the compensation that Kellner paid to the Nathansons. In return, the Nathansons paid sham finders fees to Peterein’s shell company, Ganis Company, Inc. at PAX’s expense.
 3. The SEC seeks permanent injunctions, disgorgement, prejudgment interest, and civil money penalties.

Short Selling/Rumor Spreading

Several enforcement developments in 2008 in the short selling and rumor spreading arena are noteworthy.

Early in the year, the SEC brought a high-profile administrative proceeding alleging that a trader created and disseminated false or misleading rumors to manipulate the price of a company’s stock. This case, against Paul S. Berliner, received a significant amount of attention from the media and Wall Street and is described below.

Moreover, in the fall of 2008, in response to extreme market volatility and the significant and precipitous decline in the value of the stock prices of a number of financial institutions, the SEC opened investigations into potential illegal short selling and the alleged creation and spread of false rumors by market participants.

Finally, in September 2008, the Commission made several extraordinary announcements concerning its investigations into the possible market manipulation of the securities of various financial institutions. In particular, the SEC stated that “hedge fund managers, broker-dealers and institutional investors with significant trading activity in financial issuers or positions in credit default swaps will be required, under oath, to disclose those positions to the Commission and provide certain other information. The Commission also approved a formal order of investigation that will allow SEC Enforcement staff to obtain additional documents and testimony by subpoena.”¹⁵

A. *In the Matter of Paul S. Berliner* (Admin. Proc. File No. 3-13035, May 5, 2008)

1. The SEC settled a case against Berliner, a Schottenfeld Group LLC (“Schottenfeld”) trader, for his dissemination of a false rumor involving an acquisition by the Blackstone Group (“Blackstone”) 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 particularly insidious because it harms investors by

¹⁵ SEC Press Release 2008-214, SEC Expands Sweeping Investigation of Market Manipulation (Sept. 19, 2008).

distorting the information they use to make investment decisions.”¹⁶

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 from association with any broker-dealer, disgorgement of his trading profits, and a civil money penalty of \$130,000.

B. *SEC v. Davidson* (E.D. Pa. July 24, 2008), *United States v. Davidson, et al* (E.D.N.Y. Oct. 25, 2007)

1. In a criminal case, a federal court entered a judgment against David Davidson and Lloyd Beirne, the former CEO and former president, respectively, of defunct broker-dealer D.L. Cromwell (“Cromwell”), for participating in a fraudulent short-selling scheme involving the stock of Expedia, Inc.
2. In late October 2002 through March 2003 on an almost daily basis, Davidson and Beirne accessed their clearing broker’s system to fraudulently enter and then cancel buy orders in order to conceal the size of Cromwell’s short position in Expedia. These fictitious buy orders gave the appearance that Cromwell’s short position was significantly smaller than it actually was, which enabled Cromwell to evade margin calls.
3. When Expedia announced a tender offer, its stock price soared. Cromwell could not meet its margin calls, and the defendants’ fraud was discovered. Cromwell’s clearing broker paid \$18 million to cover the short position.
4. Both Davidson and Beirne pled guilty and were sentenced to five years of probation and ordered to pay restitution of \$6.9 million.

¹⁶ 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 Mr. Friestad and George Curtis.

5. In a follow-on civil action brought by the SEC, Davidson and Beirne consented to the entry of a final judgment permanently enjoining them from further violations and barred them from associating with any broker or dealer. In light of the penalties imposed in the criminal proceedings, the Court did not order them to pay disgorgement or a civil money penalty.

Specialists

In 2008, federal prosecutors faced significant setbacks in their prosecution of former employees of specialist firms, while the SEC continued to settle cases against several specialists on similar charges.

- A. By way of background, in April 2005, federal prosecutors indicted fifteen former specialist firm employees on securities fraud charges. Following the indictments, but prior to 2008, two defendants were acquitted (Robert Scavone, Jr. and Richard Volpe), two defendants pled guilty (Joseph Bongiorno and Patrick McGagh, Jr.), two were convicted (Michael Hayward and Michael Stern), one defendant was found guilty by a jury but had his conviction set aside by the judge (David Finnerty), one defendant remained at large (Freddy DeBoer), and federal prosecutors dropped all charges against the seven remaining defendants. The prosecutors appealed the judge's decision to set aside Finnerty's conviction. As of the end of 2007, federal prosecutors had obtained two convictions, two guilty pleas, and had charges pending against DeBoer, who remained at large.
- B. The Second Circuit Court of Appeals affirmed the acquittal of Finnerty in July 2008 and reversed the convictions of Hayward and Stern in August 2008, reasoning that prosecutors had not demonstrated that the defendants had misrepresented the value of securities to clients because the employees did not interact with clients. Subsequently, in August, a federal district court vacated the guilty pleas of Bongiorno and McGagh approximately one year after they had begun serving prison time. Finally, federal prosecutors dropped the charges against the lone remaining defendant (DeBoer).
- C. Back in 2005, the SEC commenced an administrative action against these 15 specialists plus an additional five specialists on related charges. In 2007, the SEC settled the charges against five respondents. In 2008, the SEC settled the charges against five

more respondents and dropped the charges against another respondent.

Best Execution

For years, best execution was a priority among regulatory examiners and also has been a focus in the enforcement area. Two such cases are 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 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 money penalty and a cease-and-desist order.
 5. 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 allegedly 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 adequately to 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 and a civil money 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.

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, a Fidelity equity trader, and Hinkle, a Capital Institutional Services, Inc. registered representative, alleging that they engaged in a scheme to front run Fidelity's mutual funds.
 2. The complaint alleges 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 2008, the SEC tried 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, an Archer Alexander Securities Corp. broker, 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, the Commission charged that 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 money 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 argued that the court relied upon suitability standards from an NASD Notice to Members in the jury instructions. The jury therefore was instructed to weigh the suitability of Solow's recommendations in connection with inverse floaters using NASD standards in an SEC action, which Solow contended was unprecedented.
4. Solow's motion for judgment as a matter of law or for a new trial was denied in March 2008, and final judgment was entered against Solow on May 14, 2008. Solow filed a notice of appeal in May 2008, and the appeal is pending.
5. On September 16, 2008, in a follow-on proceeding an ALJ issued a decision barring Solow from association with any broker or dealer. The judge rejected Solow's contention that the bar was superfluous in light of the permanent injunction ordered by the court because the federal appellate court could reverse the decision granting the permanent injunction.

Senior Citizens

Over the past several years, the SEC, along with 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 and suitability.

Although not an enforcement-led initiative, a September 2008 SEC, NASAA, and FINRA report titled “Protecting Senior Investors: Compliance, Supervisory and Other Practices Used by Financial Firms in Serving Senior Investors” bears mention. In this report, the regulators provided practical examples of ways in which the industry is attempting to work with senior investors in a sound and principled manner. Specifically, the report includes a summary of certain practices used by firms and individuals in serving senior investors, including communicating with investors, training and educating firm employees, obtaining information during the account opening process, and developing focused supervision, surveillance and compliance reviews.

On the enforcement front, we describe the cases below.

A. *SEC v. Gary J. Gross* (S.D. Fla. Sept. 22, 2008)

1. The SEC filed a complaint charging Gary Gross, an Axiom Capital Management, Inc. registered representative, with using various abusive sales practices to defraud his firm’s elderly and financially unsophisticated clients.
2. Between early 2004 and September 2006, Gross allegedly:
 - (a) sold his clients’ conservative investments and used the proceeds to purchase risky, illiquid speculative securities contrary to their risk-averse investment objectives;
 - (b) made material misrepresentations and omissions regarding the risks of the securities, including private investments in public equities (“PIPEs”), that he bought in his clients’ accounts;
 - (c) engaged in unauthorized discretionary trading in clients’ accounts;

- (d) churned clients' accounts;
 - (e) fabricated account values when questioned by his clients about losses in their accounts; and
 - (f) traded on margin in customer accounts without discussing margin trading with them and told his clients to dismiss any margin call letters they received.
3. As a result of this conduct, Gross allegedly caused his clients to lose over \$2.7 million while generating for himself more than \$700,000 in commissions and fees.
 4. The SEC seeks declaratory relief, a permanent injunction, disgorgement, and prejudgment interest.

B. *SEC v. Mark Salyer* (E.D. Tenn. Dec. 3, 2008)¹⁷

1. The SEC settled an action against Mark Salyer, a MetLife Securities, Inc. ("MetLife") registered representative, in which it alleged that he misappropriated millions of dollars from MetLife clients.
2. According to the complaint, between June 2005 and October 2007, Salyer misappropriated approximately \$6 million from no less than 33 MetLife clients, most of whom were senior citizens and had long-standing business relationships with him. Salyer allegedly diverted the funds from the client accounts into multiple entities, two of which he directly controlled, by forging signatures on wire transfers forms and encouraging the clients to invest in his company as if it were a MetLife investment.
3. The complaint further alleged that Salyer facilitated and otherwise concealed his fraudulent activities by falsifying customer brokerage account statements and providing

¹⁷ Note that this case was commenced after the close of the SEC's FY 2008.

clients with fraudulent explanations for discrepancies in the account balances reflected in their account statements.

4. Salyer consented to a permanent injunction and to pay disgorgement and a civil money penalty in an amount to be determined by the court.

Record Retention and Production

In the past several years, the Commission (as well as other securities regulators) has brought cases against broker-dealers for failure to retain and/or produce e-mails requested in connection with their investigations. The case below is an interesting example of a litigated matter in this area.

A. *In the Matter of vFinance Investments, Inc., (“vFinance”) Nicholas Thompson and Richard Campanella* (Admin. Proc. File No. 3-12918, Nov. 7, 2008)¹⁸

1. In a contested administrative proceeding, the Division of Enforcement alleged that vFinance, a broker-dealer, failed to preserve and produce customer correspondence of one of its registered representatives, Thompson. Campanella, a senior vFinance executive, allegedly failed to restrain Thompson’s use of personal e-mail and instant messaging systems in communicating with customers, failed to create and implement procedures to capture Thompson’s communications, and failed to respond promptly to the Division of Enforcement’s request for records.
2. The Enforcement Division contacted vFinance in July 2005 to request documents in connection with a suspected manipulation of stock by Thompson. Although vFinance made productions in response to the July 2005 and other SEC requests, no vFinance employee searched Thompson’s office for responsive documents until March 2007.
3. vFinance employees had informed Thompson that it was his responsibility to keep copies of e-mails sent in his personal account. Nevertheless, when the SEC staff inspected Thompson’s hard drive, they observed that it had been

¹⁸ Note that this decision was issued after the close of the SEC’s FY 2008.

systematically erased and that instant messenger chat logs and e-mails had been deleted from the hard drive.

