

III(e) GI — Dealing with Regulatory Enforcement

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.

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.

¹ 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. As noted below, Section II.D. is taken from “Litigating with the SEC and SROs” by Anne C. Flannery and John Shin presented at the SIFMA Compliance & Legal Division 2007 Annual Seminar. The descriptions of enforcement developments and case summaries in Section III are from “U.S. SEC, FINRA and NYSE Regulation: Mid-Year Review – Selected Broker-Dealer Enforcement Cases and Developments” by Ben A. Indek, Anne C. Flannery, Michael S. Kraut, Bonnie L. Altro, Julia N. Miller and John Shin. This outline is current as of June 30, 2009. Copyright, Morgan Lewis & Bockius LLP.

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>).

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, 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 and NYSE Regulation now routinely post sweep inquiry letters on their websites. 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 – Throughout the investigation process, companies should be mindful of the cooperation they provide regulators. Both the SEC and FINRA evaluate a company’s cooperation in determining whether and how to charge violations:
- In October 2001, the SEC issued a Section 21(a) report (commonly referred to as the “Seaboard Report”) that established certain criteria that the Commission indicated it would consider in determining “whether and how much to credit self-policing, self-reporting, remediation and cooperation.⁶ Those criteria include: What is the nature of the misconduct involved?; How long did the misconduct last; How long after the discovery of the misconduct did it take to implement an effective strategy?; Did the company commit to learn the truth, fully and expeditiously?; Did the company make available to the SEC the results of its own internal investigation?; Did the company provide information to the staff that was not explicitly requested?; and What assurances are there that the conduct is unlikely to recur?
 - FINRA’s Sanction Guidelines also 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.⁷ 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.⁸ The Notice identifies four “extraordinary cooperation” factors:
 - (1) *Proactive and early self-reporting of violations*: the disclosure must be

⁶ See Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission statement on the Relationship of Cooperation to Agency Enforcement Decisions, SEC Release No. 34-44969 (October 23, 2001), available at: <http://www.sec.gov/litigation/investreport/34-44969.htm>

⁷ FINRA Regulatory Notice 08-70 (Nov. 2008), <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p117452.pdf>.

⁸ The guidance set forth in the Notice also applies to cases brought against individuals.

“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 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.

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 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.⁹

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.

E. Deciding Whether to Settle or Litigate¹⁰

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.

⁹ See The Securities Enforcement Manual, 2d Ed., 165 (ABA 2007).

¹⁰ “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.¹¹

¹¹ 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 CASES¹²

A. Recent Trends: Mid-year 2009

SEC

The SEC's current top priorities for broker-dealer enforcement include: (1) insider trading on Wall Street; (2) Madoff and other Ponzi schemes; (3) subprime mortgages; (4) auction rate securities; (5) internet enforcement; (6) microcap fraud; (7) municipal securities fraud; and (8) registered representative sales practices.

FINRA

FINRA's current top enforcement priorities include: (1) anti-money laundering policies, procedures and systems; (2) sales to senior investors; (3) auction rate securities; (4) variable annuities; (5) supervision of brokers; (6) mutual fund sales practices; (7) sales of municipal securities to retail investors; (8) hedge fund advertising and sales literature; and (9) sales of collateralized mortgage obligations.

During the past six months, FINRA has stepped up its use of sweeps, canvassing member firms on topics such as retail municipal securities transactions, municipal underwritings and municipal derivative instruments, exchange traded funds, sale and promotion of non-traded REITs, hedge fund advertising and sales literature, and continued to look into collateralized mortgage obligations. As FINRA's Chief of Enforcement Susan Merrill announced at a recent conference, "sweeps are back in vogue."¹³

B. Recent SEC Cases

Insider Trading

As in the past several years, the SEC brought a number of insider trading cases in the first half of calendar year 2009, several of which involved allegations against Wall Street professionals employed by well-known investment banks, including the following six cases. Of note, the SEC brought a

¹² "U.S. SEC, FINRA and NYSE Regulation: Mid-Year Review – Selected Broker-Dealer Enforcement Cases and Developments" by Ben A. Indek, Anne C. Flannery, Michael S. Kraut, Bonnie L. Altro, Julia N. Miller, and John Shin.

¹³ See FINRA Ramps Up Sweep Program, Compliance Reporter, July 6, 2009.

substantial case involving a firm's failure to establish and maintain protocols to prevent insider trading and its first ever insider trading case relating to credit default swaps.

