

IV(a) BD – Enforcement Workshop

I. INTRODUCTION¹

This outline is intended to highlight certain issues involved in the evolution of enforcement matters, both at the SEC and FINRA.² The outline is not intended to be an exhaustive survey of the enforcement process, but rather to generally describe the stages of an investigation and to identify key issues that arise in those matters. In this presentation, we address: (1) the investigation process; (2) deciding whether to settle or litigate; and (3) recent cases and developments in broker-dealer enforcement. In light of the significant changes to the SEC's enforcement powers as a result of the recently enacted Dodd-Frank legislation, this year we have added a section to this outline on this important topic.

II. EVOLUTION OF THE ENFORCEMENT PROCESS

A. Background Information

In 2008 and 2009, the SEC and FINRA both published materials that generally describe their enforcement processes.

In an effort to make its processes more transparent, in October 2008, the SEC made public its Division of Enforcement Manual.³ 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 came 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.⁴

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.

In March 2009, FINRA published Regulatory Notice 09-17 in which it provided guidance to the industry concerning its enforcement process. Although apparently not breaking new ground, the Regulatory Notice provides a useful high-level description of various FINRA enforcement protocols,

¹ Unless otherwise noted, this outline was created by Ben A. Indek of Morgan Lewis & Bockius LLP. The views expressed herein are his own and not those of his firm or the other panelists or their organizations.

² While focused on SEC and FINRA investigations, the issues identified in this outline may also pertain to state securities commission and/or state attorney general investigations.

³ The full text of the manual can be found on-line at <http://www.sec.gov/divisions/enforce/enforcementmanual.pdf>.

⁴ 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>).

including information regarding managerial oversight of investigations, reviews of the sufficiency of evidence, the Wells process, FINRA's Disciplinary Advisory Committee, and the Office of Disciplinary Affairs.

The SEC's Manual and FINRA's Notice should be consulted with respect to many of the topics described below.

B. Opening an Investigation

1. Sources of an investigation

a. An investigation can originate from several sources, including:

- Customer complaints
- Media interest in particular issues
- Investor and/or shareholder lawsuits
- Form filings (e.g., U-4, U-5, 3070, etc.)
- Trade reporting/regulatory surveillance
- Referrals resulting from routine or for cause examinations
- Whistleblowers or other tips
- Internal identification of a potential issue by regulatory staff (e.g., FINRA's Ahead of the Curve initiative)

Issue: Regulators continue to conduct sweep investigations in which they simultaneously probe the activities of a number of firms. FINRA now routinely posts sweep inquiry letters on its website. Compliance officers and counsel should consider whether to conduct their own internal review of the sweep subject matter in instances where their firm did not receive the initial sweep letter.

2. Commencing an investigation at the SEC

a. In 2007, Walter Ricciardi, then Deputy Director of Enforcement, described in a speech a new SEC Enforcement Management Plan, which, among other things, requires that a Deputy Director approve an investigation before it is opened.⁵ This topic is more formally covered in the SEC's Enforcement Manual.

C. Fact investigation

1. Document requests – Regulators routinely request numerous categories of documents during the course of an investigation. Several considerations for counsel to consider when they receive and respond to such requests include:

⁵ Notes on the speech Mr. Ricciardi gave in July 2007, outlining the Enforcement Management Plan, are available at: <http://www.sifmacl.org/attachments/files/24/July%20Monthly%20Luncheon%202007.pdf>

- Upon receipt of the requests, the firm should attempt to ascertain the documents the company has in its possession, those documents that can be obtained for production and determine when production can reasonably be made.
- Where it is determined that documents cannot be reasonably obtained or produced, company counsel should consider developing a counter-proposal for production and discuss it with the enforcement staff. Counsel and staff should also negotiate any modifications to the request, including any necessary extensions of time.
- It is critical for counsel to keep the regulators informed of the progress of the document production process.
- Productions of documents and information should be accompanied by requests for confidential treatment.

Issue: Requests for e-mails, instant messages and other electronic communications are routine. However, they can be burdensome, costly and time/labor intensive. Counsel must quickly engage the staff in productive discussions about the need for such material, the breadth of the requests and a timeline for production.

Issue: Certification of Production. Various regulators have begun to require companies to certify that their document productions are complete at the conclusion of the investigation. As such, firms should create and maintain records reflecting the efforts undertaken to comply with regulatory requests in order to execute these certifications.

2. Creation of information for regulators – Recently, there has been an increase in requests from certain regulators that ask companies to create and provide analyses of data and information that are not kept in the ordinary course of business. Examples of materials created for regulators include chronologies of key events, databases populated with various information, spreadsheets sorting and analyzing transaction data, and summaries of relevant facts.

Issue: Firms should consider whether and how they can respond to requests for these kinds of requests. Firms should keep in mind the type of request being made and whether the records requested are those required to be kept by the relevant securities laws and rules.

3. Testimony – Many investigations will require the testimony (or informal interviews) of relevant individuals at the company. Requests for such testimony may come in the form of a subpoena or a request letter. Some of the steps involved in preparing a witness for testimony, include:

- Gather and review key materials, including produced documents that refer to or relate to the witness; references to the witness in prior testimony of others and; and a chronology or outline of key facts and events.
- Attempt to ascertain the anticipated scope of the testimony from counsel for other witnesses, where possible without compromising confidentiality, and from enforcement counsel.

- In preparing the witness: review and develop the facts of the case; evaluate whether the testimony is likely to evoke answers that could be privileged and discuss how to approach; and provide the witness with the “rules of the road.”
 - In this environment where there is significant overlap and coordination between the SEC and criminal prosecutors, counsel should be aware of any potential issues that might arise in the criminal context (e.g., the need to advise a witness to assert her Fifth Amendment rights).
4. Cooperation with Regulators: FINRA – Throughout the investigation process, companies should be mindful of the cooperation they provide regulators.
- FINRA’s Sanction Guidelines list a number of factors that the staff will consider in resolving a matter, including: a company’s relevant regulatory history; whether a firm voluntarily employed corrective measures prior to detection or intervention by a regulator; whether the firm provided substantial assistance to FINRA in connection with its investigation; and whether the misconduct was the result of an intentional act, recklessness or negligence.
 - 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.⁶ 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.⁷ 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;” (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: (1) a reduction in fine; (2) a reduction in or elimination of an

⁶ FINRA Regulatory Notice 08-70 (Nov. 2008), <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/pl17452.pdf>.

⁷ The guidance set forth in the Notice also applies to cases brought against individuals.

undertaking; (3) a discussion of the firm's cooperation in the settlement document and press release; and (4) 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 Information Memos 05-65 and 05-77 continue to provide relevant guidance on the topic of cooperation. As contemplated in these information memos, extraordinary cooperation by a firm plays a role in whether and how to bring an action against the firm. Information Memo 05-65 defines "extraordinary cooperation" as: "cooperation that goes beyond that required by the rules of the Exchange and federal securities laws, and that has the potential, in appropriate cases, to influence the outcome of an investigation, for instance by causing the Exchange to seek a reduced sanction, to decide to bring reduced or less serious charges, to obviate the need for an undertaking, or to decide to forgo bringing charges altogether."

Issue: Waiver of Attorney-Client Privilege. A key issue to be considered by counsel is whether a company will waive the attorney-client privilege in producing documents and information to a regulator. This issue and regulators' views on it is constantly changing and must be carefully tracked by counsel.

5. Cooperation with the regulators: SEC⁸

a. SEC 2001 21(a) Report - "Seaboard Factors"

- (i) Focus on crediting behavior of entities as opposed to individuals
- (ii) Generally speaking, SEC would provide credit to entities that "seek out, self-report and rectify illegal conduct, and otherwise cooperate with Commission Staff"
- (iii) Outlined the factors that would be considered for credit through a series of questions - the criteria included:
 - (a) nature of the conduct
 - (b) how the misconduct occurred
 - (c) where in the organization it occurred iv) how long the misconduct lasted

⁸ This section was drafted by panelist A. Brad Busscher in connection with the SIFMA Legal and Compliance Annual Compliance Seminar in May 2010.