4. The ALJ found that vFinance violated broker-dealer record retention requirements by failing to maintain information in an easily accessible place for a two year period and failing promptly to produce requested information to the Division of Enforcement.
5. The ALJ concluded that Campanella aided and abetted and caused the firm's violations of the books and records provisions by failing to produce vFinance's responsive documents for nearly eighteen months. The ALJ also based his decision, in part, on his conclusion that Campanella was aware that Thompson was using a personal e-mail account for business purposes and failed to take any meaningful remedial action.
6. The ALJ issued cease-and-desist orders against vFinance and Campanella, ordered them to pay civil penalties of \$100,000 and \$30,000, respectively, and censured Campanella. Earlier in 2008, Thompson settled with the SEC and consented to a cease-and-desist order, a five-year bar from associating with any broker-dealer and a \$30,000 civil money penalty.

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. ("PAZ"). 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 Council ("NAC") and then to 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 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 wrote 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, on remand, found that because NASD Regulation lacked subpoena power, a member's compliance with its Rule 8210 requests was essential. According to the SEC, 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 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.

SEC Enforcement Developments

Inspector General Investigations

One of the main missions of the SEC is to investigate and prosecute securities law violations. Its investigations are carried out by the staff of the Division of Enforcement. In 2008, the Division of Enforcement found itself the subject of several investigations conducted by the Commission’s Office of the Inspector General (“OIG”). These investigations included reviews relating to the staff’s handling of investigations of Bear Stearns & Co. (“Bear Stearns”), Pequot Capital Management (“Pequot”), and Bernard Madoff Investment Securities LLC (“BMIS”).¹⁹

Bear Stearns

In April 2008, the OIG opened an investigation in response to U.S. Senator Charles Grassley’s request for a report on any improper action or misconduct relating to a Division of Enforcement’s investigation of Bear Stearns and its decision to abandon that inquiry without recommending any enforcement action.

The SEC’s probe of Bear Stearns, which was referred to the Miami Regional Office (“MIRO”) in February 2004, concerned the possible improper valuation of collateralized bond obligations and collateralized loan obligations purchased by a Puerto Rico-based financial holding company.

On September 30, 2008, the OIG submitted its report, finding that MIRO Regional Director David Nelson had an “ongoing personal relationship” with counsel for Bear Stearns, who worked with Nelson and counsel for another defendant as attorneys with the Division of Enforcement approximately 20 years ago. The report concluded that MIRO, under Nelson’s supervision, had abruptly terminated the investigation just as two years of settlement negotiations with Bear Stearns were nearing an agreement. The OIG further stated that the investigation was “plagued by numerous unconscionable delays” and that “a

¹⁹ While the OIG reports and Initiating Official Brenda Murray’s reports are labeled confidential, they are available on the Internet.

significant opportunity to coordinate with the U.S. Attorney's Office and uncover evidence of a systematic problem at Bear Stearns was also lost through neglect.”

The OIG noted that while there was no direct evidence of improper influence, the close relationship between defense counsel and senior SEC staff officials, such as Nelson, could potentially harm the Commission's reputation. The OIG concluded that Nelson failed to administer his statutory obligations and responsibilities to vigorously enforce compliance with the securities laws in connection with the Bear Stearns investigation. Accordingly, the OIG referred the matter to the SEC Chairman for disciplinary and/or performance-based action.

After reviewing the OIG report and the Division of Enforcement's response, among other documents, Administrative Law Judge Brenda Murray, the Initiating Official appointed by the SEC, found that “the record does not show that Nelson failed to vigorously enforce compliance with the securities laws.” Rather, ALJ Murray determined that the OIG's conclusions were not supported by his report, most significantly the OIG's conclusions that: (i) Nelson was responsible for closing the Division of Enforcement's investigation of Bear Stearns; (ii) Nelson engaged in “improper or unethical conduct;” (iii) the SEC lost an opportunity to identify widespread misconduct by Bear Stearns; and (iv) the Division of Enforcement's investigation “was plagued by numerous unconscionable delays.” After rejecting these conclusions, ALJ Murray determined that there was no basis for the OIG's recommendation of disciplinary or performance-based action against Nelson.

Pequot

In November 2003, the Division of Enforcement commenced an investigation into possible insider trading by Pequot concerning an acquisition that had not yet been made public, allegedly resulting in Pequot's \$18.9 million trading profit. Enforcement closed its investigation without recommending enforcement action. Subsequently, former SEC staff attorney Gary Aguirre alleged that he had been terminated as retaliation for his complaints that he had been prevented by his superiors from taking the testimony of John Mack, a former chairman of Pequot and chief executive officer of Credit Suisse First Boston, and that Mack had received favorable treatment from the Division of Enforcement. In 2008, the OIG began an investigation into whether: (i) Mack received favorable treatment from Enforcement during the investigation due to his prominence or political connections; and (ii) any Division of Enforcement staff attorneys, including Director of Enforcement Linda Thomsen, acted inappropriately.

On September 30th, 2008, the OIG reported its findings, concluding that Division of Enforcement supervisors failed to fulfill their management responsibilities and that their conduct raised serious questions about the impartiality and fairness of the Pequot investigation. In addition, the OIG could not rule out a connection between the Division of Enforcement's decision to terminate staff attorney Gary

Aguirre and his pursuit to take the testimony of Mack in connection with the Pequot investigation. The OIG found no evidence that Aguirre received negative feedback in connection with his performance reviews until he became more insistent on taking Mack's testimony. The OIG concluded that the Division of Enforcement failed in numerous respects in how it managed Aguirre and allowed inappropriate reasons to factor into its decision to terminate him.

The OIG also expressed serious concerns about the appropriateness of communications between counsel for Morgan Stanley, which was considering hiring Mack as its chief executive officer, and Thomsen, the Director of Enforcement. In general, the OIG criticized the appropriateness of the Division of Enforcement's common practice of allowing counsel to bypass the line attorney and providing access to high-level SEC officials when counsel sought to escalate issues.

The OIG recommended disciplinary and/or performance-based action against three individuals, including Thomsen. The OIG also recommended that the SEC reassess and clarify its practice of allowing counsel access to those supervising attorneys, to avoid favorable treatment, or the appearance thereof.

After reviewing the OIG report and the Division of Enforcement's response, among other documents, Brenda Murray, once again the Initiating Official appointed by the SEC, found that: (i) Thomsen believed that she was fulfilling her duties as Director of Enforcement when she provided information to counsel for Morgan Stanley; (ii) the record did not support Aguirre's claims that the Commission conducted a sham investigation to exonerate Mack; (iii) Aguirre did not demonstrate that his termination was retaliation for his whistleblowing; and (iv) the Division of Enforcement had grounds to terminate Aguirre that were unrelated to the Pequot investigation. ALJ Murray concluded that the record did not support disciplinary and/or performance-based action against Thomsen or one other supervisor. Ms. Murray deferred a recommendation as to the third individual.

Madoff

As previously noted, on December 16, 2008, SEC Chairman Christopher Cox called upon the OIG to investigate the SEC's conduct regarding the vast Ponzi-scheme allegedly orchestrated by Bernard Madoff. Chairman Cox stated that "credible and specific allegations regarding Mr. Madoff's financial wrongdoing"²⁰ repeatedly were brought to the attention of the SEC staff since at least 1999 but no action was ever recommended or taken. One day later, Chairman Cox softened his stance, emphasizing that "there is no evidence that anyone is aware of at this point that any personnel did anything wrong."²¹

²⁰ SEC Press Release 2008-297, Statement Regarding Madoff Investigation (Dec. 16, 2008).

²¹ Stephen Labaton, *S.E.C. Knew Him as Friend and Foe*, New York Times (Dec. 17, 2008).

The OIG will examine the SEC's purported failures to respond to allegations involving Mr. Madoff and the reasons why they were not found credible. The review also will focus on the SEC's internal policies for elevating these types of allegations to the Commission, whether those policies were followed, and whether improvements are needed.

SEC Enforcement Manual²²

In an effort to make its processes more transparent, in October 2008, the SEC made public its Division of Enforcement Manual.²³ Substantial sections of the 122-page manual will be familiar to veterans of the Division of Enforcement because a version of this document, known internally at the SEC as the "Red Book," has long been used by the Division of Enforcement staff as a guide to conducting investigations. Notably, the release of the manual comes only eight months after former Commissioner Paul Atkins publicly encouraged the staff to publish such a document to bring more "predictability" to the SEC's enforcement process.²⁴

The manual sets forth standard practices for key SEC enforcement processes, such as opening and closing investigations, obtaining formal orders of investigation, conducting witness interviews and testimony, requesting documents and other information, the Wells process, privilege waivers, and cooperation with other agencies and organizations. The manual also contains a number of template forms that staff and counsel can use in certain situations, including model confidentiality agreements, witness assurance letters and tolling agreements.

Treasury Proposal to Restructure Financial Regulation

In March 2008, the U.S. Treasury Department (the "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."

- A. The Blueprint contains several short-term and intermediate-term recommendations to enhance and/or reform the current financial institution regulatory structure.

²² For a detailed analysis of the manual, see <http://www.morganlewis.com/index.cfm/publicationID/eeecf235-c856-4cad-8b33-f7959403f485/fuseaction/publication.detail>.

²³ The full text of the manual can be found on-line at <http://www.sec.gov/divisions/enforce/enforcementmanual.pdf>.

²⁴ See Paul Atkins, Remarks to the "SEC Speaks in 2008" Program of the Practising Law Institute (Feb. 8, 2008) (available at <http://www.sec.gov/news/speech/2008/spch020808psa.htm>).

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

- E. In light of the unprecedented events that swept the markets later in 2008, the criticism of the SEC and other regulators regarding their perceived lack of regulatory and enforcement activity, and the election of a new U.S. President, it is unclear whether and how the securities, banking and insurance regulatory regimes will change in 2009. In short, it is simply not possible to predict at this time whether any of the Blueprint's recommendations will be implemented next year or beyond.

Creation of the SEC Office of Collections and Distributions²⁵

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.

At the time the Office of Collections was created, it held \$5 billion in "Fair Funds" to be distributed to investors.

Cooperative Arrangements with the Federal Reserve and Foreign Financial Regulatory Counterparts

In 2008, the SEC agreed to share information with the Federal Reserve and, continuing the trend in recent years, executed another Memorandum of Understanding with a foreign regulator (this time with Australia).

- A. The Federal Reserve
 - 1. In a bid to strengthen cooperation between the SEC and the Federal Reserve, the two agencies signed a Memorandum of Understanding on July 7, 2008 in which they agreed to share information and meet quarterly to discuss regulatory changes.
 - 2. The deal calls for the SEC and the Federal Reserve to share information in several areas, including anti-money

²⁵ 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).

laundering, bank brokerage activities, clearance and settlement, and the regulation of transfer agents.

