

Retail Brokerage and Advisory Issues: New Products, New Problems?

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I. INTRODUCTION¹

This outline highlights several key areas concerning retail brokerage and advisory issues. Specifically, the outline covers the following topics: (1) retail structured products; (2) sales to seniors; (3) technology and surveillance issues; (4) compensation practices; (5) investment advisor due diligence for broker-dealers; and (6) repeal of New York Stock Exchange Rule 312(f)(1).

II. RETAIL STRUCTURED PRODUCTS

Over the last several years, regulators have exhibited significant concerns regarding the so-called “retailization” of complex products to individual investors. These concerns have been set out in various regulatory notices, speeches, examination priorities, and enforcement efforts. This section outlines these issues.

A. Regulatory Notices

1. New Products – NASD Recommends Best Practices for Reviewing New Products.

In Notice to Members 05-26 (September 2005), NASD stated that it was concerned about the rising number of ever increasingly complex products being offered by member firms.

- (i) Some products have features that may not be fully understood by investors or registered representatives; and
- (ii) Some products raised suitability and conflict of interest concerns.

The NASD urged firms to be proactive in reviewing and improving their procedures for creating and vetting new products. The NASD stated that all firms offering new products should have formal written procedures to confirm that no new product is introduced before it has been fully vetted. At a minimum, such procedures should identify what constitutes a new product and confirm that the right questions are asked and answered before a product is offered to clients.

After surveying firms, the NASD noted the following best practices:

- (i) “A mandatory, standardized process that requires a written “new product” proposal and thorough accompanying documentation;

¹ This outline was drafted by Ben A. Indek, a partner of Morgan, Lewis & Bockius LLP. The outline represents the views of Mr. Indek and not those of the other panelists and their organizations. Portions of this outline were developed by Mr. Indek for this same panel at the 2008 SIFMA Compliance & Legal Division Fall Compliance Seminar. Mr. Indek is indebted to last year’s panelists for their input on that outline.

- (ii) A preliminary assessment of a proposed product or concept by compliance and/or legal personnel to determine, among other things, whether it is a new product or a material modification of an existing product, and the appropriate level of internal review;
- (iii) For new products or material modifications to existing products, detailed review by a committee or working group made up of representatives from all relevant sectors of the firm, including compliance, legal, finance, marketing, sales and operations;
- (iv) A formal decision to approve, disapprove, or table the proposal by a new product committee or other decision-making group that includes members of the firm's senior management; and
- (v) If the product is approved, some level of post-approval follow-up and review, particularly for products that are complex or are approved only for limited distribution."

2. Structured Products – NASD Provides Guidance Concerning the Sale of Structured Products

Definition: according to the NASD, structured products are “securities derived from, or based on a single security, a basket of securities, an index, a commodity, a debt issuance and/or a foreign currency.” Their characteristics include:

- (i) Principal protection varies – may offer full or limited protection of the principal invested, or none at all.
- (ii) Most pay an interest rate substantially above prevailing market.
- (iii) Are typically issued by investment banks or their affiliates.
- (iv) Have a fixed maturity.
- (v) Are sometimes listed on an exchange, but in such cases, generally are very thinly traded.

Structured as two components – a note and a derivative (often an option):

- (i) Note pays interest to the investor at specified rate and interval.
- (ii) Derivative component establishes payment at maturity (effectively acting like a put or call option).

NASD's 2005 guidance (Notice to Members 05-59) on structured products states firms should:

- (i) provide balanced disclosure in promotional efforts;

- (ii) ascertain accounts eligible to purchase structured products;
- (iii) deal fairly with customers with regard to derivative products;
- (iv) perform a reasonable-basis suitability determination;
- (v) perform a customer-specific suitability determination;
- (vi) supervise and maintain a supervisory control system; and
- (vii) train associated persons.

Balanced disclosure should not portray a product as “conservative” or a source of “predictable current income” unless such statements are accurate, fair, and balanced. In promoting advantages such as interest rate offered and creditworthiness of the company, a firm must balance its presentation with disclosures concerning risks, e.g., loss of principal and the possibility that at expiration the investor will own the reference asset at a lower price. Sales materials and oral presentations that omit description of the derivative component and instead present such products as ordinary debt securities would violate Rule 2210. Firms should also balance any statements that a structured product has a ticker symbol or has been approved for listing on an exchange with the risks that an active and liquid trading market may not develop in the future.

The NASD cautioned that presentation of a credit rating for a structured product suggesting that the rating relates to the safety of the money invested or the likely investment returns will be seen as misleading by the staff. The Notice further states “creditworthiness of the issuer does not affect or enhance the likely performance of the investment, other than the ability of the issuer to meet its obligations.”

Eligible Accounts:

- (i) Firms should consider whether structured products should be limited to clients approved for options accounts.
- (ii) Otherwise, the member must develop (and be prepared to defend) comparable procedures designed to confirm that structured products are only sold to persons for whom risk is appropriate.
- (iii) Due to potential conflicts of interest, sale of a firm’s or affiliate’s structured product to a discretionary account requires the client’s prior specific written approval of the trade.