- (d) how much harm was inflicted on investors and other constituencies
- (e) how the misconduct was detected
- (f) how long did the company take to implement an effective response upon discovering the misconduct
- (g) steps the company took to address the misconduct
- (h) process the company followed to resolve the issues and ferret out information
- (i) scope of the company's investigation
- (j) cooperation with SEC Staff
- (k) assurances that the misconduct was an isolated occurrence
- (l) has the company changed in any way since the misconduct was detected

b. January 19, 2010 - SEC Policy Statement Concerning Cooperation by Individuals in its Investigations and Related Enforcement Actions.

- (i) Focus on rewarding cooperation by individuals
- (ii) SEC Enforcement Director Khuzami described the policy as a "potential game-changer." SEC says cooperation by individuals and entities can contribute significantly to the success of SEC's mission, including detecting violations of the Federal securities laws, increasing the effectiveness and efficiency of the Commissions' investigations as well as providing important evidence for its enforcement actions
- (iii) Evaluation of cooperation handled on case-by-case basis in light of four (4) specific factors:

Assistance provided by the individual

- (a) value of the cooperation
- (b) timeliness of the cooperation
- (c) initiation of the investigation as a result of the cooperation
- (d) quality of the cooperation
- (e) conservation of SEC time and resources
- (f) voluntary cooperation g. assistance provided

- (g) volunteered non-privileged information
- (h) encouraged or authorized others to cooperation

Importance of the underlying matter

- (a) Commission priority
- (b) types of violations
- (c) age and duration of the misconduct
- (d) number of violations
- (e) isolated or repetitive violations
- (f) amount of harm or potential harm
- (g) type of harm
- (h) number of individuals or entities harmed

Societal interest in holding the cooperating individual fully accountable

- (a) severity of individuals misconduct in light of the individual's background
- (b) culpability of the individual (e.g., acted with scienter)
- (c) steps taken by the individual to prevent violations from occurring or continuing
- (d) efforts taken by the individual to remediate the harm caused by the violations
- (e) sanctions imposed on the individuals by other federal or state authorities or industry organizations for these violations

Personal and professional profile of the individual

- (a) individual's history of lawfulness
- (b) individual's acceptance of responsibility for the misconduct
- (c) potential for the individual to engage in future misconduct

c. January 13, 2010 - Announcement of Additional Tools Related to Cooperation

- (i) Cooperation Agreements - formal written agreements in which the Enforcement Director would recommend to the Commission that a

cooperating individual or entity receive a specified credit to settle without admitting or denying the underlying allegations:

- (a) Potential downside - not binding on the Commission
- (ii) Deferred Prosecution Agreements - formal written agreements in which Commission agrees to forego an enforcement action against a cooperating individual or firm:
 - (a) May require a long-term tolling agreement, compliance with certain prohibitions and undertakings and/or disgorgement of ill-gotten gain or the payment of penalties
- (iii) Non-Prosecution Agreements - formal written agreements in which the Commission agrees not to pursue an enforcement action against a cooperating individual or entity if such person or firm agrees to cooperate fully and truthfully and comply with express undertakings which might include the admission of certain facts, disgorgement of ill-gotten gain, civil penalties and/or other undertakings:
 - (a) Downside - likely a rare occurrence
- (iv) Department of Justice Immunity Requests - the Commission has delegated authority to the Enforcement Director to submit witness immunity order requests directly to the DOJ for witnesses that have provided substantial assistance in the Commission's investigations and related enforcement actions
 - (a) Enforcement Director may also seek Commission consideration of such requests as well
- (v) Proffer Agreements - the Commission's Enforcement Manual also discusses a Proffer Agreement which is a written agreement providing that any statements made by a person, on a specific date, may not be used against that individual in subsequent proceedings, except that the Commission may use statements made during the proffer session as a source of leads to discover additional evidence and for impeachment or rebuttal purposes if the person testifies or argues inconsistently in a subsequent proceeding.

d. **Issues:**

- (i) April 2010 - Enforcement Director Khuzami informed The Washington Post that the SEC is considering the possibility of making publically available "statements of facts" underlying an SEC investigation and settlement
- (ii) FRE 408 v. FRE 803(8)(C) - FRE 408 bars the admission of evidence obtained in the course of settlement negotiations. FRE 803 (8)(C)

permits the admission of public records setting forth factual findings from an investigation

- (iii) Courts are split, however, trend appears to be making such documents admissible.
- (iv) Possible expansion of collateral civil litigation stemming from an SEC settlement.

6. New Cooperation Initiatives by the SEC Relating to Individuals

- On January 13, 2010, the Commission announced a series of new measures designed to encourage individuals and companies to cooperate in Enforcement Division investigations and enforcement actions. First, the SEC issued a policy statement setting forth for the first time formal guidelines to evaluate and potentially reward cooperation by individuals in investigations and enforcement actions. Second, the Commission authorized the use of a number of new “cooperation tools” designed to establish incentives for individuals and companies to cooperate with the Division. The enforcement staff now is authorized to execute formal written cooperation agreements, deferred prosecution agreements, and nonprosecution agreements with individuals and companies, although a formal witness proffer will be required in most cases before any of these new agreements may be used. These new measures are codified in a revised version of the Division’s Enforcement Manual in Section 6, titled “Fostering Cooperation.”⁹
- The Commission’s new cooperation incentives demonstrate the importance it places on individual and company cooperation in its enforcement efforts. In his public statement announcing these new measures, SEC Enforcement Director Robert Khuzami characterized them as a potential “game changer” for the Commission, and recognized that there is “no substitute for the insider’s view into fraud and misconduct that only cooperating witnesses can provide.”

Issue: How should a firm or counsel for an individual deal with these new Commission initiatives? Does this new paradigm raise potential conflicts of interest between firms and employees who want to cooperate with the SEC?

D. Wells Process

Although the Wells process only formally applies to SEC investigations, FINRA also often uses a Wells-like protocol in the evaluation of its matters.

1. If at the conclusion of an investigation, the regulator determines that a firm may be subject to charges, it will often send the company a “Wells notice,” which lists the firm’s potential charges. (Oral Wells notices are also common.) The company will then have the opportunity to respond, in a “Wells submission,” and state why the firm

⁹ The full text of the Commission’s release can be found at <http://www.sec.gov/news/press/2010/2010-6.htm>; the Commission’s policy statement is set forth in Release No. 34-61340 (Jan. 13, 2010) at <http://www.sec.gov/rules/policy.shtml>; and the full text of the Division’s Enforcement Manual can be found at <http://www.sec.gov/divisions/enforce/enforcementmanual.pdf>.

should not be charged with certain violations (or all of the alleged acts) and what kind of sanctions, if any, should be assessed. As noted in a well-used treatise on enforcement:

This is a key step in the regulatory investigation process. A Wells submission is a firm's opportunity to set forth key facts as well as to make legal and policy arguments. It is a chance to convince the staff that they should either not pursue an action or reduce the charges against the firm.¹⁰

2. As part of the SEC's Enforcement Management Plan, a firm will not receive a Wells notice until a Deputy Director has been notified and signed off on such a step.
3. The newly passed Dodd-Frank legislation generally requires the SEC to either commence an action or close a case within 180 days of a Wells notice.

E. Deciding Whether to Settle or Litigate¹¹

At the conclusion of the investigatory phase, a regulator can determine to close the matter without action or pursue charges. The subject firm (or individual) is then faced with a choice: to settle or to litigate. In deciding whether to settle or litigate an enforcement action with a regulator, the following issues must be considered:

1. Language and Scope of Charges

In a litigated context, respondents have no ability to influence the language used by the staff and may also face charges that the staff might agree to exclude in a settled context. Because any charges will have reputational impact and may also have collateral consequences (as discussed below), the ability to negotiate the scope of charges (*e.g.*, excluding an allegation of fraud or substituting an SRO rule for a charge alleging SEC Rule 10b-5 violations) may be of great significance. Similarly, regulators will typically agree to negotiate the language and tone of a settled charge document. If a case is to be litigated, the staff will often plead the allegations aggressively.

2. Publicity

Consideration must be given to whether the respondent can endure the negative publicity surrounding the issuance of a complaint and the collateral effects on a firm or individual's ongoing business activities. In addition, litigation might involve two waves of publicity (upon the filing of a complaint and at the conclusion of a case) as opposed to a settlement, which generally is covered in the media only at the resolution of the matter. In a settlement, respondents are usually given a limited opportunity to review and comment upon the regulator's proposed press release. No such opportunity will exist if the parties expect to litigate and the tone of the release is likely to be more aggressive.