B. Australia

1. On August 25, 2008, the SEC entered into a mutual recognition agreement with the Australian government and Australian Securities and Investments Commission (“ASIC”).
2. Under the arrangement, the first of its kind, the SEC and ASIC agreed to consider providing exemptions to exchanges and securities brokers in one another’s countries, such as permitting broker-dealers to directly engage foreign investors while remaining subject to regulations of their own countries. The SEC and ASIC would retain their jurisdiction to investigate and prosecute violations of their respective anti-fraud laws, but would depend on their foreign counterpart to enforce securities regulations. At the time the agreement was announced, the process of considering exemptions for approval was expected to be concluded in early 2009.
3. A significant element of the SEC/ASIC arrangement was the execution of a Memorandum of Understanding that permits greater regulatory and enforcement cooperation and coordination between the two countries’ securities regulators.

SEC, FINRA, and State Regulators: Auction Rate Securities

A topic that received among the most media and industry attention in 2008 was auction rate securities (“ARS”), as the SEC, FINRA and more than a dozen state securities regulators launched inquiries and/or brought cases in this area. For ease of reference, we have prepared a chart on the following pages, which reflects key details for selected SEC, FINRA, and state regulatory enforcement settlements in 2008.

Firm	Regulator(s)	Date	Civil Penalty/Fine
Banc of America Securities LLC and Banc of America Investment Services, Inc. (collectively, "Banc of America")	SEC	10/08/2008 (preliminary)	Possible financial penalty after completion of obligations under settlement agreement
	NASAA; New York	10/8/2008	\$50 million

Primary Allegations	Purchase/Reimbursement Details
<ul style="list-style-type: none"> • Misrepresentations to clients regarding the safety and liquidity of ARS • Inadequate disclosures that liquidity resulted from Banc of America's support of auctions • Marketed ARS as cash alternative despite awareness of escalating risks of ARS market 	<ul style="list-style-type: none"> • Liquidate at par ARS held by individual investors, small business investors with account values up to \$15 million, and charitable investors with account values up to \$25 million who purchased ARS from Banc of America prior to February 2008 • Make whole losses of above clients who purchased ARS before February 13, 2008 and sold afterward at a loss and offer no-net-cost loans to the above clients until their ARS have been purchased • Use best efforts to provide liquidity to other clients
<ul style="list-style-type: none"> • Falsely represented to clients that ARS were safe and liquid cash substitutes 	<ul style="list-style-type: none"> • Liquidate at par ARS held by individual investors, small/mid-size business investors with account values up to \$15 million, and charitable and non-profit investors with account values up to \$25 million who purchased ARS from Banc of America prior to February 11, 2008 • Make whole losses of above investors who purchased ARS before auctions failed and sold afterward at a loss • Provide liquidity options to all institutional investors • Refund refinancing fees to municipal issuers that issued ARS between August 2007 and February 11, 2008 and that refinanced after February 11, 2008

Firm	Regulator(s)	Date	Civil Penalty/Fine
BNY Mellon Capital Markets, LLC	FINRA	10/23/2008 (preliminary)	\$250,000
Citigroup Global Markets, Inc. ("Citigroup")	SEC	12/11/2008	Possible financial penalty after completion of its obligations under the settlement agreement

Primary Allegations	Purchase/Reimbursement Details
<ul style="list-style-type: none"> • Used marketing and advertising materials that did not enable clients to assess benefits and risks of ARS • Failed to establish and maintain a reasonable supervisory system 	<ul style="list-style-type: none"> • Liquidate at par ARS purchased between May 31, 2006 and February 28, 2008 by individuals, non-profit charitable organizations, religious corporations or entities, and other clients that held up to \$10 million in ARS • Make whole individual investors who sold ARS below par after February 28, 2008 • Use best efforts to provide liquidity to other investors who purchased ARS between May 31, 2006 and February 29, 2008
<ul style="list-style-type: none"> • Made misrepresentations to clients regarding the safety and liquidity of ARS • Inadequately disclosed that liquidity resulted from Citigroup’s support of auctions • Inadequately disclosed that by late 2007, Citigroup’s ability to support auctions was impaired; at the same time, Citigroup stepped up efforts to sell its inventory to clients • Failed to disclose to clients that some ARS were not viable in the weakening market • Failed to disclose increased risk of failed auctions in late 2007 	<ul style="list-style-type: none"> • Liquidate at par ARS held by individuals, charities and small businesses, even if clients moved their accounts from Citigroup • Make whole losses of “eligible” clients who sold ARS below par and reimburse “eligible” clients who borrowed money from Citigroup for excess interest costs resulting from ARS illiquidity • Use best efforts to provide liquidity to other clients

Firm	Regulator(s)	Date	Civil Penalty/Fine
Citigroup, continued	New York, NASAA	8/7/2008	\$50 million to New York; \$50 million to NASAA
City National Securities	FINRA	10/23/2008 (preliminary)	\$315,000
Comerica Securities, Inc. ("Comerica")	Michigan	9/18/2008	\$10,000 to the State of Michigan; \$100,000 to the Michigan Investor Protection Program

Primary Allegations	Purchase/Reimbursement Details
<ul style="list-style-type: none"> • Falsely represented to clients that ARS were safe and liquid cash substitutes • Failed to preserve documents required to be retained under state law 	<ul style="list-style-type: none"> • Liquidate at par ARS held by all individuals, all charities, and all businesses with account values up to \$10 million • Make whole losses of above investors who purchased ARS before auctions failed and sold afterward at a loss • Provide liquidity options to all institutional investors • Refund refinancing fees to municipal issuers that issued ARS between August 2007 and February 11, 2008 and that refinanced after February 11, 2008
<ul style="list-style-type: none"> • Used marketing and advertising materials that did not enable clients to assess benefits and risks of ARS • Failed to establish and maintain a reasonable supervisory system 	<ul style="list-style-type: none"> • Liquidate at par ARS purchased between May 31, 2006 and February 28, 2008 by individuals, non-profit charitable organizations, religious corporations or entities, and other clients that held up to \$10 million in ARS • Make whole individual investors who sold ARS below par after February 28, 2008 • Use best efforts to provide liquidity to other investors
	<ul style="list-style-type: none"> • Liquidate ARS held by all clients who purchased from Comerica

Firm	Regulator(s)	Date	Civil Penalty/Fine
Comerica, continued	FINRA	9/18/2008 (preliminary)	\$750,000
Credit Suisse Securities (USA) LLC	NASAA	9/16/2008	\$15 million
Deutsche Bank Securities, Inc. and Deutsche Bank AG	NASAA; New York	8/21/2008	\$15 million

Primary Allegations	Purchase/Reimbursement Details
<ul style="list-style-type: none"> • Used marketing and advertising materials that did not enable clients to assess benefits and risks of ARS • Failed to establish and maintain a reasonable supervisory system 	<ul style="list-style-type: none"> • Liquidate at par ARS purchased between May 31, 2006 and February 28, 2008 by individuals, non-profit charitable organizations, religious corporations or entities, and other clients that held up to \$10 million in ARS • Make whole individual investors who sold ARS below par after February 28, 2008 • Use best efforts to provide liquidity to other investors who purchased ARS between May 31, 2006 and February 29, 2008
<ul style="list-style-type: none"> • Falsely represented to clients that ARS were safe and liquid cash substitutes 	<ul style="list-style-type: none"> • Liquidate at par ARS held by all individuals, all charities, and all businesses with account values up to \$10 million • Make whole losses of above investors who purchased ARS before auctions failed and sold afterward at a loss • Provide liquidity options to all institutional investors
<ul style="list-style-type: none"> • Falsely represented to clients that ARS were safe and liquid cash substitutes 	<ul style="list-style-type: none"> • Liquidate at par ARS held by all retail investors • Make whole losses of retail investors who purchased ARS before auctions failed and sold afterward at a loss • Provide liquidity options to all institutional investors • Refund refinancing fees to municipal issuers that issued ARS since August 2007

Firm	Regulator(s)	Date	Civil Penalty/Fine
First Southwest Company	FINRA	9/18/2008 (preliminary)	\$300,000
Goldman Sachs Group Inc. ("Goldman Sachs")	NASAA; New York	8/21/2008	\$22.5 million
Harris Investor Services, Inc.	FINRA	10/23/2008 (preliminary)	\$150,000

Primary Allegations	Purchase/Reimbursement Details
<ul style="list-style-type: none"> • Used marketing and advertising materials that did not enable clients to assess benefits and risks of ARS • Failed to establish and maintain a reasonable supervisory system 	<ul style="list-style-type: none"> • Liquidate at par ARS purchased between May 31, 2006 and February 28, 2008 by individuals, non-profit charitable organizations, religious corporations or entities, and other clients that held up to \$10 million in ARS • Make whole individual investors who sold ARS below par after February 28, 2008 • Use best efforts to provide liquidity to other investors who purchased ARS between May 31, 2006 and February 29, 2008
<ul style="list-style-type: none"> • Falsely represented to clients that ARS were safe and liquid cash substitutes 	<ul style="list-style-type: none"> • Liquidate at par ARS held by all retail investors that were purchased through Goldman Sachs • Make whole losses of retail investors who purchased ARS before auctions failed and sold afterward at a loss • Provide liquidity options to all institutional investors • Refund refinancing fees to municipal issuers that issued ARS since August 2007
<ul style="list-style-type: none"> • Used marketing and advertising materials that did not enable clients to assess benefits and risks of ARS • Failed to establish and maintain a reasonable supervisory system 	<ul style="list-style-type: none"> • Liquidate at par ARS purchased between May 31, 2006 and February 28, 2008 by individuals, non-profit charitable organizations, religious corporations or entities, and other clients that held up to \$10 million in ARS • Make whole individual investors who sold ARS below par after February 28, 2008. • Use best efforts to provide liquidity to other investors who purchased ARS between May 31, 2006 and February 29, 2008

Firm	Regulator(s)	Date	Civil Penalty/Fine
JP Morgan (including Bear Stearns & Co.)	NASAA; New York	8/14/2008	\$25 million
Merrill Lynch, Pierce, Fenner & Smith, Inc. ("Merrill Lynch")	SEC	8/22/2008 (preliminary)	Possible fine after its completion of its obligations under the agreement

Primary Allegations	Purchase/Reimbursement Details
<ul style="list-style-type: none"> • Falsely represented to clients that ARS were safe and liquid cash substitutes 	<ul style="list-style-type: none"> • Liquidate at par ARS held by individuals, charities, non-profits, and institutional clients who have account values and household assets of \$10 million or less • Make whole losses of retail investors who purchased ARS before auctions failed and sold afterward at a loss • Provide liquidity options to all other institutional investors • Refund refinancing fees to municipal issuers that issued ARS since August 2007 and refinanced after auctions failed
<ul style="list-style-type: none"> • Misrepresented that ARS were safe liquid cash equivalents, even after becoming aware of increased risk in late 2007 and early 2008 • Failed to disclose that liquidity resulted from Merrill Lynch's support of auctions 	<ul style="list-style-type: none"> • Liquidate at par ARS held by individual investors, small businesses and charities (up to \$4 million) who purchased ARS prior to the market collapse • In a second wave, liquidate at par ARS held by remaining individual investors, charities and small businesses (up to \$100 million), even if accounts were transferred to other firms • Make no-cost loans to above clients until liquidation occurs and reimburse clients for any past loans provided to ARS clients • Make whole customers who sold ARS after February 12 at a loss • Use best efforts to liquidate ARS held by other clients

