

MEMORANDUM

TO: Clients and Friends of the Firm

FROM: Ben A. Indek

DATE: September 29, 2006

SUBJECT: NASAA Annual Conference –
Report on Enforcement and Examination Issues

Last week the North American Securities Administrators Association (“NASAA”) held its 89th Annual Conference. Outlined below are my notes of the issues relating to enforcement and regulatory examinations that were discussed by senior NYSE Regulation, NASD, SEC and NASAA staff during the program. I hope you find this information useful in your practice.

Panel Discussion: Enforcement Priorities – 2006 and Beyond

Mark Connelly, Director of Securities Registration, New Hampshire Department of State, led this panel discussion that included Emily Gordy (Deputy Director of Enforcement at the NASD), Susan Merrill (Chief of Enforcement at NYSE Regulation) and Linda Thomsen (Director of the SEC’s Division of Enforcement). While Mr. Connelly did not make any substantive remarks, those of the other panelists are outlined below.

NASD

Ms. Gordy discussed several procedural and substantive issues. On the procedural side, Ms. Gordy noted that the NASD continues to focus on self-reporting and extraordinary cooperation. These two activities help the NASD leverage its resources. As an example of self-reporting and cooperation, Ms. Gordy pointed to the Prudential Regulation 60 action instituted several years ago and recent email cases. These matters reflect the substantial credit afforded to firms for self-reporting and corrective action.

The NASD is also focused on compliance with self assessments and regulatory sweeps. The NASD believes that it is critical for firms to provide reliable and accurate information in response to staff requests and that, in the last several years, some firms have failed to do so. Ms. Gordy noted that the NASD was currently litigating such a case with Oppenheimer and its CEO for allegedly providing inaccurate information in connection with the staff’s breakpoint review. On the day of her remarks, Ms. Gordy noted that the NASD had announced a \$5 million action against three MetLife entities for allegedly providing inaccurate and misleading information to the staff in connection with an investigation concerning late trading of mutual funds. Of particular note, Ms. Gordy pointed out that the NASD alleged that the failure to respond accurately stemmed in part from the firm’s reliance on a committee to respond to the staff’s requests without clear lines of authority or specifically identifying individuals responsible for the submission of accurate and adequate responses. (We have

obtained a copy of the AWC resolving these matters; please contact us if you would like to receive one.)

As to substantive issues, Ms. Gordy discussed supervisory deficiencies, Special Purchase Acquisition Corporations (“SPACs”), mutual fund trading, bank-affiliated brokerage firms, anti-money laundering and research analysts.

Regarding supervision, Ms. Gordy noted that the staff is currently investigating certain large firms with offices around the country where the staff is concerned about the staff and resources devoted to supervision and the adequacy of such firms’ supervisory structures.

NASD is concerned about certain conflicts of interest arising from the use of SPACs, including payment of finder’s fees.

Mutual funds continue to be an area of focus, including CDSC waivers (e.g., the recent Citigroup case), directed brokerage, sales contests, class shares, NAV transfers, late trading and market timing. With respect to NAV transfers, Ms. Gordy noted that several years ago the staff brought its first case in this area against AXA and later started a sweep to identify firms that had not offered NAV opportunities to clients. She hopes to wrap up these cases shortly. As to market timing, while the staff continues to look at firms, it has also brought about 15 cases against individuals, mostly supervisors.

In the bank-affiliated broker-dealer area, the NASD continues to be concerned about securities transactions occurring in locations where the broker-dealer is located on a bank’s premises. In particular, the staff is concerned about transactions where senior citizens with CDs maturing are sold variable annuities.

In the anti-money laundering area, the NASD is bringing cases. Ms. Gordy noted that they are looking at situations where, although the NASD might not have jurisdiction over the underlying customer trading, broker-dealers may be “turning a blind eye” to money laundering issues in light of the large commissions being generated. The NASD intends to attack anti-money laundering cases by looking at these kinds of situations.