Fair Dealing:

- (i) “Member must be familiar with each customer's financial situation, trading experience, and ability to meet the risks involved with such

products and make every effort to make customers aware of the pertinent information regarding the products.”

Reasonable Basis Suitability:

- (i) This aspect of suitability includes due diligence.
- (ii) NASD expects members to exercise market expertise to identify where a lower yielding instrument does not represent a reasonable rate of return, given the attendant risks, as compared to other similar products or direct investments in the underlying securities with similar risk/reward attributes.

Customer-Specific Suitability:

- (i) Derivative component and potential loss of principal may be unsuitable for investors seeking alternatives to debt securities.
- (ii) “While structured products pay interest like debt securities, they often exhibit profit and loss potential more like an option contract.”
- (iii) Where there is a risk of losing all or a substantial portion of the principal in return for above-market rate current income, the volatility of the reference asset upon which total return of the investment depends is an important factor in determining suitability.

3. High Yield Securities – FINRA Reminds Firms of Their Sales Practice Obligations with Regard to the Sale of Securities in a High Yield Environment

FINRA Regulatory Notice 08-81 (December 2008) was intended to reiterate to firms their obligations in connection with the sale of certain securities during periods in which yields reached unusually high levels.

Specifically, FINRA’s Notice was intended to remind firms of their obligation to balance the discussion of yield with an appropriate description of the features of bonds, bond funds, structured products, and non-conventional investments and the risks associated with such transactions.

4. Non-Traditional ETFs – FINRA Reminds Firms of Sales Practice Obligations Relating to Leveraged and Inverse Exchange-Traded Funds

In Regulatory Notice 09-31 (June 2009), FINRA provided guidance concerning firms’ sales practice obligations that arise in connection with investments in leveraged and inverse ETFs.

In particular, the Notice stated that recommendations must be suitable and based upon a complete understanding of the terms and features of the recommended product. In addition, FINRA cautioned that sales materials relating to leveraged and inverse ETFs must fairly and accurately describe the products. FINRA also emphasized that firms must train their brokers about the terms, features and risks of ETFs. As it relates to leveraged and inverse ETFs, the training should focus on the need to understand an investor's time horizons and the impact of time and volatility on the investment's performance. The Notice stated that firms are obligated to have adequate supervisory procedures in place for these products. Specifically, firms that permit brokers to recommend leveraged and inverse ETFs must have written supervisory procedures that require:

- (i) an appropriate reasonable-basis suitability analysis is conducted;
- (ii) brokers conduct an appropriate customer-specific suitability review;
- (iii) sales materials are accurate and balanced presentations; and
- (iv) relevant FINRA and SEC rules are adhered to.

B. Speeches

In his recent speech at the SIFMA Annual Meeting, FINRA's Chairman and CEO, Rick Ketchum, spent considerable time describing new products and sales practices.² Although commending firms for developing and implementing protocols to vet the introduction of new products, Mr. Ketchum urged firms to institutionalize their product committees and focus their efforts not solely on the development of new products but how such investments evolve over time. In short, he stated that "product review cannot be a static process and firms must understand when market forces render a change in the risks of a product at the earliest reasonable time."

C. Examination Priorities

In its March 9, 2009 letter outlining new and existing areas of importance to its examination program, FINRA described the staff's focus on alternative investments in light of the then-current market conditions. Among other things, the letter describes the suitability, disclosure, and supervisory obligations imposed on firms recommending structured products, high-yield bonds and bond funds, and other alternative investments. Of note, FINRA indicated that there was an increase in firm applications for firms to engage in retail foreign currency exchange business. The staff observed that this business is "particularly risky for

² See remarks of FINRA's CEO and Chairman, Rick Ketchum, at the SIFMA Annual Meeting (October 27, 2009) at finra.org.

individual investors, and has generated problems from abusive sales practices to the financial failure of retail forex merchants.” Accordingly, FINRA examiners will closely review firms already engaged in or seeking to conduct retail forex business.

D. Enforcement Developments

In addition to the foregoing, structured products have also been the focus of various enforcement efforts.

First, earlier this year the new Director of Enforcement at the SEC, Robert Khuzami, announced the formation of five specialized units. In an August 5, 2009 speech, Mr. Khuzami laid out his plans for a Structured and New Products Unit:

The Structured and new Products Unit will focus on complex derivatives and financial products, including CDS, CDOs and securitized products. These are huge markets, with outstanding notional amounts that at one time came close to the market capitalization of all publicly traded companies in the world. They are also opaque markets due to the complexity of the products, the limited availability of trading information and the prevalence of private offerings. This lack of transparency has become fertile ground for abuse and misconduct, and staying on top of these markets, and whatever new products are next devised, requires specialized knowledge and commitment.

Second, regulators have initiated disciplinary action against firms and individuals in connection with improper sales practices relating to structured products. Some of these cases include the following:³

1. *SEC v. William Betta, Jr., et al.*, 09-Civ-80803 (S.D. Fla. May 28, 2009)

The SEC charged ten brokers with fraud related to their sales to customers of collateralized mortgage obligations (“CMOs”), alleging that the brokers had misrepresented to customers that the CMOs were safe and suitable for retirees.