Firm	Regulator(s)	Date	Civil Penalty/Fine
Merrill Lynch, continued	NASAA; New York	8/21/2008	\$125 million
Morgan Stanley	NASAA; New York	8/14/2008	\$35 million

Primary Allegations	Purchase/Reimbursement Details
<ul style="list-style-type: none"> • Falsely represented to clients that ARS were safe and liquid cash substitutes 	<ul style="list-style-type: none"> • Liquidate at par ARS held by retail investors with accounts of \$4 million or less • In a second wave, liquidate at par ARS held by remaining retail investors and institutional investors with accounts of \$100 million or less • Make whole losses of retail investors who purchased ARS before auctions failed and sold afterward at a loss • Provide liquidity options to all institutional investors • Refund refinancing fees to municipal issuers that issued ARS since August 2007
<ul style="list-style-type: none"> • Falsely represented to clients that ARS were safe and liquid cash substitutes 	<ul style="list-style-type: none"> • Liquidate at par ARS held by all individuals, charities, and non-profits, as well as institutional clients that have account values and household assets of \$10 million or less • Make whole losses of retail investors who purchased ARS before auctions failed and sold afterward at a loss • Provide liquidity options to all other institutional investors • Refund refinancing fees to municipal issuers that issued ARS in the initial primary market between August 2007 and February 11, 2008 and that refinanced after February 11, 2008

Firm	Regulator(s)	Date	Civil Penalty/Fine
RBC Capital Markets Corp. ("RBC")	SEC	10/8/2008 (preliminary)	Possible financial penalty after the completion of its obligations under the agreement
	NASAA; New York	10/8/2008	\$9.8 million

Primary Allegations	Purchase/Reimbursement Details
<ul style="list-style-type: none"> • Misrepresented to clients that ARS were safe and liquid cash equivalents, even after it became aware of increasing risks in late 2007 and early 2008 • Failed adequately to disclose extent to which auctions cleared because of RBC's support 	<ul style="list-style-type: none"> • Liquidate at par ARS held by individual investors, small business investors (up to \$10 million), and investors that are nonprofit, charitable or religious organizations (up to \$25 million) that purchased ARS that do not have successful auctions from RBC prior to February 11, 2008 • Make whole losses of above clients who purchased ARS before February 11, 2008 and sold them afterward at a loss • Offer non-recourse loans at no net cost to the above clients until their ARS is purchased • Use best efforts to provide liquidity to other clients
<ul style="list-style-type: none"> • Falsely represented to clients that ARS were safe and liquid cash substitutes 	<ul style="list-style-type: none"> • Liquidate at par ARS held by individuals, any other entity with accounts of \$10 million or less, and charities, non-profits, government entities with accounts of \$25 million or less • Make whole losses of above investors who purchased ARS before auctions failed and sold afterward at a loss • Provide liquidity options to all institutional investors • Refund refinancing fees to municipal issuers that issued ARS between August 2007 and February 11, 2008 and that refinanced after February 11, 2008

Firm	Regulator(s)	Date	Civil Penalty/Fine
SunTrust Investment Services, Inc. ("STIS") and SunTrust Robinson Humphrey, Inc. ("STRH")	FINRA	9/18/2008 (preliminary)	STIS \$300,000; STRH \$1.65 million
UBS Securities LLC and UBS Financial Services, Inc. (collectively, "UBS")	SEC	12/11/2008	Possible financial penalty after the completion of its obligations under the agreement

Primary Allegations	Purchase/Reimbursement Details
<ul style="list-style-type: none"> • Used marketing and advertising materials that did not enable clients to assess benefits and risks of ARS • Failed to establish and maintain a reasonable supervisory system 	<ul style="list-style-type: none"> • Liquidate at par ARS purchased between May 31, 2006 and February 28, 2008 by individuals, non-profit charitable organizations, religious corporations or entities, and other clients that held up to \$10 million in ARS • Make whole individual investors who sold ARS below par after February 28, 2008 • Use best efforts to provide liquidity to other investors who purchased ARS between May 31, 2006 and February 29, 2008
<ul style="list-style-type: none"> • Misled clients by marketing ARS as cash alternatives • Knew or was reckless in not knowing that there was a greater risk of illiquidity in the second half of 2007 • Knew or was reckless in not knowing that a large portion of its ARS program was undesirable if auctions failed • Failed to disclose information to clients concerning maximum rate resets on student loan ARS 	<ul style="list-style-type: none"> • Liquidate at par ARS held by current and former UBS customers who held ARS at UBS as of February 13, 2008 or who purchased their ARS at UBS between October 1, 2007 and February 12, 2008, even if they moved accounts to another firm • Make whole losses of “eligible” clients who sold ARS below par and reimburse “eligible” clients who borrowed money from UBS for excess interest costs resulting from ARS illiquidity • Use best efforts to provide liquidity to other clients

Firm	Regulator(s)	Date	Civil Penalty/Fine
UBS, continued	New York, NASAA	8/11/2008	\$75 million to New York and \$75 million to NASAA
Wachovia Securities, LLC and Wachovia Capital Markets, LLC (collectively, "Wachovia")	SEC	8/15/2008 (preliminary)	Possible financial penalty after the completion of its obligations under the agreement
	NASAA; New York	8/15/2008	\$50 million

Primary Allegations	Purchase/Reimbursement Details
<ul style="list-style-type: none"> • Falsely represented to clients that ARS were safe and liquid cash substitutes • Was aware of impending collapse of ARS market and reduced its own ARS exposure but kept selling ARS to clients 	<ul style="list-style-type: none"> • Liquidate at par ARS held by retail investors (including charities) that have under \$1 million on deposit • In a second wave, liquidate ARS held by remaining retail investors, charities, and small/mid-sized investors • Make whole losses of above investors who purchased ARS before auctions failed and sold afterward at a loss • Provide liquidity options to all institutional investors (deadline of June 30, 2010) • Refund refinancing fees to municipal issuers that issued ARS after August 2007 and that refinanced after auctions failed
<ul style="list-style-type: none"> • Misrepresented liquidity risk of ARS by marketing them as cash alternatives • Failed adequately to disclose extent to which auctions cleared because of Wachovia's support 	<ul style="list-style-type: none"> • Liquidate \$5.7 billion of ARS held by individual investors, charities and small businesses • In a second wave, liquidate \$3.1 billion of ARS held by all other investors • Offer non-recourse loans at no net cost to the above clients until their ARS is purchased
<ul style="list-style-type: none"> • Falsely represented to clients that ARS were safe and liquid cash substitutes 	<ul style="list-style-type: none"> • Liquidate at par ARS held by all non-profits, as well as individuals and businesses that have account or household values of \$10 million or less • In a second wave, liquidate ARS held by all other clients • Make whole losses of retail investors who purchased ARS before auctions failed and sold afterward at a loss • Refund refinancing fees to municipal issuers that issued ARS since August 2007 and that refinanced after February 11, 2008

Firm	Regulator(s)	Date	Civil Penalty/Fine
WaMu Investments Inc.	FINRA	9/18/2008 (preliminary)	\$250,000

Primary Allegations	Purchase/Reimbursement Details
<ul style="list-style-type: none"> • Used marketing and advertising materials that did not enable clients to assess benefits and risks of ARS • Failed to establish and maintain a reasonable supervisory system 	<ul style="list-style-type: none"> • Liquidate at par ARS purchased between May 31, 2006 and February 28, 2008 by individuals, non-profit charitable organizations, religious corporations or entities, and other clients that held up to \$10 million in ARS • Make whole individual investors who sold ARS below par after February 28, 2008 • Use best efforts to provide liquidity to other investors who purchased ARS between May 31, 2006 and February 29, 2008

In addition to the cases addressed in the above chart, the Commonwealth of Massachusetts brought an action against Oppenheimer & Co., Inc. (“Oppenheimer”) for allegedly misrepresenting ARS as safe and liquid investments and failing to alert clients of ARS market disruptions. The complaint also named as respondents three Oppenheimer executives who sold their personal ARS holdings in the weeks leading up to the February 2008 ARS market failures.

Regulators also brought two ARS-related cases against employees of broker-dealers, which are discussed below.

A. *SEC v. Julian T. Tzolov and Eric S. Butler* (S.D.N.Y. Sept. 8, 2008)

1. The SEC filed a civil complaint against two former Credit Suisse Securities (USA) LLC (“Credit Suisse”) brokers, Tzolov and Butler, alleging they defrauded customers by making more than \$1 billion in unauthorized purchases of subprime-related ARS.
2. The SEC alleged that Tzolov and Butler misled customers into believing that the ARS being purchased on their behalf were backed by federally guaranteed student loans and were safe and liquid investments. The ARS that were bought were instead backed by far riskier collateral, including subprime mortgages and CDOs.
3. In addition, Tzolov and Butler allegedly deceived foreign corporate customers by altering confirmations to add the terms “St. Loan” or “Education” to the names of non-student loan securities purchased for the customers and deleting the words “CDO” and/or “Mortgage.”
4. The SEC alleged that as a result of Tzolov’s and Butler’s misrepresentations, their customers were left holding more than \$800 million in illiquid securities when certain ARS auctions began to fail in August 2007.
5. A criminal action filed against Tzolov and Butler in federal district court alleging conspiracy to commit securities and wire fraud also is still pending.

B. *In the Matter of David Aufhauser*, State of New York Office of the Attorney General (Oct. 7, 2008)

1. The New York Attorney General (“NYAG”) settled a matter involving David Aufhauser, the former General Counsel of UBS AG (“UBS”), in which he alleged that Aufhauser sold his

ARS holdings after receiving inside information regarding the anticipated collapse of the ARS market.

2. The NYAG alleged that on December 14, 2007, Aufhauser read an e-mail from the firm's chief risk officer that revealed material non-public information relating to serious problems in connection with auctions managed by UBS. After reading the e-mail, Aufhauser e-mailed his financial advisor and directed him to sell all of Aufhauser's ARS. On December 17, 2007, Aufhauser repeated the instruction. On December 18 and 21, 2007, the financial advisor sold Aufhauser's ARS holdings for \$250,000.
3. Also in December 2007, Aufhauser allegedly told a senior UBS executive that he was selling his auction rate securities. When the senior executive followed up with him, Aufhauser denied it and stated that he had only requested that his financial advisor look into them.
4. In mid-February 2008, Aufhauser allegedly asked his broker to buy back the ARS securities he had sold in December. These securities were not available so the broker bought \$300,000 of similar ARS.
5. Aufhauser settled with the NYAG and agreed to pay a civil money penalty of \$6.5 million, which includes his \$6 million 2008 discretionary incentive compensation. Aufhauser also agreed to a two-year bar from the securities industry, from serving as a director or officer of any public company, and from practicing law in New York.