1. *SEC v. Nicos Achilleas Stephanou, Ramesh Chakrapani, Achilleas Stephanou, George Paparrizos, Konstantinos Paparrizos, Michael G. Koulouroudis, and Joseph Contorinis* (S.D.N.Y. Feb. 5, 2009)

The SEC filed a complaint against two mergers and acquisitions ("M&A") professionals, Nicos Stephanou (an associate director of UBS Investment Bank) and Ramesh Chakrapani (a managing director of Blackstone Advisory Services, L.P.), along with five individuals whom they allegedly tipped in an insider trading ring.

The SEC alleges that between November 2005 and December 2006, the two M&A professionals tipped friends and family members (including Joseph Contorinis, a Jefferies Group, Inc. hedge fund portfolio manager and managing director) concerning three separate M&A deals. Stephanou's and Chakrapani's employers served as financial advisors to the acquiring or target companies in the three deals. Prior to public announcement of the transactions, Stephanou and Chakrapani allegedly passed confidential information to their friends and family members by telephone, after which the tippees engaged in substantial trading.

The complaint further alleges that Stephanou either tipped his father or traded in his father's account to avoid detection.

The SEC alleges that the tipped investors made profits and avoided losses totaling more than \$8 million. Most of the illegal profits were reaped by the Jefferies hedge fund managed by Contorinis, which allegedly netted \$7.2 million in profits.

The SEC seeks injunctive relief, disgorgement of illicit profits, and civil fines.

2. *In the Matter of Merrill Lynch, Pierce, Fenner, & Smith Incorporated* ("Merrill Lynch") (Admin. Proc. File No. 3-13407, Mar. 11, 2009)

The SEC settled an administrative proceeding against Merrill Lynch, alleging that the firm failed to establish and enforce policies and procedures reasonably designed to prevent the misuse of material, non-public information.

The SEC alleged that between 2002 and 2004, Merrill Lynch retail brokers positioned their telephone receivers in a way that provided A.B. Watley Group's day traders with real-time access to confidential Merrill Lynch institutional customer order information transmitted over the squawk boxes. The SEC alleged that the day traders used this information to trade ahead of Merrill Lynch's customers and profited as a result of the market movement resulting from the subsequent trades by Merrill Lynch's institutional customers. In exchange for providing this access, the Merrill Lynch brokers allegedly received commissions and cash.

The SEC further alleged that Merrill Lynch did not have adequate written policies or procedures reasonably designed to prevent misuse of customer order information because the firm did not limit access to the squawk box to its brokers who had a bona fide need for the information and because the firm did not track brokers' access to, or monitor their use of, the squawk box.

Merrill Lynch consented to a censure, a cease-and-desist order, and to pay a \$7 million civil penalty. The firm also agreed to a number of undertakings, including an obligation to design and implement a program to enforce policies and procedures regarding the confidentiality of information sent through the squawk box and a requirement that the firm audit the squawk box system every two years for the next six years and report results and recommendations to the Enforcement staff.

Several A.B. Watley Group employees and one Merrill Lynch broker previously faced civil enforcement actions for their alleged misuse of material, non-public information in connection with their roles this activity.¹⁴

The “squawk box” abuses have also been the subject of criminal cases. After a mistrial was declared in a May 2007 criminal trial, federal prosecutors retried three brokers (one each from Merrill Lynch, Smith Barney and Lehman Brothers) and three A.B. Watley Group executives in April 2009. The jury convicted all six men on charges of conspiracy. Each defendant faces up to 25 years in prison at sentencing. According to media reports, at least some of the defendants intend to appeal.

3. *SEC v. Jon-Paul Rorech and Renato Negrin*, 09-Civ-4329 (S.D.N.Y. May 5, 2009)

The SEC filed an action in federal district court against Renato Negrin (a Millennium Partners, L.P. portfolio manager) and Jon-Paul Rorech (a Deutsche Bank Securities, Inc. (“Deutsche Bank”) salesman), charging insider trading in the credit default swaps (“CDS”) of VNU N.V. (“VNU”), the holding company of Nielson Media.

Deutsche Bank was serving as lead underwriter for a VNU bond offering. The SEC alleges that Rorech learned about a change in a proposed VNU bond offering that likely would increase the price of CDS on VNU bonds and tipped Negrin about the bond news. After being tipped, Negrin placed orders with Deutsche Bank for €20 million of VNU CDS over two days. Negrin’s trades profited \$1.2 million after the news broke.

The SEC seeks permanent injunctions, civil penalties, and disgorgement.

This is the first CDS insider trading case brought by the SEC.

Supervision

Every year the SEC brings failure to supervise cases against broker-dealers. Four such actions from calendar year 2009 are described below. In three of them, the SEC not only sued the firm but also a supervisor at the company.