The SEC’s complaint alleges that between 2004 and 2006, Brookstreet Securities Corp. (“Brookstreet”) brokers defrauded more than 750 customers by telling them that CMOs were safe, secure, and liquid, leading customers to purchase more than \$175 million in CMOs. The

³ The summaries of these cases are taken from the “Year in Review” publications issued by Morgan Lewis. These reports are available at morganlewis.com.

brokers earned CMO commissions of more than \$16 million in connection with the CMO sales.

Contrary to the brokers' representations, the CMOs were not all guaranteed by the U.S. government, put the customers' yield and principal at risk, were largely illiquid, and were only suitable for sophisticated investors with a high tolerance for risk. The brokers also traded heavily on margin in customers' accounts, despite assurances from some defendants that margin would be used sparingly.

When the CMO market began to fail in 2007, margin calls resulted in heavy losses, and customers lost over \$36 million.

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

FINRA brought similar charges against six other Brookstreet brokers. FINRA alleges that the brokers did not have an adequate understanding of CMOs and that they misrepresented or failed to disclose information to customers relating to the risks of investing in CMOs. FINRA's complaint also charges the brokers with exercising discretionary authority in customer accounts without written authorization. That case has not yet been resolved.

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

Three SAMCO Financial Services, Inc. brokers settled FINRA actions in connection with misconduct in marketing and sales of Collateralized Mortgage Obligations to retail customers.

FINRA alleged that between June 2004 and September 2006, Berkowicz, Schwartz, and Webberly recommended inverse floaters to non-sophisticated retail investors for whom the securities were not suitable. As a result of these recommendations, nine clients collectively lost approximately \$535,000.

FINRA also alleged that the brokers allowed the SAMCO head trader, who was also their supervisor, to exercise discretion to purchase CMOs in the clients' accounts.

Berkowicz and Schwartz each consented to be barred from the industry. Webberly consented to a two-year suspension and to assist FINRA in its ongoing prosecution of matters regarding sales of CMOs at the SAMCO Financial branch office involved in the case.

This case reflected FINRA's first enforcement action involving allegations of unsuitable recommendations of mortgage-backed securities to retail clients.

III. SALES TO SENIORS

Over the past several years, the SEC, FINRA, and state regulators have focused on senior investors as the baby boomer generation moves toward retirement age. Key issues involve adequate disclosures to clients (particularly with respect to registered representatives' titles and so called "free lunch" seminars) and suitability. Outlined below are some of the key regulatory initiatives in this area.⁴

A. SEC Seniors Summits and Regulators' Educational Efforts

The Commission held Senior Summits in July 2006, September 2007 and September 2008. Those meetings brought together regulatory staff from the SEC, FINRA, and state securities commissions as well as other interested parties (e.g., AARP). These sessions have focused on, among other topics, senior investor education efforts, regulatory changes affecting seniors, and examination and enforcement updates.

Both the SEC and FINRA have been active in providing education to seniors concerning investments in the securities markets. As two examples, in November 2008 FINRA created a podcast called "'Free Lunch' Investment Seminars - Avoiding the Heartburn of a Hard Sell" and in October, 2009 released a podcast entitled "Seniors Beware: What You Should Know About Life Settlements."

B. FINRA Regulatory Notices

Two relatively recent FINRA Regulatory Notices provide guidance to the industry concerning dealing with senior investors.

1. Regulatory Notice 07-43 – Senior Investors

Regulatory Notice 07-43 (September 2007) both reminded member firms of their obligations relating to senior investors and highlighted certain industry practices that some firms have developed to better serve these customers.

Regulatory Notice 07-43 begins by pointing out that although FINRA does not have special rules for member firms dealing with senior investors, the age and life stage of a customer can be important factors and firms should create and implement procedures that take these two considerations into account where appropriate. In particular, FINRA noted two areas of concern: suitability of recommendations and communications with senior investors.

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An excellent White Paper on compliance issues surrounding senior investors was prepared by Alston + Bird and Bressler, Amery & Ross for the NSCP in September 2007.

FINRA's suitability rule requires a member firm to have reasonable grounds for believing that the recommendation is suitable for a customer based on certain facts disclosed by the investor. Here, FINRA noted that, although the suitability rule does not explicitly refer to an investor's age or life stage (e.g., pre-retired, semi-retired or in retirement), these are important factors to consider in conducting a suitability analysis. As such, FINRA urged firms to obtain information about a customer's age, life stage and liquidity needs through a series of questions designed to elicit such information. Finally, the Regulatory Notice warned firms that FINRA's examiners will focus on recommendations to seniors in connection with routine examinations. In particular, examiners may focus on recommendations concerning:

- (i) products with withdrawal penalties or lack of liquidity;
- (ii) variable life settlements;
- (iii) structured products;
- (iv) mortgaging home equity to buy investment products; and
- (v) using retirement money to invest in high risk securities.