As we reported last year, FINRA issued a press release announcing the commencement of its operations on July 30, 2007. 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.²⁶ The major remaining task revolves around the creation of a single rulebook. In 2008, FINRA submitted several proposed new consolidated rules to the SEC for its review and approval. This process will continue in 2009.

Statistics and Enforcement Priorities

Statistics

This year was FINRA's first full year as an SRO. As a result, there is no historical performance against which to measure the level of FINRA enforcement activity. FINRA has confirmed that in calendar year 2008, 946 new cases were initiated, 14 member firms were expelled, 321 individuals were barred from membership, and 300 individuals were suspended. In addition, a total of \$1.2 billion in restitution or reimbursement was agreed to in various settlements executed in 2008. That figure includes the agreements in principle relating to contemplated "buy backs" of auction rate securities by member firms.

Based on our review, however, it appears that the number of FINRA enforcement cases with large fines is lower than the number of such cases brought in the past by NASD and NYSE Regulation. In 2008, there were two FINRA settlements in which the fine was greater than \$1 million and one Hearing Panel Decision in which a fine of \$1,535,000 was ordered.²⁷ The following chart reflects FINRA settlements with firms in 2008 that involved fines greater than \$100,000.²⁸

²⁶ See Remarks by Mary L. Schapiro, CCO Outreach BD National Seminar (Mar. 7, 2008).

²⁷ See *Department of Enforcement v. Mutual Service Corp.* (Dec. 16, 2008).

²⁸ These statistics were derived based upon our review of the disciplinary actions described by FINRA in its Regulatory Notices from January 2008 through December 2008. These figures do not include preliminary agreements in the ARS area that have not yet been announced as final settlements.

Fine Range	Number of Settlements
\$100,001 to \$250,000	45
\$250,001 to \$500,000	10
\$500,001 to \$750,000	4
\$750,001 to \$1,000,000	2
\$1,000,001 to \$1,500,000	2
\$1,500,001 or more	0

Enforcement Priorities

Based on our review of currently available information, we believe the following list reflects several of FINRA's top priorities for enforcement in 2008 and 2009:

1. Auction rate securities, focusing on smaller downstream firms;
2. Subprime securities and mortgage-backed securities, including disclosures to investors and at larger investment banks issues relating to underwriting and origination of such securities.
3. Sales practices, including sales of CDOs and sales to senior citizens;
4. Anti-money laundering;
5. Supervision;
6. Variable annuities;
7. Relationships with hedge funds;
8. Regulation SHO;

9. Life settlements;
10. Reverse mortgages; and
11. False or misleading rumors.

Enforcement Actions

Variable Annuity Sales

Sales practices surrounding variable annuities continue to be an enforcement 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."²⁹ 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 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,

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

income needs and the surrender periods of the variable annuities, the recommendations were unsuitable and in violation of NASD Rules 2310 and 2110.

4. FINRA also asserted that the firm violated Conduct Rule 3010(a) because the firm's principals were aware of the customers' circumstances but did not consider adequately the various factors before approving the unsuitable transactions.
5. Finally, FINRA 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 2008, FINRA brought cases involving mutual fund sales practices against a number of firms, including Royal Alliance Associates, Wells Fargo, Merrill Lynch, UBS Financial Services, Prudential Securities, Pruco Securities, and Banorte Securities.

- 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 for mutual fund sales violations and supervisory failures in connection with the sale of mutual funds.

2. FINRA alleged that four of the firms, Wells Fargo, Merrill Lynch, UBS-FS, and Prudential, failed to implement adequate supervisory systems to identify customers who were eligible for 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.
3. Prudential, UBS-FS and Merrill Lynch consented to fines of \$250,000 related to the supervisory failures.
4. 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.
5. The four firms also consented to remediation plans for customers who were eligible for NAV transfer programs. The total remediation was expected to exceed \$25 million.
6. 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.* ("Royal Alliance") (Feb. 2008)

1. FINRA alleged that Royal Alliance 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 Class A share transactions to determine whether inappropriate fees were charged and provide refunds to customers.

C. *Banorte Securities International, Ltd.* (“Banorte”) (Oct. 16, 2008)

1. FINRA settled an action in which it alleged that Banorte sold Class B shares of off-shore mutual funds to customers for whom the purchases were unsuitable.
2. FINRA alleged that Banorte negotiated lower front-end sales charges for off-shore mutual fund Class A shares but failed to inform its sales force that customers would benefit from the lower front-end sales charges for purchasing Class A shares rather than more expensive Class B shares. Banorte’s policies and procedures also allegedly did not require sales representatives to calculate the economic differences between share classes and explain those differences to clients.
3. As a result, between 2003 and May 2004, Banorte registered representatives often recommended that their clients purchase Class B mutual fund shares, which caused the clients to obtain a lower return than if they had purchased Class A shares.
4. Banorte consented to a \$1.1 million fine and a remediation plan involving 1,400 transactions in the accounts of over 300 customers.

Supervision

Supervisory cases are always a mainstay of the FINRA enforcement program. Described below is a case involving supervision of a firm's registered representatives.

A. *SWS Financial Services, Inc.* ("SWS") (July 17, 2008)

1. FINRA settled a matter with SWS in which it alleged that the firm failed adequately to supervise its registered representatives.
2. Among other violations, FINRA alleged that, between December 1998 and February 2003, SWS failed to follow its schedule for inspecting unregistered branch offices. One unregistered branch office that was not inspected pursuant to the inspection schedule was located in the home of an independent contractor registered representative who fraudulently misused over \$700,000 of investors' funds.
3. FINRA also found that SWS failed to supervise another registered representative and could not identify the representative's assigned supervisor or evidence supervisory review of a client's account that had losses of over \$54,000. FINRA alleged that SWS also failed to investigate and follow up on "red flags" that should have alerted it to possible improper activity by the representative. Specifically, a client's account appeared on exception reports at least 14 times, yet the firm failed to investigate and never contacted the investor.
4. In addition, FINRA alleged that SWS failed adequately to supervise discretionary trading accounts, direct mutual fund trading, and registration of its principals, and failed to retain required documents.
5. The firm consented to a censure and fine of \$150,000.

Anti-Money Laundering

Over the last several years, FINRA examiners have focused on compliance with the anti-money laundering rules. In addition, the enforcement staff has brought a number of cases in this area. 2008 was no exception; one case is described below.

- A. *Southwest Securities, Inc.* (“Southwest”) (July 18, 2008)
1. FINRA settled a matter with Southwest in which it alleged that between April 2002 and October 2005, the firm failed to establish effective written AML policies and procedures and failed to correct the issue after it was identified in three prior tests of the AML program.
 2. Southwest’s AML procedures for monitoring possible suspicious activity consisted of a manual review of daily fund activity and large fund transactions, which involved more than 100,000 transactions in over 28,000 customer accounts daily. FINRA found that Southwest’s procedures did not enable the firm to identify patterns of suspicious activity over time.
 3. FINRA found that Southwest’s policies and procedures were inadequate to satisfy the Bank Secrecy Act’s requirements to detect and report patterns of suspicious activity.
 4. Southwest was alerted to the deficiency in its AML procedures several times beginning as early as August 2003 through its independent testing but took no action to enhance its procedures for more than two years.
 5. Southwest consented to a censure and a fine of \$75,000.

Best Execution

FINRA, like the SEC, brought one particularly significant best execution case in 2008.

- 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 a trade allocation scheme employed by the firm’s head trader and the firm’s anti-money laundering, reporting, record-keeping, and supervisory deficiencies.
 2. FINRA alleged that Alexis Rivera, the firm’s 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.
 3. 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.
 4. 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 material, non-public 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 AML 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 that charges did not exceed five percent.
5. 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 barred Rivera 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. The primary violator was 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 co-respondent Abram Silver, the firm failed to establish written supervisory procedures related to trading and market making and failed to supervise Simon's trading and market making

activities. These failures enabled Simon to assist in the stock price manipulation.

3. FINRA also concluded that through Silver, the firm failed to establish and implement anti-money laundering procedures to monitor suspicious transactions and to comply with the Bank Secrecy Act.
4. 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.
5. 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.

Short Selling

FINRA continues to bring disciplinary actions against firms for alleged short selling violations. Two cases from mid-2008 are described below.

A. *UBS Securities LLC* (Aug. 2008)

1. FINRA alleged that between December 2003 and September 2004, UBS Securities executed potentially manipulative short sales in violation of NASD and SEC Rules.
2. With respect to 255 short sale orders for UBS Securities' proprietary or clients' accounts, UBS Securities failed to confirm that the firm would receive delivery of or could borrow the security for itself or on behalf of its customer for delivery by the settlement dates. In 47 other instances, the firm allegedly failed to mark the order tickets to indicate that they were short sales or failed to report the trades as short sales to the Nasdaq Market Center.

3. FINRA also alleged other operations-related deficiencies against UBS Securities that FINRA discovered during several examinations, including untimely submission to OATS of reportable order events.
4. FINRA found that UBS Securities' supervisory procedures were inadequate because they did not identify: (a) who was responsible for compliance with the short sale marking and reporting and various other NASD rules, (b) what supervisory steps were to be taken, (c) how frequently such supervisory steps should be taken, and (d) how to memorialize that such steps had been taken.
5. UBS Securities consented to a censure and a fine of \$116,000. \$50,000 of the fine related to the short sale violations, \$20,000 related to the supervisory violations, and the remaining \$46,000 related to the various other operations-related deficiencies. UBS Securities also consented to revise its written supervisory procedures concerning the topics identified in the settlement.

B. *Lehman Brothers, Inc.* ("Lehman") (Aug. 14, 2008)

1. FINRA settled a matter with Lehman in which it alleged that the firm failed to comply with two distinct Regulation SHO requirements.
2. Under Reg. SHO, a firm is required to aggregate all of its positions in a security in order to determine its net long or short position, unless the firm qualifies for independent trading unit aggregation.
3. FINRA found that between May 2004 and December 2006, Lehman failed to meet the requirements for independent trading unit aggregation because: (a) its written plan of organization failed to describe accurately a separate aggregation unit created for risk management, and (b) it failed to ensure that traders in each aggregation unit pursued only the particular trading strategy of that unit, as opposed to coordinating its strategies with others.