Finally, with respect to research analysts, Ms. Gordy noted that the NASD has brought about 50 cases and that their main areas of focus are conflicts and disclosures.

NYSE Regulation

Susan Merrill began by stating that her staff was working on a potential Information Memo on the steps NYSE Regulation is taking to avoid regulatory duplication. Unfortunately, while Ms. Merrill stated that she would talk further about regulatory duplication, the panel session ended before she could do so.

In the sales practice area, Ms. Merrill indicated that the staff is taking a more risk-based approach to its review of the thousands of filings it reviews each year. Two analysts are focusing on identifying risk trends rather than reviewing day-to-day filings. Ms. Merrill identified four issues that had surfaced as a result of this approach. First, the staff has noted issues where member firm employees also work for bank-affiliated entities. The concerns

identified to date include misappropriation and unsuitable transactions. Second, firms are not following up on outside business activities disclosed by employees. In such situations, employees are later found to have offered investments to clients that are either inappropriate or unsuitable. Third, the staff has noticed an increase in misappropriations and unsuitable trading occurring in customer accounts where there is a family relation between the customer and a member firm employee. Ms. Merrill speculated that this might be occurring because branch managers may not be focusing on the supervision of family-related accounts. Fourth, NYSE Regulation has noticed instances of unsuitable and excessive trading in guardian accounts. Ms. Merrill concluded by noting that these trends are under investigation and will take time to work their way through the investigation and disciplinary proceeding system.

Ms. Merrill mentioned the Charles Schwab case (05-110) regarding that firm's alleged failure to put in place adequate procedures relating to third party money managers. Specifically, Schwab was alleged to have failed to have adequate procedures in place to protect customer assets managed by third party money managers. Ms. Merrill commented further that similar types of cases are in the pipeline.

With respect to market timing and late trading, Ms. Merrill stated that there are several firm cases still under investigation, but NYSE Regulation is now turning its attention to brokers who facilitated such trading and their supervisors.

In the stock loan area, Ms. Merrill mentioned the Van der Moolen case (06-091) in which the firm was fined \$3.5 million for alleged abuse in connection with the use of finders. NYSE Regulation's Member Firm Regulation has done a sweep and found many firms abusing finders and a lack of procedures for the use of such individuals. Ms. Merrill noted that one trader and one supervisor from Dresdner were sanctioned, but no case was brought against the firm because of the extraordinary cooperation demonstrated by that company, which let the NYSE open cases against several other firms.

NYSE Regulation has been active in the Reg SHO area. Member Firm Regulation has referred several firms to Enforcement for investigation for inadequate Reg SHO policies and procedures. In July, NYSE Regulation sanctioned four firms (Goldman Sachs, Credit Suisse, Citigroup and Daiwa) for alleged Reg SHO violations.

Ms. Merrill also mentioned fee-based accounts and noted the recent AG Edwards settlement (06-133) in which the firm was alleged to have had no procedures in place to prevent customers from being inappropriately placed in non-managed fee-based accounts. She also stated that customers had no trades in 2 years, with some paying 25 times more in fees than they would have in commissions. Ms. Merrill indicated that the firm was ordered to pay restitution to affected customers.

Ms. Merrill apparently had more to discuss but her time had run out.

SEC

Linda Thomsen began with a discussion of options backdating. Because those issues generally do not affect broker dealers, we will skip that part of her presentation.

In the hedge funds area, Ms. Thomsen stated that the SEC had brought a number of cases and expected to continue to do so. Here, Ms. Thomsen urged broker dealers to be alert to suspicious trading activity by hedge funds and to quickly notify the Commission staff of such trading.

Ms. Thomsen stated that she thinks that the SEC will see more investigations and cases in the insider trading area with the recent surge in mergers and acquisition activity and the staff's enhance tools capable of identifying suspicious trading.

According to Ms. Thomsen, non-Nasdaq OTC fraud cases are on the rise.

Cases Involving Senior Citizen Fraud

The NASD, NYSE Regulation and SEC officials all commented on the increased regulatory attention being paid to senior citizen fraud.