With respect to communications with the public, the Regulatory Notice describes FINRA's concern regarding the spread of the use of professional designations, particularly those suggesting expertise in retirement planning or handling the financial needs of senior investors. FINRA pointed out that some firms ban the use of certain designations that include the words "senior" or "retirement." Other firms create and maintain a list of approved designations; those titles not on the list must be reviewed and approved by a firm committee. FINRA also noted its concern regarding the use of aggressive or misleading sales practices aimed at senior investors. In particular, FINRA exhibited concern regarding the use of "free lunch" seminars.

Finally, Regulatory Notice 07-43 tackles the difficult issues surrounding the diminished capacity and suspected financial abuse of seniors. After surveying firms concerning these issues, FINRA shared a number of steps that some are taking to address these matters. Steps taken by firms include the following:

- (i) designating a particular individual or department to serve as a central point of contact within a firm for questions about senior issues;
- (ii) giving written guidance to representatives on senior-related issues;

- (iii) asking customers whether they have executed a durable power of attorney;
- (iv) requesting whether customers would like to designate an individual to be contacted if the firm could not reach the customer or had concerns about the investor's whereabouts or health;
- (v) asking whether the customer would prefer to include a friend or family member in firm meetings;
- (vi) informing the customer that particular unsolicited trades are not suitable, where appropriate;
- (vii) reiterating to brokers the importance of basing recommendations on current information; and
- (viii) providing training to brokers to help them understand and meet the needs of senior investors.

2. Regulatory Notice 09-42 – Variable Life Settlement Transactions

Regulatory Notice 09-42 (July 2009) provided several reminders to firms currently involved in (or seeking to begin handling) variable life settlement transactions, which are generally defined as sales of existing life insurance policies to third parties.

The Notice stated that many investors, particularly those close to or in retirement, may be concerned about their financial situation in today's market and economic environment. Accordingly, FINRA provided guidance concerning the suitability, disclosure, communications, commissions and fees associated with variable life settlements.

As to suitability and disclosure, FINRA cautioned that before firms can make an adequate suitability determination, they must take steps to make investors aware of, among other things:

- (i) the tax treatment of any life settlement transaction;
- (ii) the investors need for current income;
- (iii) the length of time a life settlement transaction takes to complete;
- (iv) the effect the sale of a life insurance policy could have on an investor's eligibility for public assistance programs;
- (v) the transaction-related costs of a variable life settlement;

- (vi) the impact that the transaction may have on the ability to obtain replacement insurance; and
- (vii) the issues surrounding an investor's requirement to provide access to his or her medical history.

Concerning communications, FINRA reminded firms of their obligation to provide balanced, fair and complete information to investors in advertising, marketing materials and other communications used to seek investors interested in variable life settlement transactions.

Finally, Regulatory Notice 09-42 provides substantial guidance concerning the commissions and fees charged to investors selling their variable life policies. In short, FINRA expressed concern that such investors may be charged excessive commissions or fees and reminded firms to comply with Rules 2440 (and IM-2440-1), 2010, and 2430.

FINRA's concerns regarding variable life settlements were underscored in an October 27, 2009 speech by Rick Ketchum, Chairman and CEO, delivered at the SIFMA annual meeting. Mr. Ketchum stated that there is "some evidence that [life settlements] are being aggressively marketed without giving investors the information they need to make an informed decision."⁵

C. Examination Priorities

FINRA has made it clear that disclosures to and sales practices regarding senior investors continue to be a focus of routine examinations. For example, in FINRA's Improving Examination Results (May 2008), the staff noted that "FINRA examiners will focus on sales to seniors and other investors approaching retirement. If member firms or their representatives target these investor classes in their marketing efforts, these are likely to be reviewed." Similarly, in FINRA's March 9, 2009 letter to firms highlighting new and existing areas of significance to its examination program, senior Member Regulation staff reiterated that "FINRA continues to pay close attention to sales practices aimed at senior investors and baby boomers." Both of these documents are available at finra.org.

D. Sweep Examinations

Securities regulators have been keenly focused on conducting targeted examination sweeps to identify potential broker-dealer misconduct in connection with sales to seniors. These sweeps include the following:

⁵ See remarks of FINRA's CEO and Chairman, Rick Ketchum, at the SIFMA Annual Meeting (October 27, 2009) at finra.org.

1. An SEC OCIE, NASAA and FINRA sweep that culminated in a September 2007 joint report titled “Protecting Senior Investors: Report of Examinations of Securities Firms Providing ‘Free Lunch’ Sales Seminars.”⁶ The regulators found:
 - (i) “sponsors” of “free lunch” sales seminars offer attractive inducements to attend;
 - (ii) often, the target attendees are seniors;
 - (iii) seminars are designed to sell;
 - (iv) some firms had particular compliance and supervisory controls that appear to be effective. And, during a small number of the examinations (5 examinations or 4% of those conducted), regulators found no problems or deficiencies;
 - (v) half of the examinations found that firms used advertising and sales materials that may have been misleading or exaggerated or included seemingly unwarranted claims (in 63 of 110 examinations, or 57%). Many broker-dealer firms did not submit their sales materials to NASD (now FINRA) for review, as required by NASD advertising rules;
 - (vi) individuals attending the sales seminars may not understand that the seminar is sponsored by an undisclosed company with a financial interest in product sales;
 - (vii) many examinations found indications that firms had poorly supervised these sales seminars;
 - (viii) some examinations found indications that registered representatives or investment advisers holding the sales seminars had recommended investments that did not appear to be suitable for the customers; and
 - (ix) in some instances the sales seminars may have involved fraud.”
2. Two sweeps announced by FINRA in September 2007 at the SEC Seniors Summit. The first was said to examine whether brokers are using various titles or designations to mislead and defraud senior investors. The second examination targeted early retirement seminars designed to entice workers to liquidate their retirement accounts and invest them with a broker or