4. As a result, Lehman's calculations of its net positions were inaccurate, which affected the accuracy of its long and short position trade reporting.
5. FINRA also alleged that during a separate review covering the period June through July 2004, Lehman failed to indicate whether it had received "locates" before it accepted approximately 96,000 short sales orders for its proprietary account and approximately 5,000 short sale orders for customer accounts. Lehman's written supervisory procedures allegedly were inadequate because, for example, they did not document which individuals were responsible for compliance with the locate rule, and how and how often they were required to take supervisory steps concerning locates.
6. Lehman consented to a censure and fine of \$250,000. Lehman also consented to revise its written supervisory procedures regarding independent trading unit aggregation and supervision of its obligation to obtain locates.

Insider Trading

Two insider trading developments at FINRA during the past year are worth noting. First, in August 2008, FINRA enhanced its efforts to monitor insider trading by entering into an agreement with ten U.S. exchanges to consolidate the surveillance and investigation of insider trading. The agreement, subject to SEC approval, will make FINRA responsible for monitoring insider trading activity in all NASDAQ and AMEX-listed equity securities, irrespective of where the trading occurs in the United States. Similarly, NYSE Regulation will be responsible for monitoring insider trading in NYSE and NYSE Arca-listed securities on all exchanges that are parties to the agreement. In the second half of 2008, the SROs published for comment proposed plans for allocating the various responsibilities for monitoring insider trading.

Second, in September 2008, FINRA announced two separate insider trading cases. In the press release issued to publicize these two cases a senior FINRA executive was quoted as stating that "the actions announced today underscore that FINRA has the resources, technical expertise and capabilities to detect and investigate insider trading across the U.S. markets."³⁰ This is interesting because FINRA's jurisdiction is limited to member firms and its associated persons and SROs have traditionally referred potential insider trading cases to

³⁰ FINRA News Release, FINRA Bars Two Registered Representatives for Insider Trading (Sept. 11, 2008).

the SEC for possible prosecution. The timing of the announcement of these two cases, coming so close on the heels of the August announcement regarding its surveillance efforts (described immediately above), is also noteworthy.

A. *Peter Kelly* (“Kelly”) and *Daniel Ivandjiiski* (“Ivandjiiski”) (Sept. 11, 2008)

1. Kelly, the former head of sales and trading in the loan syndication department of an investment banking firm, was found to have tipped three friends about a pending merger six days before the public announcement of the deal. Kelly did not personally purchase shares before the merger or profit from the tipping, but the tippees earned \$66,000 in illegal gains. According to FINRA, this conduct breached his duty to his employer to keep confidential the information about the merger. Kelly was barred from the industry by FINRA.
2. Ivandjiiski had been employed by an investment banking firm working on a transaction to increase the credit line of a publicly traded company. The day before a public announcement was made concerning the new financing, Ivandjiiski purchased 1,000 shares of the company’s stock while in possession of material, non-public information he had learned about the transaction. Ivandjiiski made illegal profits of \$780 by selling his stock several days later. Ivandjiiski was barred from the industry by FINRA.

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 2008 case involving alleged theft from a senior investor is described below.

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. Mullins also used the customer's charitable organization to buy gift cards that he used himself.
3. 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 U-4 to conceal his officer, trustee and Power of Attorney status for the customer's will and charitable foundation.
4. These charges are still pending.

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.

- A. On January 8, 2008, FINRA fined 19 broker-dealers for "substantially overstating their advertised trade volume to three private service providers."³¹ 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.
 1. 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

³¹ FINRA News Release, FINRA Fines 19 Firms a Total of \$2.8 Million for Inaccurate Advertised Trade Volume Information (Jan. 8, 2008).

lacked adequate supervisory systems and procedures for communicating trade volumes.

2. Eight firms were fined \$200,000 each (Broadpoint Capital, Inc.; CIBC World Markets Corp.; Lehman Brothers; Merrill Lynch; Needham & Company, LLC; Robert W. Baird & Co.; Thomas Weisel Partners, LLC; and UBS Securities).
3. 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).
4. Piper Jaffray & Co. (“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.
5. Four firms were fined \$50,000 each (Friedman, Billings, Ramsey & Co., Inc.; Jefferies & Company, Inc.; JMP Securities, LLP; and Pacific Crest Securities, Inc.).
6. Apart from Piper Jaffray’s cooperation, the amounts of the fines varied between the firms because of “the number of misstatements and the magnitude of the misstatements.”³²

Municipal Securities

In early 2008, FINRA settled a case regarding the sale of municipal securities.

A. *Associated Bond Brokers, Inc.* (Jan. 2008)

1. FINRA alleged that Associated Bond Brokers, while acting as a municipal securities broker’s broker, lowered the highest bid to achieve a level close to the cover bid without the bidding broker-dealer’s prior knowledge or consent. In

³² 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).

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 implement adequate supervisory procedures or systems to monitor communications to broker-dealers, and failed adequately to preserve its electronic communications.
3. The firm consented to a censure and a fine of \$100,000.

Stock Loan

Regulators have brought numerous cases in the stock loan area in recent years.

A. *A.G. Edwards & Sons, Inc.* (June 27, 2008)

1. FINRA settled a matter with A.G. Edwards in which it alleged that the firm failed to establish, maintain, and enforce written supervisory procedures to prevent and detect fraudulent securities lending by one of its stock loan traders and his supervisor.
2. The SEC filed separate actions against A.G. Edwards stock-loan employees, alleging that between 2003 and 2005 they caused A.G. Edwards to loan stocks at artificially low prices in exchange for kickback payments. These transactions also involved payment of more than \$1 million in sham finder fees.
3. During this period, the firm delegated supervisory authority over its securities lending business to an employee who was not registered or approved by the NYSE to act in such a role. Further, the firm did not have any independent follow-up procedures to verify that the supervision was conducted properly.
4. FINRA also alleged that the firm's written supervisory procedures were deficient because they did not specify the steps that supervisors should take when reviewing stock

loan supervisory reports, what actions should be taken in the event suspicious activity was found, or how to document that the supervisory reviews occurred.

5. Finally, FINRA alleged that the firm failed to retain required electronic communications because the firm did not preserve copies of faxes sent or received by the stock loan desk.
6. The firm consented to a censure and a fine of \$300,000.
7. One of the A.G. Edwards traders (Michael McCormack) pled guilty to criminal charges and also settled with the SEC in May 2008, as discussed previously in this outline. Criminal and SEC charges against the second representative are still pending.

B. *Raymond James & Associates* (“Raymond James”) (Sept. 22, 2008)

1. In September 2008, FINRA settled a case against Raymond James in which it alleged that the firm violated FINRA rules relating to stock loan.
2. FINRA alleged that between January 2002 and February 2005, Raymond James’s stock loan supervisor allowed a non-registered finder to select counterparties and to negotiate all terms in connection with transactions in which Raymond James loaned securities to RBC Capital Markets. Raymond James compensated the non-registered finder for his services, which went far beyond those typically provided by a stock loan finder, and therefore required the finder to be registered.
3. In addition, FINRA alleged that Raymond James made payments to certain finders that did not provide any service in connection with the stock loan transactions. The firm’s stock loan traders, with the approval of the stock loan supervisor, made some of these payments to provide additional compensation to finders for their services in connection with smaller stock loan transactions that did not provide a substantial rebate to the finders. In other

instances, Raymond James made these payments at the direction of a counterparty despite knowledge that the “finder” had not provided any services in connection with the transaction. FINRA also alleged that Raymond James failed to maintain accurate books and records to the extent that they reflected that these finders participated in the transactions for which they were compensated.

4. FINRA alleged that the firm lacked adequate supervisory procedures to detect and prevent such transactions from occurring based, in part, on the conflict of interest that arose because the stock loan supervisor was compensated based on the profitability of the stock loan department. In addition, FINRA alleged that the firm lacked written supervisory procedures concerning its stock loan operations, including with respect to the use and compensation of finders.
5. Raymond James consented to a censure and a \$1 million fine.

Fee-Based Brokerage

Beginning in 2005, the NASD and then NYSE Regulation began bringing enforcement actions against firms relating to their fee-based brokerage account programs. FINRA brought another case in 2007 and continued that trend in 2008.

A. *SunTrust Investment Services, Inc.* (“SunTrust”) (Oct. 15, 2008)

1. FINRA settled a matter with SunTrust in which it alleged that the firm failed to supervise adequately its fee-based brokerage program.
2. FINRA alleged that between November 2002 and February 2006, SunTrust opened over 2,644 Portfolio Choice accounts for customers without an adequate determination that such accounts were appropriate for the customers. Specifically, FINRA alleged that the firm did not have benchmarks to determine whether the Portfolio Choice account was appropriate for customers and did not have monitoring tools to review its Portfolio Choice accounts to determine whether they remained suitable.

3. FINRA alleged that at least 36 Portfolio Choice accounts were charged more than \$129,000 in fees, despite the fact that no trading occurred in those accounts for eight consecutive quarters.
4. In addition, FINRA identified 932 instances in which SunTrust double charged clients a trading commission as well as an account fee, resulting in SunTrust's clients paying approximately \$437,500 in excess fees or commissions.
5. This case also included charges concerning excessive commissions. Specifically, FINRA alleged that between January 2002 and September 2005, the firm lacked an adequate supervisory system to ensure that fair commissions were charged because the firm's procedures did not address how a registered representative should determine a fair commission. As a result, customers were charged a total of approximately \$99,585 in excessive commissions.
6. SunTrust consented to a censure and a fine of \$700,000.
7. In setting its sanction, FINRA considered SunTrust's voluntary refunding of over \$713,000 in fees and interest to Portfolio Choice customers.

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 additional actions in this area. In fact, in 2008, FINRA settled several actions, 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 file timely 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 e-mail 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 censures 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 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 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. FINRA alleged that for each of these transaction types, 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 or back-office types of actions, including the following cases relating to the submission of fingerprints.

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 confirm 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 two of its 159 temporary workers whose fingerprints were not submitted were statutorily disqualified from associating with firms in the securities industry.
3. The firm's settlement acknowledged that it self-reported the matter to FINRA, 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 a fine of \$95,000.

B. *Morgan Stanley & Co. Incorporated* (“MSDW”) (May 19, 2008)

1. FINRA alleged that MSDW failed to submit fingerprints and failed to conduct background checks for individuals who were required to be screened for statutory disqualifications. FINRA also alleged that MSDW failed to maintain adequate procedures to comply with NASD rules regarding employment of individuals who may be subject to statutory disqualification.
2. Between September 2004 and March 2006, MSDW allegedly failed to fingerprint timely 427 permanent employees and failed to conduct background checks on 1,563 temporary employees and 436 interns and consultants.
3. Although MSDW had policies and procedures regarding fingerprinting, background checks, and screening for statutory disqualifications for its permanent employees, its policies for temporary workers were limited.
4. MSDW consented to a censure and fine of \$425,000.
5. The AWC noted that in 2004, MSDW consented to a censure and a fine of \$13 million in a matter involving several various violations, including failing to file fingerprint cards for 1,500 employees and for hiring four individuals who were subject to statutory disqualification.