¹⁰ See The Securities Enforcement Manual, 2d Ed., 165 (ABA 2007).

¹¹ "Litigating with the SEC and SROs" by Anne C. Flannery and John Shin presented at the SIFMA Compliance & Legal Division 2007 Annual Seminar.

3. Regulatory Filings

Upon the issuance of complaints, firms and individuals are required to disclose the nature of the disciplinary action through the CRD system. The filing of forms disclosing regulatory complaints must be considered when deciding whether to litigate or settle.

4. Reputational Risks

Publicity and/or regulatory filings can adversely affect a firm's or an individual's reputation and standing in the securities industry and the national or local community. The reputational risks associated with litigating disciplinary actions must be carefully weighed. Of course, firms and individuals may wish to vindicate their position through litigation rather than settle on unfavorable or inaccurate terms.

5. Collateral Consequences

Respondents must consider the collateral consequences of a litigated decision. These consequences include collateral estoppel in connection with private litigation or arbitration involving the same facts that can arise from fully litigating a regulatory matter. In contrast, regulatory settlements are resolved without admitting or denying the facts and are less likely to raise collateral estoppel issues in related litigation or arbitration.

6. Regulatory Relationships

For firms, litigating with their regulators can lead to, at a minimum, a perception that the broker-dealer is not committed to cooperating with the regulatory process. Because firms will have to continue to work with and be examined by regulators on an ongoing basis, broker-dealers must consider the potential damage to regulatory relationships arising out of litigating with their regulators.

7. Sanctions

Generally speaking, there is a perception within the industry that firms or individuals can settle with regulators on terms that may be more advantageous than the sanctions levied at the conclusion of a litigated case. Consideration to the types of charges, fines, undertakings and language available in a settlement must be weighed against those that can be obtained by a regulator in litigation. Consideration also needs to be given to the collateral consequences of an injunction imposed by the SEC.¹²

¹² Based upon a review of reported decisions, the sanctions imposed in litigation matters may be different from, and at times less than that which may have been procured through settlement. Some commentators have expressed the view that it might be worthwhile to litigate against regulators even if it is likely that the regulator will win on liability. See, e.g., Brian L. Rubin & Christian J. Cannon, *It Sometimes Pays to Litigate Against FINRA*, INSIGHTS: THE CORPORATE & SECURITIES LAW ADVISOR, Vol. 22 No. 5, May 2008.

8. Distraction

Firms and individuals can be distracted from their business activities while litigating with a regulator. The time, effort and disruption that can come with a protracted and contentious litigation must be considered before deciding to fight a disciplinary action.

9. Costs

Litigation (in any context) can be a costly endeavor. Legal fees and expert witness fees, to name two costs, can be significant and the money spent in litigating must be considered before deciding to do so.

III. RECENT DEVELOPMENTS AND CASES¹³

A. Recent Trends: Mid-Year 2010

1. SEC Enforcement Priorities

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

- a. The marketing and sale of CDOs and other complex derivative products
- b. The valuation of and disclosures relating to subprime securities
- c. Sales of unsuitable securities to retail investors
- d. Municipal securities and political contributions
- e. Insider trading by Wall Street professionals
- f. Failure to supervise registered representatives
- g. The causes of the May 6, 2010 "flash crash"

2. FINRA Enforcement Priorities¹⁴

- a. Regulation D offerings: FINRA is concerned about suitability and potential fraud in these kinds of offerings. In addition to the recent Provident Asset Management case, additional actions will be forthcoming. Firms should consult Regulatory Notice 10-22 regarding obligations to conduct a reasonable inquiry in connection with Regulation D offerings.

¹³ This section is drawn from the recently published Morgan Lewis outline titled: "2010 Mid-Year Review: SEC and SRO Selected Enforcement Cases and Developments Regarding Broker-Dealers" by Ben A. Indek, Anne C. Flannery, Michael S. Kraut, Kevin T. Rover, and Mary M. Dunbar. This outline is available at www.morganlewis.com. This section is generally covers the period January through June 30, 2010.

¹⁴ Information regarding these priorities is based upon the author's notes of the comments made by James Shorris, FINRA's Acting Head of Enforcement, at the May 2010 SIFMA Annual Compliance & Legal Society seminar.

- b. Illegal distributions of stock and related penny stock scams: Recently FINRA brought five actions in this area. Previously it had issued Regulatory Notice 09-05.
- c. Ponzi schemes and other frauds: Ponzi schemes and other fraudulent misconduct raise questions for FINRA about the supervisory practices of member firms.
- d. Fixed income trading and sales: Mr. Shorris noted that the sales of bond funds (*e.g.*, the recent FINRA action concerning Morgan Keegan) and markup issues are priorities.
- e. Exotic products: Mr. Shorris discussed leveraged ETFs and Regulatory Notice 09-31 with respect to this topic.
- f. Stock-for-cash programs: This issue relates to offshore companies that lend money to investors and receive securities as collateral. Issues have been raised regarding the offshore companies' liquidation of collateral rather than the maintenance of such collateral until the end of the loan.
- g. Principal protected notes: Mr. Shorris referenced Regulatory Notice 09-73.
- h. Reverse convertibles: Mr. Shorris expressed concern regarding the qualifications of customers to purchase these products and the use of put options.
- i. Equity indexed annuities (“EIAs”) and variable annuities: FINRA is looking into sales practices (including switching and exchanges) and supervision of EIAs and variable annuities.
- j. Auction rate securities: Enforcement has seemingly cleared its docket of ARS advertising and sales practice cases and is now moving on to “more serious” actions.
- k. Day trading
- l. Municipal securities transactions: FINRA is looking into underwriters who engage in swap transactions that are too costly for municipalities that are unsophisticated. Investigators are also looking at potential conflicts of interest in this area.
- m. Life settlements¹⁵

¹⁵ Interestingly, on July 22, 2010, the SEC released a staff report that recommends that life settlements be defined as securities and issued an Investor Bulletin to describe the key issues concerning life settlements and several of the risks of such investments. *See* “SEC Releases Report of the Life Settlements Task Force,” July 22, 2010, available at www.sec.gov.

B. Recent SEC Cases

1. Marketing and Sales of Collateralized Debt Obligations

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

- a. *SEC v. Goldman Sachs & Co. ("Goldman Sachs") and Fabrice Tourre*, 10-CV-3229 (S.D.N.Y. filed Apr. 16, 2010)
 - (i) The SEC brought an action in federal district court against Goldman Sachs and one of its employees, Fabrice Tourre, alleging fraud in connection with the sale and marketing of a synthetic collateralized debt obligation ("CDO").
 - (ii) The SEC alleged that, in 2007, as the U.S. housing market and related securities were beginning to decline, Goldman Sachs created and marketed a synthetic CDO that was connected to the performance of subprime residential mortgage-backed securities. The marketing materials for the CDO, including the offering memorandum and term sheet, stated that the portfolio of residential mortgage-backed securities underlying the CDO was selected by an experienced third party, ACA Management LLC ("ACA").
 - (iii) According to the SEC complaint, a hedge fund, Paulson & Co. ("Paulson"), played a major and undisclosed role in the portfolio selection process, despite the fact that its economic interest was adverse to investors. Specifically, Paulson allegedly sold short the securities portfolio after helping to select it by entering into credit default swaps with Goldman Sachs, which provided protection on certain elements of the CDO's structure. Accordingly, Paulson allegedly had an incentive to choose securities for the portfolio that would ultimately decline in credit quality.
 - (iv) The SEC also alleged that Tourre was primarily responsible for structuring the relevant CDO and that he prepared the marketing materials and communicated with investors. The complaint alleged that Tourre knew about Paulson's short interest and its participation in selecting the portfolio but did not disclose this information to investors. The SEC further alleged that Tourre was responsible for misleading ACA into believing that Paulson was an equity investor in the CDO and therefore had interests aligned with ACA Management.