1. *In the Matter of Ferris, Baker Watts, Inc.* (“Ferris”), SEC Admin. Proc. File No. 3-13364 (Feb. 10, 2009); *In the Matter of Patrick J. Vaughan*, SEC Admin. Proc. File No. 3-13367 (Feb. 10, 2009)

The SEC settled a matter against Ferris for failing to design reasonable systems to implement its written supervisory policies and procedures to prevent and detect violations of the securities laws and failing to file Suspicious Activity Reports (“SARs”).

¹⁴ See *SEC v. Amore, et al.* (E.D.N.Y. Aug. 15, 2005); *SEC v. A.B. Watley Group, Inc., et al.* (E.D.N.Y. Mar. 21, 2006).

Between August 2002 and November 2005, Stephen Glantz, a registered representative employed by Ferris, participated in a scheme to manipulate the market for the stock of Innotrac Corp. (“Innotrac”), a NASDAQ security in which Ferris made a market.

With respect to Innotrac, Glantz and non-Ferris employees allegedly engaged in a variety of devices (e.g., marking the closing price of the stock, engaging in matched and wash trades, and attempting to artificially create down bids to suppress short selling of Innotrac) designed to manipulate the price of the stock. Glantz also made unauthorized and unsuitable trades in Innotrac and certain other securities. In September 2007, Glantz pled guilty to securities fraud and subsequently was sentenced to, among other sanctions, 33 months in prison. In February 2009, Glantz was barred from association with any broker, dealer, or investment adviser.

Despite warnings about Glantz’s history of customer complaints and “questionable reputation” before joining Ferris, the firm’s senior executives permitted Glantz to work under a special arrangement, allowing him greater freedom and less supervision than other Ferris registered representatives. For example, Glantz was assigned to one branch office but was permitted to work at a different branch several days each week, which enabled him to evade Ferris’ supervision.

Red flags regarding Glantz’s conduct were raised orally by the Compliance Department on numerous occasions and in writing on two occasions during the relevant time period. Despite these warnings, the firm’s senior executives opted not to take action.

The SEC also alleged that information available to Ferris concerning the alleged market manipulation of Innotrac should have prompted Ferris to file SARs. By failing to do so, the firm allegedly violated the Bank Secrecy Act.

Ferris consented to a censure and agreed to pay a civil penalty of \$500,000 and to disgorge approximately \$222,000.

The SEC also settled an action against Patrick Vaughan, Ferris’s Director of Retail Sales, for failing to reasonably supervise Glantz to detect and prevent violations of the securities laws and reasonably respond to red flags regarding Glantz’s misconduct and special working arrangement. Vaughn consented to a six-month suspension from any supervisory or investment advisory capacity, a civil penalty of \$50,000, and disgorgement of over \$12,000.

2. *In the Matter of Oppenheimer & Co., Inc.*, (“Oppenheimer”) Admin Proc. File. No. 3-13378 (Feb. 24, 2009)

The SEC settled an administrative proceeding against Oppenheimer in which the SEC alleged that Oppenheimer failed to reasonably supervise a former salesperson in order to prevent and detect the salesperson’s violations of the federal securities laws.

The SEC alleged that between May 2003 and August 2004, a former Oppenheimer salesperson, Frank Lu, and Victor Machado, a former trader at Leumi Investment Services Inc. and Bank of Leumi USA (collectively, “Leumi”), participated in a fraudulent scheme that increased order flow from Leumi to Oppenheimer. Lu gave Machado gratuities and entertainment, and Machado sent orders to Oppenheimer at prices that benefited Oppenheimer and harmed Leumi’s customers.

Lu and Machado traded and generally communicated by Bloomberg messaging. The SEC alleged that a number of the Bloomberg messages raised “red flags” and demonstrated that Machado was directing

order flow to Oppenheimer in return for gifts and entertainment. As the result of an inadequacy in Oppenheimer's Bloomberg message collection procedures, none of Lu's Bloomberg emails were gathered or reviewed during the relevant time period. The SEC asserted that Lu's misconduct could have been prevented or detected earlier if Lu's Bloomberg emails had been reviewed.

Oppenheimer agreed to a censure and \$850,000 civil penalty. The firm also consented to an undertaking to review its policies, procedures and systems regarding the collection and review of electronic communications.