⁶ This report is available at sec.gov and finra.org.

firm. These two new sweeps were in addition to ongoing examinations focusing on sales of CDOs and life settlements to seniors.

3. Finally, in September 2008, the SEC, NASAA and FINRA released a report titled “Protecting Senior Investors: Compliance, Supervisory and Other Practices Used by Financial Firms in Serving Senior Investors.”⁷ In this report, the regulators provided practical examples of ways in which the industry is attempting to work with senior investors in a sound and principled manner. Specifically, the report includes a summary of certain practices used by firms and individuals in serving senior investors in these areas:
 - (i) “getting started: how firms are thinking of ways to remodel their supervisory and compliance structures to meet the changing needs of senior investors;
 - (ii) communicating effectively with senior investors;
 - (iii) training and educating firm employees on senior-specific issues (such as how to identify signs of diminished capacity and elder abuse);
 - (iv) establishing an internal process for escalating issues and taking next steps;
 - (v) encouraging investors of all ages to prepare for the future;
 - (vi) advertising and marketing to senior investors;
 - (vii) obtaining information at account opening;
 - (viii) ensuring the appropriateness of investments; and
 - (ix) conducting senior-focused supervision, surveillance and compliance reviews.”

E. Rulemaking

As a complement to their examination and enforcement efforts, regulators have also focused on rulemaking in the senior area. Of particular note is the NASAA Model Rule on the Use of Senior-Specific Certifications and Professional Designations adopted on March 20, 2008.⁸ The Model Rule is intended to prohibit the misuse of certifications or designations by industry professionals.

⁷ This report is available at sec.gov and finra.org.

⁸ The Model Rule is available at nasaa.org.

Although not specific to senior investors, it is important to note that FINRA has completed its rulemaking process concerning variable annuity sales practices. The new provision, Rule 2821, describes specific sales practice requirements and supervisory obligations surrounding the recommendation of variable annuity products to investors.

F. Enforcement Efforts

In addition to educational efforts, examination priorities, sweeps and rulemaking, regulators have been busy in the enforcement arena. Below are several cases involving alleged misconduct in connection with senior investors.²

1. *Sergio M. Del Toro* (Oct. 8, 2009)

Del Toro allegedly effected unsuitable transactions in the account of a 90 year old customer who was living in a nursing home at the time of the investments. Specifically, FINRA found that Del Toro engaged in a series of six private securities transactions totaling over \$500,000 in which his customer invested in a “speculative, development-stage company.” According to FINRA, Del Toro received a 15% sales commission on the trades. The customer died in 2006 and his daughter later brought Del Toro’s practices to FINRA’s attention.

In announcing the case, FINRA stated that “one of [our] highest objectives is to protect our nation’s elderly citizens from fraudulent conduct by brokers.”

Del Toro was permanently barred from the securities industry.

2. *In the Matter of Prime Capital Services, Inc., et al.*, Admin. Proc. No. 3-13532 (June 30, 2009)

The SEC filed an administrative proceeding against Prime Capital Services, Inc. (“PCS”), its president, one of its senior compliance employees, its parent company (Gilman Ciocia, Inc.), and several PCS registered representatives and their supervisors in connection with PCS representatives’ sale of variable annuities to customers whom they solicited during free lunch seminars.

The SEC alleged that between 1999 and 2007, the 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

² Many of the summaries of the cases below are taken from the “Year in Review” publications issued by Morgan Lewis in 2006, 2007, 2008 and 2009 that describe certain SEC and SRO enforcement actions and developments. These reports are available at morganlewis.com.

investments were unsuitable based on the customers' ages, liquidity and investment objectives.

The SEC also claimed that Gilman Ciocia, Inc. aided and abetted PCS's fraud by arranging free-lunch seminars in and around several senior citizen communities in Florida where the registered representatives would recruit senior citizens as customers and induce them into buying variable annuities.

Further, PCS, as well its president, compliance officer, and two supervisors allegedly failed to supervise and failed to set up a system of following up on, among other topics, branch examinations, supervisory review of variable annuity transactions, and customer complaints.

3. *SEC v. Aura Financial Services, Inc., et al.*, 09-Civ-21592 (S.D. Fl. filed Jun. 11, 2009)

The SEC filed a complaint against Aura Financial Services ("Aura") and six registered representatives for fraudulent sales practices.