- (v) Paulson allegedly paid Goldman Sachs approximately \$15 million to create and market the CDO, which was finalized on April 26, 2007. By late October 2007, most of the residential mortgage-backed securities in the portfolio had declined in credit quality, and by the end of January 2008, 99% of the portfolio securities had been downgraded.
- (vi) The SEC alleged that investors in the CDO lost more than \$1 billion, while Paulson's short positions resulted in an approximately \$1 billion profit.
- (vii) Paulson was not charged with any wrongdoing in this matter.
- (viii) The SEC's lawsuit alleged that Goldman Sachs and Tourre's conduct violated Sections 17(a)(1), (2) and (3) of the Securities Act of 1933 ("Securities Act") and Section 10(b) of the Securities Exchange Act ("Exchange Act") of 1934 and Rule 10b-5 thereunder and sought injunctive relief, disgorgement, and penalties.
- (ix) On July 15, 2010, the SEC announced a \$550 million settlement with Goldman Sachs, which, as noted above, is the largest SEC penalty ever assessed against a Wall Street firm. In its settlement, the Commission stated that \$250 million of the penalty will go to harmed investors and \$300 million will be paid to the U.S. Treasury. In addition to the monetary sanction, Goldman Sachs agreed to comply with a number of undertakings for three years, including actions regarding its product review and approval process, the role of both internal and external legal counsel, and the education and training of certain personnel involved in the structuring or marketing of mortgage securities offerings.
- (x) Although the SEC's complaint charged the firm with violations of Section 10(b) of the 1934 Act and Rule 10b-5 and Section 17(a) of the 1933 Act, the final judgment enjoined Goldman Sachs only from violating Section 17(a) of the 1933 Act.
- (xi) As is typical in such resolutions, Goldman Sachs neither admitted nor denied the SEC's allegations, but as part of the settlement, it acknowledged that the marketing materials for the CDO product "contained incomplete information," and that it was a "mistake" not to disclose Paulson's role in the selection of the portfolio and its adverse economic interest.
- (xii) The SEC's case against Tourre is ongoing, and on July 19, 2010 Tourre filed his answer to the complaint, denying the SEC's allegations.

2. MSRB Rule G-37: Municipal Bonds and Political Contributions

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

- a. *Report of Investigation re JP Morgan Securities Inc., Securities Exchange Act Release No. 61734 (Mar. 18, 2010)*
- (i) The SEC investigated JP Morgan Securities Inc. ("JPMSI") for violating MSRB Rule G-37, which prohibits a broker, dealer, or municipal securities dealer from underwriting municipal bonds for an issuer within two years after the broker, dealer, or municipal securities dealer makes a political contribution to an official of that issuer. Although no disciplinary action was taken in this matter, the SEC decided to release the results of its investigation to reaffirm its prior guidance regarding Rule G-37.
 - (ii) The SEC's investigation revealed that between July 2002 and September 2004, the vice chairman of JPMorgan Chase's global investment banking, asset management, and private wealth businesses supervised, among other things, its U.S. municipal securities. The vice chairman was the lone JPMorgan Chase officer who had responsibility for all of JPMSI's businesses and actively promoted JPMSI's activities. He served as CEO of JPMorgan Chase's investment bank and served on its executive committee.
 - (iii) In August 2002, the vice chairman collected \$8,000 in political campaign donations from JPMorgan Chase and some of its senior officials for the California state treasurer (and personally made a \$1,000 personal contribution). In the two years following these contributions, JPMSI participated as senior manager or comanager in more than 50 negotiated underwritings for California state agencies. The underwritten bonds sold in the aggregate for more than \$15.8 billion, and JPMSI received approximately \$37 million in investment banking fees from these deals.
 - (iv) Although the vice chairman was not a director, officer, or employee of JPMSI, the SEC concluded that he was "associated" with JPMSI, as the term is defined in the Exchange Act. The Commission issued its report to remind firms that the applicability of Rule G-37 depends on whether a person has a financial incentive to make a contribution in an effort to obtain underwriting business, not merely the person's title or employment status.

3. Short Sales

The Commission, like FINRA and its predecessors, the NASD and NYSE Regulation, has focused recently on compliance with its short sale rule, referred to as Regulation SHO. Below is an example of cases in this area brought by both the SEC and NYSE Regulation.

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

4. Supervision¹⁶

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

¹⁶ As this outline went to press, an SEC ALJ handed down a decision in *In the Matter of Theodore W. Urban*, File 3-13655 (Sept. 8, 2010), dismissing the Commission’s failure to supervise charges against Urban, the General Counsel of a broker-dealer.

- a. *In the Matter of Axiom Capital Management, Inc.* (“Axiom”), Admin. Proc. File No. 3-13786 (Feb. 22, 2010); *In the Matter of David V. Siegel*, Admin. Proc. File No. 3-13787 (Feb. 22, 2010)
- (i) The SEC commenced administrative proceedings against Axiom and Siegel, an Axiom branch officer manager, in which it alleges that they failed to reasonably supervise a registered representative who defrauded elderly customers.
 - (ii) In 2003, Axiom assigned Siegel to be the direct supervisor of Gary J. Gross, a registered representative in Axiom’s Boca Raton office. As a result of customer complaints about Gross’ conduct while he was employed by his former firm, the State of Florida required Axiom to place Gross on heightened supervision.
 - (iii) The SEC alleges that, between 2004 and 2006, Gross recommended to elderly customers unsuitable private placements that he described as riskless, , engaged in unauthorized trading, and churned clients’ accounts.
 - (iv) The SEC alleges that the respondents failed to reasonably supervise Gross by failing to follow Axiom’s heightened supervisory procedures. Siegel allegedly failed to monitor Gross’ transactions and did not respond to red flags concerning Gross’ churning activity. Because Siegel’s compensation was partially dependent on the office’s net commissions, Siegel allegedly profited as a result of Gross’ illegal conduct.
 - (v) Axiom settled the matter by consenting to a censure, to pay a \$60,000 civil penalty, and to retain an independent compliance consultant.
 - (vi) The matter against Siegel is ongoing.
 - (vii) In 2008, Gross consented to an injunction, to pay a civil penalty and disgorgement, and to a permanent bar from association with a broker or dealer.
- b. *In the Matter of Salvatore F. Sodano*, Admin. Proc. File No. 3-12596 (Feb. 22, 2010)
- (i) As we reported in our 2007 Outline, in March 2007, the SEC settled an administrative proceeding against the American Stock Exchange LLC (“Amex”), alleging that, from at least 1999 through 2004, the exchange allegedly failed to surveil adequately for its members’ violations of the order-handling rules and also failed to keep and furnish surveillance and

other records. At the time, the SEC also initiated a related administrative proceeding against former Amex chairman and CEO Salvatore Sodano.

- (ii) In August 2007, an ALJ granted Sodano's motion for summary disposition on the grounds that the applicable statute only vests the SEC with jurisdiction to bring charges against current officers and directors of an SRO. Sodano had resigned from those positions with Amex by 2005. In December 2008, the SEC reversed the ALJ's decision, concluding that the statute permitted the SEC to censure current *and former* SRO officers.
 - (iii) In February 2010, the SEC settled its administrative proceeding against Sodano. The SEC alleged that Sodano, as Chairman and CEO of the Amex, was responsible for enforcing compliance with regulatory rules. The SEC further alleged that Sodano failed to ensure that the Amex complied with its own rules and satisfied its regulatory obligations. Specifically, Sodano did not establish procedures to correct deficiencies in the Amex's surveillance and enforcement systems, and he unreasonably relied on others to address widespread problems.
 - (iv) Interestingly, in settling this matter, the SEC did not impose any sanctions or penalties on Sodano.
- c. *In the Matter of First Allied Securities, Inc.* ("First Allied"), Admin. Proc. File No. 3-13808 (Mar. 5, 2010)
- (i) The SEC settled an administrative proceeding against First Allied in which the Commission alleged that firm failed to reasonably supervise one of its registered representatives.
 - (ii) Between May 2006 and March 2008, Harold H. Jaschke, a former First Allied registered representative, allegedly engaged in an unauthorized high-risk, short-term trading strategy on behalf of two municipal customers. This strategy, which involved short-term trading in "STRIPS" (Separate Trading of Registered Interest and Principal of Securities) that were financed through the use of repurchase agreements, directly violated the terms of the customers' investment ordinances.
 - (iii) The SEC alleged that Jaschke's trading strategy was unsuitable for the customers in light of their investment objectives. Jaschke allegedly lied to the customers about the performance and activity of their accounts and failed to disclose unrealized losses. Jaschke also allegedly engaged in unauthorized trading in the customers' accounts and excessively traded in (or churned) these accounts for his own financial gain.