Ms. Gordy stated that NASD is trying to leverage the visibility of its enforcement cases by sending out investor alerts in these kinds of cases. As an example, Ms. Gordy noted the recent Securities America case in which a broker was alleged to have encouraged employees of a company to retire early and then engaged in unsuitable trading that was not properly supervised by the firm. The NASD ordered restitution and imposed a fine. There are other cases in this area currently under review.

Ms. Merrill indicated that NYSE Regulation is meeting with elder organizations with a goal of providing information on the types of cases they are seeing with the aim of educating senior citizens. This effort also involves putting together a package of cases to show the types of frauds that are being perpetrated on seniors so that such individuals can be aware of the schemes to prevent future cases. In particular, NYSE Regulation is working with AARP to get this message out.

Ms. Thomsen mentioned that the SEC's approach is a good model. The Commission is using education, enforcement and examinations to tackle this issue. Ms. Thomsen noted that seniors are susceptible to Ponzi schemes, offering frauds and unsuitable recommendations. The Commission will try to bring message cases in these areas and attempt to get local news media coverage to get the word out to senior citizens on these types of scams.

While not on this panel, NASD Chairman Mary Schapiro mentioned in her remarks to the entire conference that the NASD, the SEC and approximately state regulators are currently conducting a sweep to review "free lunch" seminars being offered to senior citizens to determine whether high pressure or inappropriate sales practices are being used.

NASAA Enforcement Section Update

At this session, the NASAA Enforcement section provided a list of trends that state regulators are seeing. These include the following:

1. Targeting of senior citizens (again, a brief discussion of the "free lunch" sweep);

2. Insurance agents persuading individuals to invest in non-securities offerings with high commissions;
3. Marketing of tenants-in-common;
4. Use of home equity loans to purchase securities;
5. Fraud in sales to pension funds;
6. Real estate investment scams;
7. Unsuitability of fee-based accounts;
8. Internet advertising investment contract schemes;
9. Life settlements;
10. Abusive variable annuity and equity indexed annuity sales practices;
11. Fake faxes, emails and calls for pump and dump schemes;
12. Debt collection schemes;
13. Improper data mining of personal information;
14. Alternative energy schemes;
15. Hedge fund fraud; and
16. Pink sheet/OTCBB fraud.

Ombudsman Meeting

At this meeting, a comment was made by Don Saxon, Florida's Securities Commissioner and NASAA ombudsman, suggesting that firms should consider contacting either the ombudsman or individual states when settling large cases with federal regulators to apprise the states of such resolutions.

Broker Dealer Section Forum

At this forum, NASAA representatives announced the results of a series of broker dealer state examinations conducted in 28 NASAA jurisdictions during a two-month period between May and June 2006. These examinations encompassed 228 broker-dealer firms. The top 10 deficiencies found were as follows:

1. Maintenance of customer account information;
2. Sales practices – suitability;
3. WSP's – failure to follow procedures;

4. Advertising/sales literature;
5. Outgoing/incoming correspondence;
6. Blotters/exception reports;
7. E-mail correspondence;
8. Internal audits – non OSJ branches;
9. Outside business activity/selling away; and
10. WSP's – failure to maintain as current.

As a result of the examination analysis, NASAA developed 10 “best practices” to assist firms in developing compliance policies and procedures. These 10 best practices are:

1. Developing, updating and enforcing WSPs;
2. Confirming compliance with the SEC account opening and updating rules;
3. Providing customers with contacts for returning inaccurate account information and information about where to send complaints and questions;
4. Developing suitability standards and criteria;
5. Generating exception reports and documenting reviews and resolutions of issues arising from such reports;
6. Implementing effective branch audit programs;
7. Confirming disclosure of outside business activities by brokers;
8. Making full and fair disclosure in advertisements and sales literature;
9. Approving seminar materials prior to use; and
10. Monitoring effectively written and electronic correspondence.

The examination findings and best practices are available on NASAA's website at www.nasaa.org.