The SEC alleged that between October 2005 and April 2009, Aura and its registered representatives employed fraudulent sales practices to induce fifteen customers to open Aura brokerage accounts. Defendants opened many of the accounts as margin accounts, despite the fact that they had not discussed with their clients the risks of margin. Defendants also allegedly engaged in excessive trading in (or churning) the accounts in order to increase commissions.

Defendants also allegedly traded in a manner that was inconsistent with their unsophisticated clients' investment objectives and risk tolerances. The customers did not understand the total transaction costs they were charged through their trading with Aura. During 2008, the churning generated total gross commissions of more than \$1 million, while the accounts lost over \$3.5 million.

The SEC alleged that Aura failed to take reasonable steps to prevent the churning practices by its registered representatives, although it was aware of high turnover in the accounts and several customer complaints about the representatives. Further, Aura allegedly was aware that FINRA had filed a disciplinary proceeding in May 2008 against one of the defendants and his supervisor concerning the falsification of new account forms at a prior employer.

The SEC seeks a preliminary injunction against Aura and the current registered representatives, a permanent injunction against future violations, disgorgement, and civil penalties.

4. *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:

- (i) unrealistic promises of consistently high investment returns, and
- (ii) 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 appears to be ongoing.

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

The SEC settled an action against Mark Salyer, a MetLife Securities, Inc. (“MetLife”) registered representative, in which it alleged that he misappropriated millions of dollars from MetLife clients.

According to the complaint, between June 2005 and October 2007, Salyer misappropriated approximately \$6 million from no less than 33 MetLife clients, most of whom were senior citizens and had long-standing business relationships with him. Salyer allegedly diverted the funds from the client accounts into multiple entities, two of which he directly controlled, by forging signatures on wire transfers forms and encouraging the clients to invest in his company as if it were a MetLife investment.

The complaint further alleged that Salyer facilitated and otherwise concealed his fraudulent activities by falsifying customer brokerage account statements and providing clients with fraudulent explanations for discrepancies in the account balances reflected in their account statements.

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

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

The SEC filed a complaint charging Gary Gross, an Axiom Capital Management, Inc. registered representative, with using various abusive sales practices to defraud his firm’s elderly and financially unsophisticated clients.

Between early 2004 and September 2006, Gross allegedly:

- (i) sold his clients’ conservative investments and used the proceeds to purchase risky, illiquid speculative securities contrary to their risk-averse investment objectives;
- (ii) made material misrepresentations and omissions regarding the risks of the securities, including private investments in public equities (“PIPEs”), that he bought in his clients’ accounts;
- (iii) engaged in unauthorized discretionary trading in clients’ accounts;
- (iv) churned clients’ accounts;
- (v) fabricated account values when questioned by his clients about losses in their accounts; and

- (vi) traded on margin in customer accounts without discussing margin trading with them and told his clients to dismiss any margin call letters they received.

As a result of this conduct, Gross allegedly caused his clients to lose over \$2.7 million while generating for himself more than \$700,000 in commissions and fees.

The SEC seeks declaratory relief, a permanent injunction, disgorgement, and prejudgment interest.

7. *John Edward Mullins and Kathleen Mullins* (Feb. 14, 2008)

FINRA filed a complaint alleging that John Mullins, a registered representative, misappropriated nearly \$400,000 from an elderly customer and her charitable organization and attempted to steal funds from his employer in the form of improper expense submissions. Mullins' wife, a broker, was also charged by FINRA.

When Mullins's customer became ill, Mullins allegedly used her checking account and debit cards to pay his and his wife's personal expenses, including paying down \$375,000 on their joint mortgage, ATM withdrawals, and paying for groceries and gas.

Mullins also used the customer's charitable organization to buy gift cards which he used himself.

Furthermore, FINRA charged that Mullins wrongly submitted \$100,000 in improper expenses to his employer, accepted an unauthorized \$100,000 loan from a customer, and made misstatements on his Form U4 to conceal his officer, trustee and Power of Attorney status for the customer's will and charitable foundation.

In September 2009, FINRA announced that a Hearing Panel had barred Mr. Mullins from the securities industry. According to FINRA, the Hearing Panel also suspended Ms. Mullins for nine months and imposed a \$20,000 fine. Unless the respondents appeal the matter to FINRA's National Adjudicatory Council, or the NAC calls the case for review, the Hearing Panel's decision will become final.

8. *In the Matter of Commonwealth Equity Services, LLP d/b/a Commonwealth Financial Network* ("Commonwealth Equity") (Admin. Proc. File No. 3-12749, Sept. 6, 2007) and *In the Matter of Detwiler, Mitchell, Fenton & Graves, Inc.* ("Detwiler") (Admin. Proc. File No. 3-12750, Sept. 6, 2007).

The SEC brought actions against both Commonwealth Equity and Detwiler in connection with their employment of Bradford Bleidt, a

registered representative. Bleidt defrauded approximately 59 customers of these broker-dealers by lying about purchases and sales, misappropriating funds and sending falsified statements related to their accounts. The Commission alleged that at least 40 of Bleidt's clients were over age 70 at the time of the SEC's charges. In July 2005, Bleidt pled guilty to mail fraud and money laundering charges and received an 11 year sentence.