The SEC also settled an administrative proceeding against Leumi Investment Services Inc. ("LISI"), in which it alleged that LISI failed to reasonably supervise Machado by not having adequate procedures to prevent and detect improper changes to trade tickets. LISI consented to an undertaking to review its policies, procedures, and systems concerning trade tickets, monitoring the trade blotter and the review of electronic communications. LISI was censured, but no money penalty was imposed. In the settlement release, the SEC acknowledged Leumi's remediation (e.g., reimbursing customers) and cooperation with the SEC staff during the investigation.

3. *In the Matter of Grant Bettingen, Inc.* ("GBI"), SEC Admin. Proc. File No. 3-1403 (Mar. 6, 2009); *In the Matter of M. Grant Bettingen* ("Bettingen"), SEC Admin. Proc. File No. 3-13402 (Mar. 6, 2009)

The SEC settled a matter against registered broker-dealer GBI for failing to supervise reasonably a registered representative because the firm did not have a supervisory policy in place regarding the sale of distressed debt securities in private placement offerings until almost one year after the registered representative began selling private placement securities.

The SEC alleged that from January 2004 to December 2005, Christopher J. Johndrow ("Johndrow"), a GBI registered representative, made misrepresentations to investors about profits that they would earn (1% monthly) from private placement offerings despite the fact that a review of the issuer's financial statements would have revealed that the issuer was not making a profit. Johndrow also allegedly instructed sales agents that he supervised to make similar misrepresentations to investors.

GBI consented to a censure and to disgorge \$88,675.00.

The SEC settled a related action against M. Grant Bettingen, the president, compliance manager, and indirect owner of GBI for failing to supervise Johndrow. In addition to his failure to implement written policies concerning private placement offerings, Bettingen did not follow existing firm procedures, including the failure to inspect Johndrow's office, which could have led to the discovery of Johndrow's violations. Further, the SEC alleged that Bettingen failed to put Johndrow on heightened supervision (required by firm policy), even though Bettingen was aware that Johndrow had been discharged by a former broker-dealer for failing to adequately supervise his branch and for "selling away" violations.

Bettingen consented to a civil penalty of \$35,000 and a bar from associating in a supervisory capacity with any broker or dealer for three years.

4. *In re Royal Alliance Associates, Inc.*, Admin. Proc. File No. 3-13456 (Apr. 28, 2009) and *In re Brad E. Parish*, Admin. Proc. File No. 3-13457 (Apr. 28, 2009)

The SEC settled charges against Royal Alliance Associates, Inc. (“Royal”) and one of its supervisors, Brad Parish, alleging that Royal and Parish failed to supervise David L. McMillan, a Royal broker who ran a Ponzi scheme that defrauded 28 investors.

McMillan ran a one-person satellite office for Royal. Between 1994 and 2004, McMillan misrepresented to customers that he was investing at least \$3 million of their funds in securities and fictitious loans to a real estate developer, when he was in fact using them for personal use or repaying other customers.

Prior to 2000, Royal did not have written supervisory policies that required supervisors to review bank records. A review of McMillan’s account in 1999 would have uncovered that he was depositing clients’ money into his operating account. Royal’s procedures for examinations of its satellite offices also were allegedly deficient in that they did not require supervisors to confirm that all sections of the examination workbook were completed. Royal also allegedly did not catch red flags, including that McMillan kept his branch in business running despite a sizeable drop in his commissions (from \$149,000 in 2000 to \$13,000 in 2004).

Additionally, Royal allegedly did not adequately implement its own procedures, which made the supervisor responsible for responding to surveillance inquiries concerning his or her direct reports. Instead, the subject of the inquiry typically was responsible for responding to the inquiry.

The SEC also alleged that Royal did not adequately implement its procedure that required transaction reports to contain all customer transactions; McMillan manually entered his own trades on the transaction report and omitted trades related to his fraudulent activity, which enabled his conduct to evade detection.

The SEC alleged that Parish, who was McMillan’s supervisor despite working approximately 200 miles away from McMillan, failed to supervise him adequately. For example, Parish falsely claimed that he had reviewed McMillan’s business banking account in 2001, despite the fact that the account that he claimed to have reviewed wasn’t opened until after the examination occurred.

Royal consented to a censure, to disgorge \$1 and pay a \$500,000 civil penalty, and to certify to the Commission staff when it implements improvements recommended by an independent consultant. Parish consented to pay disgorgement of \$1, a \$30,000 civil penalty, and a one-year bar from association with any broker-dealer in a supervisory capacity.

In the settlement release, the SEC noted Royal’s enhancements to its supervisory system and its cooperation with the Commission staff.

C. Recent FINRA Cases

Variable Annuity Sales

Sales practices surrounding variable annuities continue to be an enforcement priority for FINRA. Below are two cases involving the sale of variable annuities, although the litigated case against Mutual Service Corp. could as easily be described as a supervision case.