- (iv) The SEC alleged that First Allied failed to establish reasonable systems designed to detect red flags regarding churning and suitability. The Commission also alleged that First Allied failed to monitor representatives' use of their personal e-mail accounts to conduct firm business and failed to preserve e-mails for the requisite three-year period.
 - (v) First Allied consented to a censure, to disgorge \$1,224,606, to pay a \$500,000 civil penalty, and to certify to the Commission staff when it implemented improvements recommended by an independent consultant.
 - (vi) In the settlement release, the SEC noted the prompt remedial actions taken by First Allied and its cooperation with the Commission staff.
 - (vii) In December 2009, the SEC filed a federal court action against Jaschke alleging that he had defrauded two municipalities. In its complaint, the SEC seeks a permanent injunction, disgorgement, and a civil penalty. This matter is ongoing.
 - (viii) Also in December 2009, the Commission settled an administrative proceeding with Jeffrey C. Young, a former vice president of Supervision and Jaschke's supervisor. The SEC alleged that Young failed to respond adequately to red flags raised by Jaschke's conduct and failed to take reasonable steps to assure that First Allied's suitability procedures were followed. Young was suspended in a supervisory capacity for nine months and fined \$25,000.
- d. *In the Matter of Prime Capital Services, Inc., et al.*, Admin. Proc. No. 3-13532 (Mar. 16, 2010)
- (i) The SEC settled an administrative proceeding against Prime Capital Services Inc. ("PCS") and its parent company, Gilman Ciocia, Inc. ("G&C"), in connection with PCS representatives' sale of variable annuities to customers whom they solicited during free-lunch seminars.
 - (ii) The SEC alleged that, between 1999 and 2007, PCS representatives sold approximately \$5 million of variable annuities to elderly clients in south Florida using misleading sales pitches, and that, in many cases, the investments were unsuitable based on the customers' ages, liquidity, and investment objectives.
 - (iii) PCS representatives allegedly told various customers that the variable annuity was guaranteed not to lose money, the customers would receive a guaranteed rate of return, and/or they would have access to invested funds whenever they needed it. During the time period, at least 23 customers were induced to buy at least 35 variable annuities.

- (iv) The SEC charged PCS with failing to supervise because it did not: implement written supervisory procedures; review and follow up on branch exams; review and approve variable annuity transactions; respond to customer complaints; comply with state regulatory orders; and supervise certain individuals.
- (v) The SEC alleged that G&C aided and abetted PCS's fraud by arranging free-lunch seminars in and around several senior citizen communities in Florida where the registered representatives recruited senior citizens as customers and induced them into buying variable annuities.
- (vi) In agreeing to settle the matter, PCS and G&C agreed to: (i) censures, (ii) cease-and-desist orders, and (iii) several undertakings, including retaining an independent compliance consultant, placing limitations on the functions that certain employees (including PCS's president and chief compliance officer) could perform, and notifying and making whole affected clients. In addition, PCS agreed to disgorge nearly \$100,000, and G&C agreed to pay a civil penalty of \$450,000.
- (vii) Earlier in FY 2010 (November 2009), the SEC settled related charges against Christine Andersen, a PCS compliance officer, for failing to supervise. Andersen consented to paying a \$10,000 civil penalty, to a one-year suspension, and to cooperate with the SEC staff's investigation.
- (viii) The SEC's case against PCS president Michael Ryan, PCS chief compliance officer Rose Rudden, and PCS representatives Eric Brown, Matthew Collins, Kevin Walsh, and Mark Wells is ongoing.

C. Recent FINRA Cases

1. Anti-Money Laundering ("AML")

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

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

- (i) FINRA alleged that Penson failed to establish and implement an adequate AML compliance program during the period October 1, 2003 through May 31, 2008.
- (ii) According to FINRA, Penson's system for detecting, reviewing, and reporting suspicious activity was inadequate. Specifically, FINRA alleged that Penson did not allocate sufficient resources to its AML compliance program, did not use appropriately risk-based criteria to

generate AML exception reports, and did not regularly review penny stock deposits and liquidations.

- (iii) FINRA alleged that in 2007, Penson committed additional resources to its AML compliance program, and, in December 2007, implemented a sophisticated automated system to assist its review of potentially suspicious activity. However, FINRA alleged that, despite these improvements, Penson failed to conduct timely investigations of potentially suspicious activity flagged by the automated system on approximately 129 occasions.
- (iv) FINRA also alleged that Penson's AML training program was deficient, that Penson failed to assess AML risks for certain foreign financial institution correspondent accounts, and that the firm's written AML procedures were deficient.
- (v) FINRA further alleged that, between March 31, 2007 and May 31, 2008, Penson failed to report required information to INSITE accurately and failed to provide certain information to its introducing broker-dealers concerning charges required to be taken to the introducing broker-dealers' net capital.
- (vi) Penson consented to a censure, a fine of \$450,000, and an undertaking to have all personnel within its AML compliance department complete 16 hours of training.

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

- (i) FINRA alleged that between January 2006 and September 2009, Pinnacle failed to establish and implement AML procedures reasonably designed to verify the identity of customers and to detect and report suspicious activity.
- (ii) Pinnacle operates as an on-line business and has a customer base of mostly foreign individuals or firms. FINRA alleged that, although nearly all of Pinnacle's customers reside in jurisdictions that have heightened money laundering risk, Pinnacle relied on AML procedures drafted by a third-party vendor that were not designed to allow the firm to evaluate or monitor AML risk of its foreign customer base. For example, according to FINRA, the firm's suspicious activity review procedures contained a list of 18 red flags taken directly from a FINRA notice, most of which did not apply to Pinnacle's business model.
- (iii) FINRA further alleged that Pinnacle's customer identification procedures were inadequate and impractical given Pinnacle's customer base and that Pinnacle failed to detect, investigate, or file suspicious

activity reports on potentially suspicious activity within customer accounts.

- (iv) One of Pinnacle's foreign financial institutional customers domiciled in Latvia had an account with Pinnacle with 55 subaccounts, some of which had additional subaccounts. According to FINRA, Pinnacle failed to obtain the required customer identification information for these subaccounts and failed to detect irregular trading patterns in these subaccounts. In March 2007, the SEC filed a complaint for injunctive relief against this foreign financial institution and certain unknown traders alleging an international on-line "pump and dump" scheme involving Pinnacle and other broker-dealers, although Pinnacle was not named as a defendant in that action.
 - (v) Pinnacle consented to a censure and a fine of \$300,000, and undertook to: (1) have its registered personnel complete three hours of AML training, and (2) hire an independent consultant to review its AML program.
- c. *Department of Enforcement v. Sterne, Agee & Leach, Inc.* ("Sterne Agee") (Mar. 5, 2010)
- (i) In this contested matter, FINRA alleged that, between April 2002 and July 2005, Sterne Agee failed to develop and implement an adequate AML program because its systems were not sufficiently automated. FINRA also alleged that, from July 2006 to April 2007, Sterne Agee's AML program was deficient because, among other reasons, it did not have adequate procedures for reviewing physical securities certificates, monitoring journal transfers, or identifying direct foreign financial institution accounts. FINRA further alleged that the firm failed to have written procedures to comply with enhanced due diligence requirements of the USA PATRIOT Act, failed to identify certain accounts as foreign bank accounts, and failed to implement certain customer identification procedures.
 - (ii) The Hearing Panel determined that, with respect to the Department of Enforcement's allegations that Sterne Agee's AML systems were not sufficiently automated, the Department of Enforcement failed to demonstrate that it was unreasonable for Sterne Agee to have relied on a system with a substantial manual component to fulfill its AML detection requirements. Specifically, the Hearing Panel found that Sterne Agee's system could be reasonably expected to detect and cause the reporting of suspicious activity and transactions.
 - (iii) The Hearing Panel concluded that, during the time period of the alleged violations, FINRA provided firms with little guidance on the degree of system automation required to maintain a reasonable AML program.