Electronic Blue Sheet Submissions

In 2006 and 2007, NYSE Regulation brought cases involving erroneous electronic blue sheet reporting. FINRA continued this trend in 2008 with a case against Barclays Capital, Inc.

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. (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 update consistently 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 either were 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 that the firm did not have adequate written procedures for the service team making changes to the account information in the firm's system.
4. Merrill Lynch automated the process in January 2006, and as a result, discovered the problems. Merrill Lynch self-reported the matter 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, despite the fact that 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 ten-day suspension, 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 and 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.

OATS Reporting

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

- A. *TradeStation Securities, Inc.* ("TradeStation"), *E*Trade Securities, LLC* ("E*Trade Securities") and *CIBC World Markets Corp.* (May 15, 2008)
 1. FINRA fined TradeStation, E*Trade Securities 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.
 2. FINRA fined TradeStation \$200,000 for failing to report approximately 23.5 million Reportable Order Events ("ROEs") relating to orders received during the years 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 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 Securities \$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 Securities \$300,000 for failing to have written supervisory procedures that identified a person responsible for supervising the firm's compliance with OATS rules and 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 Panel 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 FINRA's National Adjudicatory Council ("NAC") decision on appeal.

- A. *In the Matter of Department of Enforcement v. American Fund Distributors, Inc.* (“AFD”) (Apr. 30, 2008)
1. FINRA’s 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.

Continuing Education Training

In March, FINRA brought actions against sixteen State Farm VP Management Corp. (“State Farm”) representatives concerning misconduct in connection with continuing education training.

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 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, 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. In addition, in 2008 FINRA brought its first case involving the suitability of mortgage-backed securities sold to retail investors. Both of these matters are described below.

- A. *Department of Enforcement v. H & R Block Financial Advisors, Inc.* (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.”

B. *Brian Berkowicz* (July 22, 2008), *Cindy Schwartz* (July 24, 2008), and *John Webberly* (June 16, 2008)

1. Three SAMCO Financial Services, Inc. (“SAMCO”) brokers settled FINRA actions in connection with misconduct in marketing and sales of Collateralized Mortgage Obligations (“CMOs”) to retail customers.
2. FINRA alleged that between June 2004 and September 2006, Berkowicz, Schwartz, and Webberly recommended inverse floaters to non-sophisticated retail investors for whom the securities were not suitable. As a result of these

recommendations, nine clients collectively lost approximately \$535,000.

3. FINRA also alleged that the brokers allowed the SAMCO head trader, who was also their supervisor, to exercise discretion to purchase CMOs in the clients' accounts.
4. Berkowicz and Schwartz each consented to be barred from the industry. Webberly consented to a two-year suspension and to assist FINRA in its ongoing prosecution of matters regarding sales of CMOs at the SAMCO Financial branch office involved in the case.
5. This case reflected FINRA's first enforcement action involving allegations of unsuitable recommendations of mortgage-backed securities to retail clients.

Fairness of Commissions and Mark-Ups

FINRA continues to be active in the commission and mark-up areas. Several representative cases are described below.

A. *Jefferies & Company, Inc.* ("Jefferies") (June 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 mark-up policy.

B. *HSBC Securities (USA), Inc. ("HSBC") (July 2008)*

1. FINRA alleged that HSBC failed to assess the fairness of commissions charged to certain clients by a registered representative who had discretion without supervisory review to set commissions charged to clients for fixed income transactions.
2. Between 2004 and 2006, approximately 66 clients who held escrow accounts with HSBC Bank were assigned one affiliated registered representative to offer additional services, such as trade recommendations and investment advice, which the clients previously had not received. That representative charged considerably higher commissions based on these additional services; however, the services were not provided.
3. FINRA also alleged that HSBC had inadequate written guidelines advising employees how to determine an appropriate mark-up or commission, failed to monitor mark-ups and commissions by relying on labor-intensive spot checks, and failed to adequately train its compliance staff to assess the appropriateness of mark-ups and commissions.
4. HSBC discovered the issue in 2006 and conducted an internal investigation, the results of which HSBC self-reported to FINRA in August 2007. HSBC refunded over \$2.3 million to the clients and terminated the employees involved, including supervisors.
5. HSBC consented to a censure and a fine of \$200,000.

C. *J.P. Turner & Company, LLC ("J.P. Turner") (Oct. 29, 2008)*

1. FINRA settled a matter with J.P. Turner in which it alleged that the firm failed to establish and maintain an adequate

supervisory system to ensure that its commission charges were fair and reasonable.

2. Between January 2002 and March 2005, J.P. Turner's policies allegedly allowed representatives to set the commission rates for transactions, with a maximum of 4.5% for trades in securities priced below \$25 and 3.5% for trades in securities priced above \$25.
3. J.P. Turner's representatives charged up to 4.5% in commissions on almost all stock trades (91% of which were priced below \$25), without considering other relevant factors besides security price, such as the type of security, the size of the trade, or the availability of the securities in the market.
4. FINRA alleged that the firm failed to provide adequate guidance to representatives to set appropriate commissions based on FINRA guidance in IM-2440. FINRA also alleged that the firm's supervision was inadequate because its supervisory reviews were limited to a determination as to whether the commissions charged were below the maximum percentages permitted by the firm's policy.
5. J.P. Turner consented to a censure and a fine of \$250,000. The firm also consented to retaining an independent consultant to conduct a full review of the firm's policies regarding FINRA's Fair Pricing Rule.

Research Disclosures

Over the past year or so, regulators have brought several research disclosure cases. In 2008, FINRA brought a case against SG Americas concerning the adequacy of disclosures in its research reports and a case against Citigroup for permitting foreign research analysts to publish research reports without proper qualifications. A third case, involving Tejas Securities, also is described below.

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.

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.

B. *Citigroup Global Markets, Inc.* (Sept. 2008)

1. FINRA found that between April 2005 and December 2006, Citigroup permitted its foreign research analysts to publish research reports without having passed the requisite examinations or obtaining an exemption.
2. A 2004 FINRA Notice to Members advised firms that research analysts that are associated with a member firm could not publish research reports until they passed the Series 86 and 87 examinations. Research analysts associated with firms, including Citigroup, that sought an exemption received a one-year grace period that expired in April 2005.
3. During the grace period, Citigroup did not require its non-U.S. research analysts to take the Series 86 and 87 examinations. Instead, Citigroup sought, but did not obtain, a further exemption for these research analysts.
4. When the grace period expired, approximately 300 non-U.S. Citigroup research analysts had not taken the examinations but continued to publish research reports through December 2006 when Citigroup deregistered the non-U.S. research analysts.
5. A partial exemption would have been available if Citigroup had disclosed on the front page of its research reports that analysts who were exempt from the examination

requirements had prepared them. However, the firm did not include such a disclosure on its research reports.

6. Citigroup consented to a censure and a fine of \$650,000.

C. *Tejas Securities Group, Inc. and Michael Lee Cuckler (July 31, 2008)*

1. FINRA settled an investigation involving allegations that Tejas and Cuckler, its chief compliance officer, violated FINRA and SEC rules regarding the firm's research reports, as well as several other FINRA rules on various topics.

2. With respect to research reports, FINRA alleged that Tejas, through Cuckler:

(a) failed to disclose in four research reports that the firm or its analyst who authored the research reports had a financial interest in the securities of the subject company;

(b) failed to disclose risks that could prevent the subject company from achieving Tejas's price target for the company;

(c) failed to disclose that Tejas had managed or co-managed a public offering for the subject company of one of the firm's research reports;

(d) allowed research analysts to purchase securities of companies that they covered within 30 days prior to publication of a research report on the company and permitted an analyst to sell securities of a subject company in a manner that was inconsistent with his published research recommendation; and

(e) permitted an individual who did not hold the requisite research licenses to publish research reports.

3. Besides allegations related to research reports, FINRA alleged that Tejas: failed to supervise adequately a registered representative's securities transaction; failed to investigate red flags related to a group of accounts with possible suspicious activity; failed to enforce the Firm's AML procedures; failed to record timestamps on order tickets; and failed to collect required information concerning clients who participated in PIPE transactions.
4. Tejas and Cuckler consented to censures. Tejas consented to a fine of \$175,000, of which Cuckler was jointly and severally liable for \$15,000. Tejas also agreed to retain an independent consultant to review the firm's supervisory systems, procedures and training related to its securities business, including research reports.

Enforcement Developments

New Case Review Process³³

FINRA reportedly has instituted a case enforcement review process to ensure consistency in the way it handles enforcement cases.

- A. This internal review process previously was used by NYSE Regulation under Susan Merrill, who moved from NYSE Regulation to become FINRA's Chief of Enforcement.
- B. 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.
- C. 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 settled within an appropriate range, without slowing down the enforcement process.

³³ See FINRA Launches New Process to Review Cases; Overall Penalty Levels Not Affected, Broker/Dealer Compliance Report, Vol. 10 No. 05, Feb. 6, 2008.

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 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.

Rumor Spreading

As at the SEC, FINRA was concerned with the improper spreading of rumors in 2008. While it does not appear that FINRA brought any enforcement actions in this area, it took at least three actions intended to combat this practice.

First, FINRA published a news release warning members firms and registered representatives to refrain from spreading false rumors.³⁴

³⁴ FINRA News Release, Self-Regulators Warn Against Spreading False Rumors and Other Abusive Market Activity (Mar. 31, 2008).

Second, FINRA, along with examiners from the SEC and NYSE Regulation, began examinations of broker-dealers in July 2008 focusing on the intentional spread of false information with the intention to manipulate securities prices.³⁵

Third, in November 2008, FINRA proposed new Rule 2030 that would prohibit any member from circulating rumors concerning a security when the member “knows or has reasonable grounds for believing [that the rumor] is false or misleading or would improperly influence the market price of such security.” The proposed rule, based upon – but different from – existing NASD and NYSE rules, also would require members to report to FINRA circumstances that “reasonably would lead the member to believe that any such rumor had been originated or circulated.”³⁶ The comment period on FINRA’s proposal ended in late December 2008.

FINRA Provides Guidance on Obtaining Credit for Extraordinary Cooperation³⁷

In November 2008, FINRA publicly announced factors it will consider in determining whether to give firms and individuals credit for extraordinary cooperation, which reflects FINRA’s first formal guidance to members on the topic since its formation in July 2007 upon the merger of the NASD and New York Stock Exchange Regulation.³⁸ The Notice stresses that FINRA imposes affirmative duties of cooperation and disclosure on its member firms. However, in certain instances, a firm that is the subject of a FINRA investigation may demonstrate “extraordinary cooperation” that exceeds mandatory compliance levels and which FINRA believes should be recognized in the outcome of the matter.³⁹ The Notice identifies four “extraordinary cooperation” factors:

1. *Proactive and early self-reporting of violations:* the disclosure must be “prompt, detailed, complete and straightforward in order to warrant special consideration;”
2. *Extraordinary steps to correct deficient procedures and systems:* a firm may receive credit, even if its remediation occurs after FINRA detected the deficiency, if the remediation is implemented without regulatory prompting and “well before completion of FINRA’s investigation;”

³⁵ SEC Press Release 2008-140, Securities Regulators to Examine Industry Controls Against Manipulation of Securities Prices Through Intentionally Spreading False Information (Jul. 13, 2008).