1. *Fifth Third Securities, Inc.* (“FTS”) (Apr. 14, 2009)

FINRA settled a matter with FTS, a subsidiary of Fifth Third Bank, in which it alleged that FTS representatives recommended unsuitable exchanges and sales of variable annuities.

FINRA alleged that between January 2004 and December 2006, 42 FTS brokers made unsuitable recommendations to 197 customers, each of which was approved by the firm. FINRA alleged that, considering the customers’ ages, incomes, financial situations and investment objectives, the recommendations were unsuitable.

A single FTS broker was responsible for 118 of the unsuitable exchanges. The representative had recently joined FTS and did not want his customers’ assets to remain with his prior firm, so he exchanged 74 customers’ variable annuities for a single annuity product sold through FTS, despite the fact that the customers’ ages (ranging from 26 to 85), sophistication and investment objectives varied greatly. These customers incurred at least \$260,000 in surrender charges to exit their old annuities and enter new annuities with longer periods and higher expenses. In such instances, customers used cash to purchase a variable annuity that was less liquid and had higher costs than their prior investments.

FINRA also alleged that FTS failed to maintain an adequate system of supervision. In 2004 and 2005, FTS conducted audits of its Principal Review Desk (“PRD”) and identified issues with the way PRD reviewed and approved variable annuity transactions. However, many of these issues were not addressed fully until March 2007.

Finally, FINRA alleged that FTS failed to maintain accurate books and records regarding variable annuity transactions. Among other things, FTS failed to retain certain correspondence to customers, and the information retained by FTS regarding the exchange transactions was incomplete.

FTS consented to a censure, a fine of \$1,750,000, and to pay restitution to the 74 customers who incurred surrender charges when exchanging variable annuities. In addition, FTS agreed to allow all 197 customers to rescind their transactions. Finally, FTS agreed to retain an independent consultant to review its supervisory system.

In a press release announcing the settlement, FINRA Enforcement Chief, Susan Merrill, warned firms to diligently supervise sales of variable annuities by their sales force, particularly brokers that recently joined from other firms.

2. *Department of Enforcement v. Mutual Service Corp.* (“MSC”), et al. (Dec. 16, 2008)

FINRA brought a contested action against MSC and several of its employees for failing to monitor MSC’s variable annuity business and/or falsifying records related thereto.

By way of background, in December 2001, MSC had entered into an Acceptance, Waiver and Consent (“AWC”) in which it accepted findings related to deficiencies in MSC’s supervision of variable annuity transactions. In connection with this AWC, MSC created a new unit in its Compliance Department to provide heightened review of such transactions and a “Red Flag Blotter” designed to capture for further review transactions that triggered one or more red flags.

In the instant litigation, a hearing panel found that between March 15 and May 31, 2004, there was a “complete meltdown” of the firm’s supervisory system, during which Dennis Kaminski, the firm’s Chief Administrative Officer and Michael Poston, the firm’s Chief Compliance Officer, directed

compliance personnel to stop the Red Flag Blotter reviews due to resource constraints. Ultimately, the process was reinstated, but the backlog of Red Flag Blotters was not reviewed until August 2004. To give the appearance that trades on the Red Flag Blotter were being reviewed, certain employees backdated the exception reports to 1-2 days after the trade occurred.

The panel found that during that same period, senior MSC officials met with FINRA staff and misled it about the firm's review of variable annuity trades, specifically failing to mention that it had ceased reviewing the Red Flag Blotter and mentioning a report that, in fact, was not yet being utilized. To give the appearance that the new report was being used, certain employees created 49 fake letters and put them in files and then "de-backdated" these records and documents prior to submitting them to FINRA in an attempt to conceal this misconduct.

When FINRA found out about the backlog of trades, it sent NASD Rule 8210 requests to the firm for documents, to which the MSC did not respond completely and truthfully.

MSC was fined \$1.535 million as follows: \$500,000 for failing to reasonably supervise its variable annuity business and the maintenance of accurate books and records; \$1 million for maintaining inaccurate books and records; \$10,000 for failing to conduct timely internal inspections; and \$25,000 for failing to respond fully to FINRA's requests for information.

Kaminski and Susan Coates (Director of Operations) were suspended in all principal capacities for six months, and each was fined \$50,000. Poston was suspended in all principal capacities for seven months and fined \$20,000. Denise Roth (an operations manager) and two compliance examiners, Gari Sanfilippo, and Kevin Cohen, were barred in all capacities from associating with any firm for falsifying the firm's books and records.