The Hearing Panel also found that Sterne Agee's written procedures for identifying and reviewing transactions, as well as its training program, were adequate.

- (iv) Notwithstanding the foregoing, the Hearing Panel concluded that Sterne Agee's program failed to detect and obtain certifications for foreign banks, did not have written due diligence procedures to comply with the USA PATRIOT Act, and failed to implement certain customer identification procedures for delivery versus payment accounts.
- (v) The Hearing Panel imposed a \$40,000 fine on Sterne Agee.

2. Customer Confidential Information

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

- a. *D.A. Davidson & Co.* ("D.A. Davidson") (Apr. 12, 2010)
 - (i) FINRA settled a matter with D.A. Davidson in which it alleged that the firm failed to employ adequate safeguards to protect confidential customer information against hackers.
 - (ii) The firm maintained its customer records, including account numbers, social security numbers, names, addresses, dates of birth, and other confidential information, on an unprotected web server with a constant internet connection.
 - (iii) On December 25 and 26, 2007, an unidentified hacker downloaded confidential information concerning approximately 192,000 customers.
 - (iv) FINRA alleged that the database was not encrypted and that the firm never changed the default password for the database. The firm also allegedly failed to review the web server logs, which showed evidence of the system breach.
 - (v) D.A. Davidson learned of the breach when it received an e-mail from the hacker threatening to blackmail the firm. Upon receipt of the threat, D.A. Davidson took remedial measures by disabling the website, reporting the incident to law enforcement officials, and assisting them in identifying the hackers. The firm took additional remedial steps, including: hiring an outside consultant to advise on electronic security, removing sensitive customer information from the database, adding a firewall, deploying additional intrusion prevention software, and

installing a repository for server logs and procedures for review of the logs.

- (vi) D.A. Davidson consented to a censure and a \$375,000 fine.
- (vii) In setting the sanction, FINRA credited D.A. Davidson for its remedial measures and its significant cooperation with criminal authorities. In addition to the remedial steps outlined above, the firm also: (i) issued a press release about the incident, (ii) provided written notice to customers and established call centers to respond to customer inquiries, (iii) offered a credit-monitoring service to affected customers for two years at a cost to the firm of \$1.3 million, and (iv) resolved a class action litigation with affected customers, which included providing loss reimbursement for potential victims of the hacking of up to an aggregate of \$1 million. FINRA also considered that, as of the date of the settlement, no customer had suffered any instance of identity theft or other actual damages.

3. Regulation SHO

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

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

- (i) FINRA settled a matter with Deutsche Bank in which it primarily alleged that the firm violated rules relating to short sale locates, marking, close-outs, and buy-ins.
- (ii) FINRA alleged that, between January 3, 2005 and September 30, 2009, the firm implemented customer Direct Market Access (“DMA”) trading systems that were designed to block the execution of short sale orders unless a locate had been obtained and documented. However, the firm disabled its system in certain instances, resulting in an unquantified number of short sales without locates. FINRA further alleged that Deutsche Bank’s “Easy To Borrow” list was not properly constructed between January 2005 and approximately April 2007 because it sometimes included hard-to-borrow securities.
- (iii) Between January 3, 2005 and approximately December 2008, the firm allegedly marked client orders long without reasonable grounds and used borrowed shares to make delivery or had fails to deliver. For example, FINRA alleged that, during a sample month of July 2007, Deutsche Bank impermissibly utilized borrowed shares to settle approximately 2,500 long sales (out of approximately six million long sale transactions).

- (iv) Between January 3, 2005 and December 30, 2007, the firm allegedly failed to monitor for Archipelago Exchange threshold securities and thus failed to timely close out fails to deliver in such securities. FINRA further alleged that, between January 2005 and approximately December 2008, the firm did not monitor, effect buy-ins, or obtain a valid extension for long sales in certain prime brokerage accounts in which Deutsche Bank had not obtained timely possession of the securities after settlement.
 - (v) Finally, FINRA alleged that the firm failed to maintain proper books and records, submitted inaccurate blue sheets, and failed to supervise reasonably with respect to the activities described above.
 - (vi) Deutsche Bank consented to a censure and a \$575,000 fine.
 - (vii) In setting the sanction, FINRA considered that the firm implemented numerous information technology improvements that minimize the need to lift the automated block and improved the firm's Easy-to-Borrow list process.
- b. *National Financial Services LLC* ("NFS") (May 13, 2010)
- (i) FINRA settled a matter with NFS in which it primarily alleged that the firm failed to obtain locates for certain short sales.
 - (ii) FINRA alleged that, between June 2005 and approximately August 2008, NFS customers traded through direct market access trading systems that were designed to block the execution of short sale orders without locates. However, the firm utilized a separate manual request and approval process for approximately 12 prime brokerage customers that did not block an unquantified number of short sale orders that did not have locates.
 - (iii) According to FINRA, requests for, and approvals of, the locates for these prime brokerage clients were transmitted via e-mail with NFS prime brokerage personnel and were not required to be entered into NFS's stock loan system at the time of approval. FINRA further alleged that, because the e-mailed locates were not documented in a central location, the firm could not accurately assess its remaining availability in each security during a trading day.
 - (iv) FINRA alleged that the firm represented that it had terminated these practices effective February 1, 2008, but that the practices continued thereafter with respect to at least one prime brokerage client.

- (v) The firm allegedly failed to perform a meaningful post-trade-date review of short sale orders to identify orders executed without a valid locate.
- (vi) Between January 2005 and December 2006, NFS allegedly failed to maintain accurate books and records in that locate request records for approximately 100,000 locates were inaccurately maintained due to a programming error.
- (vii) Finally, FINRA alleged that the firm failed to have an adequate supervisory system for confirming reasonable compliance with the locate requirement.
- (viii) NFS consented to a censure and a \$350,000 fine.

4. Supervision

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

- a. *H&R Block Financial Advisors, Inc. (“H&R Block”) and Andrew MacGill* (Feb. 16, 2010)
 - (i) FINRA settled a matter with H&R Block in which it alleged that the firm failed to establish adequate supervisory systems and written procedures for supervising retail sales of reverse convertible notes (“RCNs”).
 - (ii) An RCN is a structured product that consists of a high-yield, short-term note of an issuer and a put option that is linked to the performance of a “linked” asset. Upon maturity of an RCN, the investor receives either the full principal of his investment plus interest, or a predetermined number of shares of the linked asset. In addition to the ordinary fixed income product risks, RCNs carry the additional risk of the underlying linked asset, which, depending on performance, could be worth less than the principal investment.
 - (iii) FINRA alleged that, between January 2004 and December 2007, H&R Block sold RCNs without having in place an adequate surveillance system to monitor for overconcentration in RCNs. As a result, the firm failed to detect and address such overconcentrations in customer accounts.
 - (iv) FINRA alleged that H&R Block failed to provide guidance to its supervising managers to enable them to effectively assess suitability related to RCNs.

- (v) FINRA alleged that, between May 2007 and November 2007, H&R Block broker Andrew MacGill made unsuitable sales of RCNs to a retired couple who invested nearly 40 percent of their total liquid net worth in nine RCNs.
 - (vi) H&R Block consented to a censure and to pay a \$200,000 fine and \$75,000 in restitution.
 - (vii) MacGill consented to a fine and disgorgement totaling \$12,023 and a 15-day suspension from associating with any FINRA member firm in any capacity.
- b. *Kenneth D. Pasternak and John P. Leighton v. FINRA* (Mar. 4, 2010)
- (i) The National Adjudicatory Council (“NAC”) issued a decision dismissing charges that Kenneth Pasternak, former CEO of Knight Securities, L.P. (“Knight”), and John Leighton, former head of the firm’s Institutional Sales Desk, failed to reasonably supervise the firm’s leading institutional sales trader, Joseph Leighton (John Leighton’s brother), in connection with alleged fraudulent sales to institutional customers. The decision brought to a close more than five years of proceedings relating to the alleged conduct.
 - (ii) The NAC reversed an April 2007 FINRA Hearing Panel decision, which found that Pasternak and John Leighton had violated FINRA’s supervision rule. That ruling fined each respondent \$100,000, barred John Leighton in all supervisory capacities, and suspended Pasternak in all supervisory capacities for two years. Those sanctions were vacated by the NAC’s decision.
 - (iii) The NAC concluded that FINRA (then NASD) failed to satisfy its burden of proof concerning allegations set forth in its March 4, 2005 complaint that Pasternak and John Leighton did not take reasonable steps to confirm that Joseph Leighton adhered to “industry standards” when executing orders for institutional customers. The NAC found that FINRA staff did not establish that the trader contravened any market or regulatory standards when providing execution services to institutional customers. The NAC further found that the preponderance of the evidence did not support the allegation that Pasternak and John Leighton failed to reasonably supervise the sales trader’s practices.
 - (iv) Finally, the NAC decided that the evidence did not support allegations that Pasternak failed to respond appropriately to certain “red flags” that were raised concerning the manner in which the trader executed institutional customer orders.