The SEC found that the respondents failed to supervise in several respects. First, Bleidt personally owned the independent office in which he worked. The firms permitted Bleidt to hire and personally employ the OSJ manager who supervised him. The SEC concluded that the conflict of interest inherent in such a structure may have compromised supervisory review. Second, the SEC concluded that the firms lacked adequate policies and procedures to follow up on red flags concerning Bleidt's outside business activities and for review of incoming correspondence.

The SEC censured each of the respondents and ordered them to pay \$250,000 in civil penalties.

9. *Citizens Bank Affiliate, CCO Investment Services Corp.* ("CCO") (Oct. 16, 2006)

CCO agreed to pay a fine of \$850,000 in settling with the NASD for failing to establish, maintain and enforce a supervisory system and written policies relating to variable annuity sales to elderly clients, customer suitability reviews, telemarketing compliance, internal inspection, review of written correspondence, registration of offices and review and approval of 529 business plans.

10. *Securities America Inc.* (Securities America") (Sept. 14, 2006)

The NASD fined Securities America for failing to adequately supervise a broker who had lured long-term employees of Exxon-Mobil to retire early, cash out their company-sponsored 401(K) and pension plans, and reinvest the funds from the retirement plans with Securities America. The broker then placed these customers into variable annuities, Class B or Class C mutual fund shares and exchange-traded funds and promised them that their monthly income from these investments would match what they would be earning in salary. Customers who followed the broker's recommendations could not maintain their recommended withdrawal amounts without depleting their retirement account to levels that threatened their incomes.

James S. Shorris, then NASD Executive Vice President and Head of Enforcement, stated "in this case, Securities America's lack of supervision resulted in Exxon employees being fraudulently induced into retiring

early, based upon false and misleading projections of future investment returns on their nest eggs.”

Securities America was fined \$2.5 million and ordered to make restitution to 32 former Exxon employees totaling \$13.8 million. Securities America also agreed to hire a consultant to conduct a review of the firm’s seminar presentations, advertising, and systems and procedures relating to retirement planning and investments for retirees.

IV. TECHNOLOGY AND SURVEILLANCE ISSUES

The markets are increasingly volatile today, with significant point and percentage decreases and increases in the Dow Jones Industrial Average seemingly every day. In addition, there have been substantial changes to the rules governing trading and disclosure (particularly in the short selling area) over the last year; some of those modifications have been on short notice to the industry. Further, the use of automation in connection with various back-office operations has been a focus of FINRA enforcement efforts in the last several years. Changes in the ways in which brokers and their customers communicate also present challenges for firms. Finally, increased coordination and communication between compliance and technology are important at member firms. Each of these items is briefly discussed below.

1. Today’s regulatory climate can necessitate rapid changes to firms’ systems and the need for fast and accurate communication with brokers, traders, supervisors and clients. Firms facing these challenges should consider the creation of ad hoc task forces or working groups composed of individuals from senior management, information technology, legal, compliance, and operations to handle these issues in an orderly and effective fashion.
2. Firms should also be mindful of the need to modify their automated surveillance systems to take into account the current market environment. For example, last year’s significant drop in the market may have caused firms’ surveillance mechanisms designed to identify substantial declines in equity in retail accounts to have become quickly overwhelmed.
3. The last several years have seen regulators bring cases against firms for failures to comply with various back-office operational rules (e.g., proxy voting, prospectus delivery, etc.). The nub of the allegations in these cases revolve around the fact that many firms had developed automated systems to carry out these back-office functions years ago and/or outsourced such activities to unregistered vendors, without adequately monitoring whether the automated programs/vendors continued to be in compliance with the relevant rules. Accordingly, regulators have cautioned that it is important for firms to periodically test and monitor such systems.

4. Firms should also be mindful of the need to both create and implement adequate technology and surveillance systems in connection with the rollout of new products or changes in product development or markets.
5. Technology changes at an extremely rapid pace. According to media reports, email is now old hat. New technology centers around social networking sites such as Facebook, LinkedIn, and Twitter. Firms are just beginning to explore ways to supervise and retain such communications. To that end, FINRA has formed a Social Networking Taskforce to explore ways in which regulation can take advantage of technological advancements without minimizing the need to continue to protect investors.¹⁰
6. Finally, in today's technological environment, it is critical for compliance officers to be able to effectively communicate with and understand their information technology counterparts. This is particularly important in connection with the design, development and implementation of new surveillance programs.

V. COMPENSATION PRACTICES

A. Background

In the aftermath of the 2008 economic crisis, much attention has been paid to the compensation of senior executives, investment bankers and traders at the country's largest financial institutions. That scrutiny has ranged from comments from President Obama, Congressional hearings, potential legislation, the selection of a pay czar, and extensive media coverage.

Of relevance to this panel, is SEC Chairman Mary Schapiro's August 31, 2009 letter to broker-dealer chief executive officers.¹¹ Rather than focusing on the pay packages of high-ranking executives and those in banking and trading, Chairman Schapiro's letter spotlights concerns regarding the recruitment of and inducements to registered representatives.