Cohen and Sanfilippo have appealed the rulings to the NAC, and the NAC called review of the sanctions imposed against Kaminski.

Operational Issues

Over the last several years, SROs have brought disciplinary actions against firms that highlight the need to pay close attention to operational matters. Two significant cases thus far in 2009 again raise this issue.

1. *Wachovia Securities, LLC* ("Wachovia") and *First Clearing, LLC* ("First Clearing") (Mar. 24, 2009)

FINRA settled a matter with Wachovia and its affiliate First Clearing in which it alleged that they failed to send numerous required notifications to customers.

FINRA alleged that between June 2003 and October 2008, Wachovia and First Clearing did not send to customers a wide variety of mandatory notifications as a result of a number of computer programming and system errors. In total, approximately 800,000 required notifications were not sent.

FINRA alleged that during the relevant time period, due to computer programming and system update errors, Wachovia failed to send in certain instances confirmation of changes in investment objectives and confirmation of address changes.

FINRA alleged that due primarily to programming errors, First Clearing failed to send in certain instances: (i) clearing agreement notifications; (ii) confirmation of address changes; (iii) confirmation of changes in investment objectives; (iv) notification of partial calls; and (v) margin disclosure statements. First Clearing also allegedly provided incorrect bond ratings on trade confirmations for transactions in certain bonds and incorrect fee statements in certain mailings.

FINRA also alleged that both Wachovia and First Clearing failed to send to customers asset transfer notifications and customer profile information forms due to operations and computer coding issues.

FINRA also alleged that the above issues went undetected because Wachovia and First Clearing failed to adequately supervise the process of mailing required notifications, and failed to have written supervisory procedures regarding such mailings.

Wachovia and First Clearing consented to a censure, a fine of \$1.1 million, and retention of an independent compliance consultant.

2. *Edward D. Jones & Co., L.P.* (“Edward Jones”) (Apr. 9, 2009)

FINRA settled a matter with Edward Jones in which it alleged that the firm failed to provide timely official statements to certain customers who purchased “new issue” municipal securities.

FINRA alleged that between 2002 and September 2008, Edward Jones “systemically” failed to provide official statements on or before the settlement date to customers who purchased such securities, as required by MSRB Rule G-32, despite learning “repeatedly” that it was not complying with the rule.

FINRA alleged specifically that: (i) between August 2002 and May 2003, Edward Jones failed to timely provide official statements in over 1,200 transactions; (ii) between February 2004 and May 2006, Edward Jones did not mail timely official statements for a significant number of its approximately 100,000 new issue municipal security transactions; and (iii) in September 2008, Edward Jones did not mail timely official statements for more than 6,200 transactions.

FINRA found that these failures occurred due to, among other reasons, inadequate procedures and employee training, resource constraints, and employee error, including failures by supervisors to provide proper guidance to mail room personnel regarding the regulatory requirements.

FINRA also alleged that Edward Jones failed to maintain adequate written supervisory procedures and accurate books and records. Edward Jones’ procedures did not address MSRB Rule G-32 requirements until May 2006, and the firm failed to maintain detailed information about deliveries of official statements for new issues required by MSRB Rule G-8.

Edward Jones consented to a censure, a \$900,000 fine and an undertaking to adopt systems and procedures to achieve compliance with MSRB rules relating to new issue transactions and official statement deliveries.

Supervision

FINRA actions continue to emphasize the importance of supervision in cases relating to early retirees. The action below is yet another example of this kind of case.

1. *Morgan Stanley & Co. Inc.* (“Morgan Stanley”) (Mar. 25, 2009)

FINRA settled a matter with Morgan Stanley in which it alleged that the firm’s supervisory system failed to detect and prevent two of its brokers from persuading customers to elect early retirement based on: (1) unrealistic promises of consistently high investment returns, and (2) unsuitable strategies.

FINRA alleged that the Morgan Stanley representatives, Michael J. Kazacos and David M. Isabella, persuaded customers in their 50s to take early retirement and turn over their retirement accounts to Morgan Stanley, promising that their investments would achieve ten percent annual returns and that they could withdraw those profits without invading their principal. Based on Kazacos’ and Isabella’s representations, many individuals transferred their retirement accounts to Morgan Stanley, and some retired early.

The brokers invested their customers’ money in unsuitable and over-concentrated investments, including variable annuities, and advised many customers to liquidate their mutual fund holdings and purchase new securities through Morgan Stanley with annual fees of 1.75% to 2.5%. Nearly 200 customers were harmed, and many were forced to return to work due to their inability to make the expected withdrawals.