- (v) In August 2005, the SEC filed a separate injunctive action against Pasternak and John Leighton relating to the same issues. In June 2008, a federal judge held that the SEC failed to prove that Pasternak or John Leighton violated the federal securities laws in connection with the firm's alleged failure to seek best execution and dismissed all charges.
 - (vi) In April 2005, Joseph Leighton consented to a permanent bar from association with a broker or dealer and to pay over \$1.9 million in disgorgement, \$660,000 in prejudgment interest, and a \$750,000 civil money penalty to settle the SEC enforcement action, as well as a \$750,000 fine to settle an NASD action.
 - (vii) In December 2004, the NASD and SEC settled enforcement actions against Knight under which Knight consented to pay a \$12.5 million fine to NASD, a \$12.5 million civil penalty to the SEC, and pay \$41 million in ill-gotten profits and \$13 million in prejudgment interest into a Fair Fund established by the SEC for compensating harmed investors.
- c. *Citigroup Global Markets, Inc.*, FINRA Case No. 20080149558-01 (Apr. 6, 2010)
- (i) FINRA settled a matter with CGMI in which it alleged that the firm failed to adequately supervise its Direct Borrowing Program ("DBP") because CGMI implemented no supervisory system and inadequate written procedures tailored to the DBP, and failed to disclose material facts to customers who participated in it.
 - (ii) FINRA found that, between January 1, 2005 and November 30, 2008, CGMI operated its DBP, through which it borrowed fully paid securities owned in large part by the firm's retail customers. The borrowed securities were pooled and used to facilitate other CGMI clients' short-selling activities. During the relevant time period, CGMI arranged through its DBP for over 4,000 loans, involving over 770 different securities borrowed from over 2,300 customers.
 - (iii) FINRA found that CGMI failed to disclose to customers who participated in the DBP certain material information, including that:
 - (a) the securities were hard-to-borrow due to short selling;
 - (b) the interest rates could be reduced by the firm;
 - (c) the brokers received commissions based upon the number of shares loaned for the duration of the loan period;

- (d) while the securities were on loan, dividends were paid as “cash-in-lieu” of dividends and were therefore subject to higher tax rates; and
 - (e) shares on loan could be sold by the customers at any time.
- (iv) Branch managers and supervisors were not aware that clients of the brokers they supervised were participating in the DBP. FINRA alleged that the firm’s supervisory tools were compromised because securities that were loaned out of the accounts were not reflected in customers’ positions; exception reports did not properly detect concentration levels; and supervisors could not ascertain the ongoing suitability of loan transactions.
 - (v) FINRA alleged that three versions of CGMI’s publicly distributed marketing materials failed to adequately disclose the risks of the DBP.
 - (vi) CGMI consented to a censure, to pay a \$650,000 fine, and to comply with an undertaking that, before it reinstates the DBP, the firm must establish a supervisory system to monitor the activities of each registered person relating to the DBP.
- d. *J.J.B. Hilliard, W.L. Lyons, LLC* (“J.J.B. Hilliard”) (Apr. 12, 2010)
- (i) FINRA settled a matter with J.J.B.Hilliard in which it alleged that the firm failed to have adequate procedures for identifying customer checks deposited from an affiliated introducing broker from April 21, 1999 through December 31, 2005.
 - (ii) J.J.B. Hilliard utilized a manual process that occasionally failed to capture certain customer-identifying information from check deposits received.
 - (iii) As a result of its failure to have adequate procedures in place, J.J.B. Hilliard was unable to identify the proper customer accounts to post deposits received from the introducing broker. After 60 days, J.J.B. Hilliard transferred the funds to an account designated for abandoned property and eventual escheatment to the Commonwealth of Kentucky.
 - (iv) FINRA alleged that more than 8,900 deposits, totaling \$133,000 of customer funds, were never properly identified or credited to the appropriate customer accounts and therefore escheated to the Commonwealth of Kentucky.
 - (v) As a result of its failure, J.J.B. Hilliard was unable to maintain proper books and records, prepare accurate customer account statements,

maintain possession and control of customer excess margin securities, and properly service customer cash and margin accounts.

- (vi) FINRA alleged that the firm failed to properly account for the unidentified funds through required reconciliations that should also have been included in the firm's computation of net capital and customer reserves.
 - (vii) FINRA alleged that the firm also failed to implement adequate procedures in 2004 and 2005 related to employee public appearances, disclosures to the media and the issuance of research reports.
 - (viii) FINRA further alleged that the firm failed to comply with rules governing analyst certifications and required disclosures in certain research reports issued between January and June 2005.
- e. J.J.B. Hilliard consented to a censure and to pay a \$200,000 fine. The firm was also required to set aside \$133,817 in an interest-bearing account for five years to reimburse clients who can prove that their funds were not properly deposited.

IV. DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT¹⁷

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

A. Landmark Legislation Gives SEC New Enforcement Capability

On July 15, the U.S. Senate passed the Dodd-Frank Wall Street Reform and Consumer Protection Act. President Obama signed the bill into law on July 21, 2010. This landmark legislation contains an array of important new measures that significantly expand the enforcement authority of the SEC and strengthen its oversight and regulatory authority over the securities markets.¹⁸ These new measures will dramatically improve the SEC's "real-time enforcement" abilities, as it attempts to deliver on its promise to move more swiftly in enforcement actions to restore investors' faith in the markets.¹⁹

¹⁷ This section of the Outline was drawn from "Landmark Legislation Gives SEC New Enforcement Capability," by Patrick D. Conner and E. Andrew Southerling, published July 19, 2010 and available at <http://www.morganlewis.com/index.cfm/publicationID/46016ef8-bbc4-41dc-a8fa-18dc8c6df911/fuseaction/publication.detail>. This article was also included in the 2010 Mid-Year Review: SEC and SRO Selected Enforcement Cases and Developments Regarding Broker-Dealers described above.

¹⁸ The key provisions within the legislation related to SEC regulation and enforcement are contained principally within Title IX, "Investor Protections and Improvements to the Regulation of Securities"; subtitle A, "Increasing Investor Protection"; subtitle B, "Increasing Regulatory Enforcement and Remedies"; and subtitle H, "Municipal Securities."

¹⁹ Morgan Lewis has published several articles about the SEC's reform efforts, including: "SEC Announces New Cooperative Initiatives," available at http://www.morganlewis.com/pubs/WP_SECAnnouncesNewCooperationInitiative_Jan2010.pdf; and "SEC Speaks 2010: Fast-Paced Reform Continues in 2010," available at http://www.morganlewis.com/pubs/SecuritiesLF_SECSpeaks2010_11feb10.pdf.

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

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

B. Changes to SEC Enforcement and Market Oversight

1. Extension of Liability and Jurisdictional Regulations

Aiding and Abetting Liability²⁰

Prior to the Dodd-Frank Act's passage, the Exchange Act and the Investment Advisers Act of 1940 ("Advisers Act") permitted the SEC to bring actions for aiding and abetting violations of those statutes in federal civil proceedings. The Dodd-Frank Act extends the SEC's enforcement authority to prosecute those who aid and abet primary violators of the federal securities laws under the Securities Act and the Investment Company Act of 1940 ("Investment Company Act"), and codifies the SEC's authority to impose penalties against aiders and abettors under the Advisers Act. The Dodd-Frank Act therefore brings the SEC's federal civil enforcement authority in line with its existing administrative authority to institute proceedings and seek sanctions against regulated entities and individuals for aiding and abetting violations.²¹

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

Control Person Liability under the Exchange Act²²

The Dodd-Frank Act amends the Exchange Act to permit the SEC to impose joint and several liability on control persons. Under the preexisting statute, control persons were liable, to the same extent as persons they controlled, to any person to whom the controlled person was liable.²³ Although the SEC routinely brings enforcement actions

²⁰ Dodd-Frank Act §§ 929M, 929N, and 929O.