³⁶ See FINRA Regulatory Notice 08-68 (Nov. 2008).

³⁷ See http://www.morganlewis.com/pubs/FINRA_Provides_Guidance.pdf.

³⁸ FINRA Regulatory Notice 08-70 (Nov. 2008), <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p117452.pdf>.

³⁹ The guidance set forth in the Notice also applies to cases brought against individuals.

3. *Extraordinary remediation to customers:* extraordinary remediation includes “promptly and immediately identifying injured customers and making such investors whole” or providing remediation to customers for transactions that are outside the scope of FINRA’s investigation; and
4. *Providing substantial assistance to FINRA investigations:* substantial assistance includes providing access to individuals or documents beyond FINRA’s jurisdictional reach, briefing FINRA on internal investigations, and assisting FINRA to detect industry wrongdoing.

FINRA identifies four ways in which firms may receive credit for extraordinary cooperation: a reduction in fine; a reduction in or elimination of an undertaking; a discussion of the firm’s cooperation in the settlement document and press release; and in unusual circumstances, FINRA may decide to take no disciplinary action against the firm at all.

Similar to the DOJ’s and SEC’s shifts away from encouraging waivers of the attorney-client privilege and work-product protection, FINRA now takes the position that cooperation credit derives not from the waiver of the attorney-client privilege, but from providing “extraordinary assistance” to FINRA staff in sharing the relevant facts of an internal investigation. Indeed, according to the Notice, the waiver or non-waiver of the attorney-client privilege will have no bearing on FINRA’s decision to grant credit for cooperation.

NYSE Regulation has not released any statistics concerning its enforcement activity in 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.

In 2008, NYSE Regulation brought noteworthy cases in the market timing, suitability, swaps, odd lot trading, and Rule 92 areas. These and other cases are described below.

Enforcement Actions⁴⁰

Market Timing/Late Trading

- A. *Evan Greenberg*, Hearing Board Decision 08-38 (July 9, 2008)
1. NYSE Regulation settled a matter in which it alleged that Greenberg, a Bear, Stearns & Co., Inc. ("Bear Stearns") registered representative, engaged in numerous deceptive practices in order to facilitate illegal market timing and late trading by his customers, generating over \$1.5 million in gross revenues for the firm.
 2. Specifically, NYSE Regulation found that between November 2000 and September 2003, Greenberg and a junior trader opened and used approximately 119 different account numbers, maintained at least 20 registered representative numbers, and traded in small dollar amounts to deceive mutual funds and continue market timing.

⁴⁰ Some of the cases below appear to be matters still working their way through the old NYSE Regulation regime.

Greenberg allegedly received over 350 complaints and/or block notices from at least 28 mutual fund families but made more than 800 transactions in violation of these notices after being asked by mutual funds to stop trading.

3. Finally, between January and June 2003, Greenberg and the junior trader also allegedly entered more than 1,000 trades on behalf of a hedge fund client after the 4:00 p.m. cutoff but permitted the hedge fund to receive same-day NAV pricing.
4. Greenberg consented to a censure, a five-year bar, and an undertaking to cooperate with NYSE Regulation in any litigation or ongoing investigation in this matter and related cases.

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, an A.G. Edwards & Sons, Inc. ("AGE") registered representative, 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 made on margin, which increased 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 bar 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 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.

Swaps

- A. *Goldman Sachs & Co.*, Hearing Board Decision 08-45 (Oct. 23, 2008)
 1. NYSE Regulation alleged that Goldman Sachs failed to reasonably supervise the business activities of its Equity Financial Group (“EFG”) and failed to establish procedures designed to, among other things, detect and prevent improper trades between affiliates from being executed by the EFG trading desk.
 2. Between December 2003 and July 2004, Goldman Sachs entered into certain over-the-counter stock swaps with its London affiliate Goldman Sachs International (“GSI”) at a price to be determined by the market closing price on the date of the trade. Goldman Sachs allegedly failed to follow its internal guidelines prohibiting the firm from taking direction from GSI with respect to the firm’s hedge regarding the number of shares to trade, the Goldman Sachs account to which the transactions should be booked, and which inter-dealer broker to use.
 3. NYSE Regulation also alleged that Goldman Sachs failed to identify and report to the NYSE certain reportable trades, failed to preserve records relating to certain transaction order tickets, failed to mark trades on tickets as long or

short, and failed to comply with the uptick rule on two occasions.

4. Goldman Sachs consented to a censure and a \$600,000 fine (\$300,000 to NYSE and \$300,000 to FINRA).
5. In determining Goldman Sachs's penalty, NYSE regulation considered that Goldman Sachs: initiated its own review of the EFG; provided information to NYSE on its own initiative; hired a law firm to conduct a review; and established and implemented enhanced procedures for EFG traders and supervisors.

Dissemination of Material, Non-Public Information

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

A. *Adam Galeon*, Hearing Board Decision 07-162 (Dec. 20, 2007)⁴¹

1. Adam Galeon, a Credit Suisse First Boston LLC ("CSFB") research analyst, consented to a finding that he violated just and equitable principles of trade. Galeon allegedly obtained 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 passed the information to certain CSFB 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

⁴¹ 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.

sent 23 e-mails to colleagues and clients, each time disclosing what he had learned. In all but one e-mail, 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 CSFB 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 e-mail. Later that night, CSFB 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 continues to be the subject of enforcement actions.

- A. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, Hearing Board Decision 07-163 (Dec. 20, 2007)⁴²
 1. NYSE Regulation alleged that Merrill Lynch failed to comply with NYSE rules concerning odd-lot transactions.
 2. Merrill Lynch 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 Lynch agreed that ABC would aggregate odd lots and report trading activity to Merrill Lynch for review.
 3. NYSE Regulation found that Merrill Lynch failed to supervise reasonably because it did not conduct surveillance of ABC's trading activity. ABC used its own proprietary system to

⁴² This action was decided on Dec. 20, 2007, although it was posted on the NYSE website on Feb. 13, 2008. This case, therefore, was not included in our 2007 outline.

submit trades through Merrill Lynch's SuperDot lines and therefore was outside Merrill Lynch's electronic surveillance process.

4. Merrill Lynch consented to a censure and a penalty of \$160,000.

B. *RBC Capital Markets Corp.*, Hearing Board Decision 08-43 (Sept. 12, 2008)

1. NYSE Regulation settled a matter with RBC in which it alleged that the firm failed to comply with NYSE rules concerning odd-lot transactions, submission of timely Daily Program Trade Reports ("DPTRs"), and by failing to supervise.
2. Between October 2004 and May 2005, RBC allegedly submitted at least 44,000 proprietary odd-lot trades through the SuperDOT system without aggregating them into round lots. These orders, all of which were program trades or index arbitrage trades, were entered prior to the opening of trading and therefore were executed at the opening market price.
3. RBC also allegedly submitted untimely information regarding 112 program trades and failed to submit information about 120 program trades via Daily Program Trading Reports. The errors resulted from a flaw in the firm's systems (following an upgrade), which did not timely identify these incorrect submissions.
4. NYSE Regulation also found that RBC's written supervisory procedures were inadequate with respect to odd lot trading and daily reporting of program trading.
5. RBC consented to a censure and a fine of \$125,000.

Order Marking

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

- A. *Goldman Sachs & Co.*, 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.
 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 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 \$225,000 fine.

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.*, Hearing Board Decision 08-006 (Feb. 20, 2008)
 1. NYSE Regulation alleged that Merrill Lynch 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 one 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, the trader caused the firm to fail to keep accurate books and records. Additionally, during the relevant period, the firm did not have policies or procedures for reviewing employees' instant messages, a practice that could have alerted the firm to the trader's misconduct.
 4. Merrill Lynch took remedial action by requiring traders to send an e-mail 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 sought 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 supervise adequately 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 to the firm 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.”

Rule 92

- A. *Credit Suisse Securities (USA) LLC*, Hearing Board Decision 08-36 (June 23, 2008)
1. NYSE Regulation settled a matter with Credit Suisse in which it alleged that the firm failed to comply with NYSE rules concerning, among other topics, trading ahead of customers, entry and cancellation of Market-on-Close and Limit-on-Close orders, submission of audit trail data regarding trades, and supervision.
 2. NYSE alleged that on four occasions between January 2005 and December 2007, Credit Suisse “traded ahead” by entering proprietary orders before entering clients’ orders that were executable at the same price as the proprietary orders. In eleven other instances, Credit Suisse failed to document whether it had received customer permission to trade ahead.
 3. NYSE Regulation also alleged that Credit Suisse submitted “G” orders (*i.e.*, orders that must yield priority, parity and precedence) without identifying them as “G” orders.
 4. Finally, NYSE Regulation alleged that between June 2004 and December 2007, the firm entered or cancelled 3,331 Market on Close or Limit on Close orders after the permitted cut-off times. Of these orders, 2,886 were attributable to either technological issues or human error.
 5. The decision noted that NYSE Regulation considered Credit Suisse’s efforts to implement new systems enhancements and controls designed to prevent future violations and that the firm conducted additional training of its personnel.

6. Credit Suisse consented to a censure and a \$350,000 fine.
- B. *Citigroup Global Markets, Inc.*, Hearing Board Decision 08-42 (Aug. 8, 2008)
1. NYSE Regulation settled a matter with Citigroup in which it alleged that the firm placed proprietary orders ahead of or along with client orders that could have been executed at the same price.
 2. After receiving a referral from its Division of Market Surveillance, NYSE Regulation alleged that on eleven occasions between January 2004 and November 2006, Citigroup “traded ahead” by entering proprietary orders before entering clients’ orders that were executable at the same price as the proprietary orders.
 3. In fourteen other instances, Citigroup failed to document whether it had received clients’ permission to trade ahead. NYSE Regulation alleged that the firm failed to supervise reasonably its process for tracking and documenting whether such consents had been obtained and also failed to review whether trade allocations were applied in a manner that was consistent with the clients’ permission.
 4. During the Rule 92 investigation, Citigroup allegedly was unable to provide certain trade data for the period February through October 2007 in the electronic format in which it was required to be maintained because Citigroup had not updated its systems to capture such trades.
 5. The decision noted that NYSE Regulation considered Citigroup’s implementation of new systems enhancements and controls designed to prevent future violations and its offer to compensate clients that were disadvantaged by the above violations.
 6. Citigroup consented to a censure and a \$235,000 fine.

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