FINRA found that during the relevant time period, Morgan Stanley was aware that these representatives were actively marketing rollover IRA accounts and failed to take reasonable steps to verify that their customers received proper risk disclosures. Morgan Stanley also allowed Isabella to use marketing materials that misstated annual returns, annual fees, and Isabella’s professional designation.

FINRA also alleged that Isabella, a former Xerox employee, provided gifts to certain current Xerox employees and obtained improperly confidential information concerning Xerox employees, including their retirement status. In addition, FINRA charged Isabella with falsifying records regarding his customers’ financial goals and giving false testimony to FINRA during its investigation.

Morgan Stanley consented to a censure, a fine of \$3 million, and payment of restitution to 90 former customers of more than \$4 million, including interest. The firm already has settled with many of the affected customers.

Kazacos consented to a permanent bar from the securities industry, while Ira S. Miller, the manager of the branch in which Kazacos and Isabella worked, consented to a \$50,000 fine and a one-year suspension from acting in a principal capacity. The case against Isabella has not been settled or adjudicated.

Anti-Money Laundering (“AML”)

AML cases continue to be a significant part of FINRA’s enforcement program. In the first half of 2009, FINRA settled significant enforcement actions against E*Trade, Park Financial Group, J.P. Turner & Co., and Legent Clearing. In two of the cases, FINRA sanctioned not only a firm but its AML Compliance Officer.

1. *E*Trade Securities, LLC and E*Trade Clearing, LLC* (collectively “E*Trade”), FINRA Case No. 2006004297301 (Jan. 2, 2009)

FINRA settled a matter with E*Trade for failing to implement anti-money laundering policies and procedures that were reasonably designed to detect suspicious securities transactions that did not involve money movements.

Between January 2003 and May 2007, E*Trade used an automated system to detect suspicious activity, which filtered transactions based on five triggers and flagged transactions as “alerts” for further review by the firm’s AML Department. E*Trade relied on employees to manually monitor the alerts to detect suspicious trading activity in accounts.

The five triggers employed by the automated system identified patterns of abnormal money movement activity in brokerage accounts. Two of the triggers were designed to flag suspicious patterns of money movement into and out of accounts. Two additional triggers were designed to flag activity based on the number or dollar value of trades executed. The last trigger was designed to monitor trading activity in employee accounts. Because the alerts were triggered only by money movements, employees reviewing the alerts did not typically review for suspicious trading activity.

FINRA alleged that E*Trade’s AML procedures were insufficient because they were not tailored to the firm’s business, which included permitting clients to have direct on-line access to trade in the securities markets. E*Trade’s surveillance filters would not have detected, for example, manipulative matched or wash trades.

E*Trade consented to a censure and a \$1 million fine.

2. *Park Financial Group, Inc.* (“Park”), *Gordon Charles Cantley and David Farber* (Jun. 4, 2009)

FINRA settled a matter with Park, Gordon Charles Cantley (Park’s owner, CEO, President, Chief Compliance Officer, and AML Compliance Officer) and David Farber (a Park trader), in which it alleged that Park failed to establish effective AML policies and procedures.

FINRA found that between September 2004 and April 2008, Park’s AML program was not specifically tailored to the firm’s business. For example, Park’s AML policies did not specifically address penny-stock trading despite the fact that many of Park’s customers, some of whom had committed securities-related violations, traded penny stocks. In addition, Park failed to adequately enforce its AML policies by not identifying or investigating red flags and failing to file SARs.

FINRA also alleged that between August 2004 and April 2008, Park failed to retain instant messages sent or received by certain of its registered representatives. Furthermore, Park did not implement supervisory procedures regarding instant message retention or review until April 2006.

Park, acting through Farber, also allegedly participated in the sale of unregistered securities of two issuers. Farber opened issuer-affiliate accounts and unlawfully sold millions of shares of restricted stock. Farber also engaged in front-running by trading for his personal or relatives’ accounts after learning of impending block trades in the same securities. FINRA alleged that Park’s supervisory systems were not reasonably designed to detect sales of unregistered stock or front-running.

Finally, Park allegedly failed to maintain minimum required net capital on three days in December 2007 and failed to file notices that its net capital had fallen below certain required thresholds.

Park consented to a censure and a fine of \$400,000 and agreed to hire a consultant to review its AML program. Cantley consented to a permanent bar from association with any FINRA member. Farber consented to a fine of \$25,000 and a 30-day suspension.