²¹ See, e.g., Exchange Act § 15(b)(4)(E); Investment Advisers Act § 203(e)(6).

²² Dodd-Frank Act § 929P(c).

²³ Exchange Act § 20(a).

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

Extension of Statute of Limitations for Securities Laws Violations²⁴

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

Expansion of the Application of Antifraud Provisions²⁵

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

Extraterritorial Jurisdiction²⁶

The Dodd-Frank Act expands the jurisdiction of federal courts in actions brought by the SEC or the DOJ that allege violations of the antifraud provisions of the Securities Act, the Exchange Act, and the Advisers Act. Congressional leaders have stated that the purpose of this provision is to make clear that in actions or proceedings brought by the SEC or DOJ, the specified provisions of the Securities Act, the Exchange Act, and the Advisers Act may have extraterritorial application, and that, for potential Securities Act or Exchange Act violations, extraterritorial application is appropriate regardless of whether the securities are traded on a domestic exchange or the transactions occur in the United States, when the conduct within the United States constitutes "significant steps

²⁴ Dodd-Frank Act § 1079A (Financial Fraud Provision). This provision adds a new Section 3301 to Chapter 213 of Title 18 of the U.S. Code.

²⁵ Dodd-Frank Act § 929L.

²⁶ Dodd-Frank Act § 929P(b).

in furtherance of the violation” or when conduct occurring outside the United States has a “foreseeable substantial effect” within the United States.²⁷

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

Jurisdiction over Formerly Associated Persons²⁸

The Dodd-Frank Act authorizes the SEC to institute proceedings against persons formerly associated with a registered entity (such as the Municipal Securities Rulemaking Board (“MSRB”), broker-dealers, government securities brokers or dealers, investment companies, national securities exchanges, registered securities associations, registered clearing agencies, self-regulatory organizations, and public accounting firms). This authorization is consistent with FINRA rules that permit the agency to bring suits against persons formerly associated with a member within two years after the effective date of the person’s termination or cancellation of registration, or, in the case of a nonregistered person, two years after the date that the person ceased to be associated with the member.²⁹

2. Enhanced Remedies

Collateral Bars for Securities Laws Violators³⁰

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

²⁷ Congressional Record, June 30, 2010, at H 5237.

²⁸ Dodd-Frank Act § 929F.

²⁹ FINRA By-laws Article V, Section 4(a).

³⁰ Dodd-Frank Act § 925.

*Civil Penalties in Cease-and-Desist Proceedings*³¹

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

3. Securities Whistleblower Incentives and Protections³²

The Dodd-Frank Act includes new whistleblower provisions designed to motivate those with inside knowledge to come forward voluntarily and assist the SEC in identifying and prosecuting persons who have violated federal securities laws. Previously, the SEC had the authority to compensate individuals for providing information leading to the recovery of civil penalties in insider trading cases, but the total amount of bounties that could be paid from a civil penalty could not exceed 10% of the collected penalties.³³

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

Moreover, under the Dodd-Frank Act, SEC whistleblowers subject to retaliatory discrimination may directly file suit in federal district court instead of having to first file a complaint with the Department of Labor. Such actions must be filed no more than six years after the date of the alleged violation, or three years after the date when facts material to the right of action are known or reasonably should have been known by the employee alleging the violation. No action, however, may be brought more than 10 years after the date on which the violation occurred.

In addition, the Dodd-Frank Act expands the whistleblower protections already in place under the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley")³⁴ to expressly prohibit retaliation against whistleblowing employees of subsidiaries and affiliates of publicly traded companies, extends the current statute of limitations for Sarbanes-Oxley whistleblower claims from 90 days to 180 days, and permits a jury trial. The Dodd-

³¹ Dodd-Frank Act § 929P(a).

³² Dodd-Frank Act §§ 922–924, and 929A.

³³ Exchange Act § 21A(e).

³⁴ Sarbanes-Oxley Section 806 creates protections for whistleblowers who report securities fraud and other violations from retaliation by their public company employers.

Frank Act also extends whistleblower protections to employees of nationally recognized statistical rating organizations (credit-rating agencies).

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

4. Regulation of Municipal Securities³⁵

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

The Dodd-Frank Act imposes a fiduciary duty on municipal advisers and associated persons when advising municipal issuers, and instructs the MSRB to adopt rules reasonably designed to prevent conduct inconsistent with this fiduciary duty. The Dodd-Frank Act imposes liability on municipal advisers for breaches of this fiduciary duty and for fraudulent, deceptive, or manipulative acts or practices.³⁶

In addition, the Dodd-Frank Act expands MSRB rulemaking authority over broker-dealers, municipal securities dealers, and municipal advisers and permits the MSRB to regulate *advice* provided by these entities and individuals to issuers (until now the MSRB had the authority to regulate municipal securities transactions), and requires the MSRB to set professional standards for municipal advisers.³⁷

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

The Dodd-Frank Act also instructs the Government Accountability Office to conduct several studies of the municipal securities markets, including a study of the disclosure

³⁵ Dodd-Frank Act §§ 975, 976, and 979.

³⁶ The statutory imposition of a fiduciary duty on municipal advisers in this context is consistent with the Supreme Court's ruling in *SEC v. Capital Gains Research Bureau, Inc.*, in which the Court held that investment advisers are deemed to be fiduciaries who owe their clients an affirmative duty of utmost good faith, owe their clients full and fair disclosure of all material facts, and are required to employ all reasonable care to avoid misleading their clients. 375 U.S. 180, 194–99 (1963).

³⁷ These provisions become effective October 1, 2010.

required to be made by issuers of municipal securities.³⁸ The SEC has demonstrated an acute interest in investor disclosure related to municipal securities. In May 2010, the SEC unanimously approved rule changes designed to improve the quality and timeliness of securities disclosures of municipal issuers.³⁹ Among other things, the new rules require a broker, dealer, or municipal underwriter to reasonably determine that an issuer has agreed to provide notice of certain important events – *without regard to materiality* – within 10 days after the event’s occurrence. These events include the failure to pay principal and interest, financial difficulties experienced by the issuer such as unscheduled payments by parties backing the issuance, and rating changes.

5. Additional Procedural Enhancements for Enforcement Actions

Nationwide Service of Subpoenas⁴⁰

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

“Speedy Trial Act” for Commencement of SEC Enforcement Actions⁴¹

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

Protecting Confidentiality of Materials Submitted to the SEC⁴²

The Dodd-Frank Act provides limitations on disclosure of certain information that registered persons and entities provide to the SEC pursuant to its examination authority, if such information has been obtained by the SEC for purposes of surveillance, risk assessments, or other regulatory and oversight activities. The Dodd-Frank Act also

³⁸ Under the Exchange Act, the SEC and MSRB currently are precluded from requiring disclosure in municipal offerings. *See* Exchange Act §15B(d) (known as the “Tower Amendment”).

³⁹ These rule changes amend Exchange Act Rule 15c2-12, which generally prohibits underwriters from purchasing or selling municipal securities unless they reasonably have determined that the municipality or other designated entity has agreed to make certain information available to investors on an ongoing basis, such as annual financial statements, payment defaults, rating changes, and prepayments. The rule changes become effective December 1, 2010 and can be found at <http://www.sec.gov/rules/final/2010/34-62184a.pdf>. The SEC’s press release announcing these measures can be found at <http://www.sec.gov/news/press/2010/2010-85.htm>.

⁴⁰ Dodd-Frank Act § 929E.

⁴¹ Dodd-Frank Act § 929U.

⁴² Dodd-Frank Act § 929I.

provides that the SEC shall not be compelled to disclose such information, except in circumstances limited to congressional or other federal agency requests, or a federal court order issued in connection with an action instituted by the DOJ or SEC.

Sharing Privileged and Other Information with Other Authorities⁴³

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

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

⁴³ Dodd-Frank Act § 929K.