As we described in our 2007 Year in Review Outline, on April 11, 2007, the SEC announced a settled action in which it alleged that Park and Cantley aided and abetted a “pump-and-dump” scheme and failed to file SARs. In that matter Park consented to a censure, a cease-and-desist order, disgorgement of approximately \$30,000 and a fine of \$50,000, while Cantley consented to a cease-and-desist order, a bar from association with any broker or dealer (with a right to reapply after two years), and a fine and disgorgement totaling approximately \$33,000.

3. *J.P. Turner & Co., LLC (“JPT”), S. Cheryl Bauman and Robert S. Meyer (Jun. 4, 2009)*

FINRA settled a matter with JPT, S. Cheryl Bauman (JPT’s Chief Compliance Officer and AML Compliance Officer), and Robert S. Meyer (a JPT branch manager), in which it alleged that between March 2005 and September 2006, JPT failed to establish effective AML policies and procedures.

FINRA alleged that JPT, acting through Bauman, failed to design and implement reasonable AML procedures and that as a result, the firm failed to detect red flags involving suspicious conduct by its customers and a former JPT principal and failed to file SARs on numerous occasions when red flags were present. FINRA also found that AML tests performed in 2005 and 2006 by an independent consultant were inadequate because they failed to address JPT’s monitoring of suspicious transactions.

Apart from AML violations, FINRA alleged that JPT paid transaction-based referral fees to an unregistered individual in exchange for institutional orders and failed to:

- report customer complaints timely and accurately and failed to maintain records of such complaints;

- maintain required customer information, including financial status, tax status, investment objectives, customer age, required signatures, tax IDs or SSNs, employment information, broker-dealer associations, telephone numbers, dates of birth, income and net worth;

- amend or timely amend Forms U-4 or U-5 to report disclosable events;

- honor clients’ requests to join the firm’s Do Not Call (“DNC”) list and permitted brokers to call individuals on the firm’s and/or the national DNC list; and

- adequately supervise the verification of orders and cancellation of trades at branch offices, including failing to enforce a “Special Supervisory Agreement” in 2004 and 2005 with a branch office with a high number of trade cancellations.

JPT consented to a \$525,000 fine (\$25,000 of which was joint and several with Bauman and \$5,000 of which was joint and several with Bauman and Meyer) and agreed that its Chief Compliance Officer would review trades for suspicious activity on a daily basis for an eighteen-month period. Bauman and

Meyer also consented to 18-month and one-month suspensions, respectively from acting in any principal capacity.

In a separate matter, FINRA alleged that between March 2005 and September 2006, John C. McFarland, a JPT trader, failed to report numerous instances of suspicious activity in his customers' accounts as required by the firm's AML procedures. FINRA further alleged that McFarland disclosed personal customer information to non-affiliated parties and took instructions for transactions from non-account holders in the absence of written authorization to do so. McFarland consented to a permanent bar from association with FINRA members.

4. *Legent Clearing LLC* ("Legent") (June 4, 2009)

FINRA settled a matter with Legent in which it alleged that between February 2004 and November 2006, the firm failed to establish effective written AML policies and procedures tailored to Legent's business of providing clearing services to introducing firms.

Some introducing firms serviced by Legent engaged in activities such as penny-stock transactions, liquidations of proceeds, and journaling between accounts that created risk of for AML violations. In addition, some of the introducing firms were the subject of prior disciplinary proceedings by the SEC, FINRA and/or state regulators for a variety of issues, including AML violations. However, in many instances involving suspicious circumstances or red flags, Legent failed to investigate and/or failed to file SARs.

FINRA further alleged that to the extent that Legent did investigate suspicious activity, it failed to document its investigation or its decision not to file a SAR. In addition, in several cases in which Legent filed a SAR, such filing was untimely. In one instance, the suspicious activity in question began sixteen months before Legent filed a SAR.

FINRA also found that Legent's AML program was not specifically tailored to its business and instead was copied from FINRA's Small Firm Template. For example, Legent's AML program failed to identify red flags for money laundering or address the firm's rapid growth during the relevant time period when the number of introducing firms serviced by Legent grew from nine to fifty. In addition, the firm's AML procedures did not contain specific information that identified how and where reviews were to be memorialized and which employees were responsible for which tasks. Legent also allegedly did not have adequate controls in place to ensure that its employees received AML training.

FINRA further alleged that on numerous occasions between June 2004 and October 2006, Legent violated Regulation T by (i) permitting customers to sell securities in cash accounts before making full cash payment for these securities, and (ii) failing to ensure that full cash payment was made within two days of the settlement date. Finally, FINRA found that on two occasions, Legent failed to make an accurate reserve computation.

Legent consented to a censure and a fine of \$350,000 and agreed to adopt policies and procedures reasonably designed to comply with Regulation T.