Specifically, Chairman Schapiro noted that media reports had suggested that broker-dealers are both engaged in energetic recruiting programs and are offering significant inducements to new brokers, including substantial up-front bonuses and enhanced commissions. Chairman Schapiro's letter was intended to remind broker-dealers and their CEO's of their supervisory responsibilities.

¹⁰ See remarks of FINRA's CEO and Chairman, Rick Ketchum, at the SIFMA Annual Meeting (October 27, 2009) at finra.org.

¹¹ Chairman Schapiro's letter is available at sec.gov.

In particular, Chairman Schapiro's letter noted that certain types of increased compensation practices may lead brokers to believe that they are obligated to sell enough securities products to justify their special arrangements. In turn, such pressures may create incentives for brokers to engage in sales practice misconduct. As examples of such improper conduct, Chairman Schapiro noted that brokers could churn accounts, recommend unsuitable investments or engage in transactions that generate commissions without regard to investors' best interests.

Chairman Schapiro's short letter encouraged CEOs and other supervisors to take particular care to closely monitor sales practices and to assure that an increase in a firm's sales force is accompanied by equal efforts to develop and implement sufficient supervisory and compliance protocols for such increased sales presence.

B. FINRA Examination and Firm Issues

It is likely that the FINRA examinations staff will be reviewing the incentives provided to new brokers and focus their examinations in this area on both the suitability and supervision of such incentives.

For firms, it is important for branch office management teams to fully understand the incentive programs being provided to brokers under their supervision and be on the look out for any sales practice abuses that could be engendered to such programs. To aid in such efforts, firms could attempt to develop trend reporting that could identify, for example, brokers who are meeting (or not) their commission-based incentives.

VI. INVESTMENT ADVISOR DUE DILIGENCE FOR BROKER-DEALERS

A fair amount of scrutiny is being placed on the use of discretionary money managers by broker-dealers. Firms may wish to consider reviewing and enhancing their due diligence processes and red flag reviews relating to the selection and use of outside managers.

As one example of the regulatory focus in the enforcement context, in early 2009, the SEC brought a case against a firm in a matter involving the selection of pension managers.

1. *In the Matter of Merrill Lynch, Pierce, Fenner & Smith, Inc.* ("Merrill Lynch"), Admin. Proc. File No. 3-13357 (Jan. 30, 2009); *In the Matter of Jeffrey Swanson*, Admin. Proc. File No. 3-13358 (Jan. 30, 2009); *In the Matter of Michael Callaway*, Admin. Proc. File No. 3-13356 (Jan. 30, 2009)

The SEC settled an administrative proceeding against Merrill Lynch alleging that the firm violated its fiduciary duties to certain pension fund clients when it failed to disclose and misrepresented material information concerning its money manager selections for clients. The SEC contemporaneously settled a related administrative against Jeffrey Swanson, a Merrill Lynch investment adviser representative, who allegedly aided and abetted Merrill Lynch's violations.

The SEC alleged that between 2002 and 2005, Merrill Lynch misrepresented its process for selecting money managers for clients of its Ponte Vedra South office. Merrill Lynch's disclosures described a complex and extensive search process through which its Consulting Services program would identify the most suitable money managers for each client based on the client's objectives and risk tolerance. The SEC alleged, however, that Merrill Lynch's Ponte Vedra South office, not the Consulting Services office, selected managers for its clients based on a much smaller universe of potential money managers, some of whom were not approved by Consulting Services.

Merrill Lynch also offered its clients an option to pay the fixed fee associated with use of its Consulting Services in cash or through directed brokerage. Merrill Lynch allegedly failed to disclose to clients that the firm received far greater revenues when clients opted to pay with directed brokerage than when they paid in cash. Similarly, Merrill Lynch allegedly failed to disclose that it had a direct financial incentive to recommend that clients use Merrill Lynch for services related to transitioning funds from one money manager to another.

The SEC also charged Merrill Lynch with failing to supervise the Ponte Vedra South branch office's provision of these services and failing to maintain adequate records.

Merrill Lynch and Swanson each agreed to a censure and to cease and desist from further violations, and the firm consented to paying a civil penalty of \$1 million.

The SEC also brought related charges against Michael Callaway, another Merrill Lynch investment adviser representative, who initially contested the charges. In June 2009, Callaway settled the matter agreeing to an order directing him to cease and desist, censuring him and imposing a \$20,000 civil penalty.

VII. REPEAL OF NEW YORK STOCK EXCHANGE RULE 312(f)(1)

Historically, New York Stock Exchange member organizations and their brokers were prohibited from recommending transactions in their own securities pursuant to NYSE Rule 312(f)(1). In contrast, NASD-only member firms were simply required to disclose to investors the existence of a control relationship prior to entering into such transactions, in accordance with NASD Rule 2240. In conjunction with FINRA's ongoing rule consolidation project, these differences will be eliminated.

In Regulatory Notice 09-60 (October 2009), FINRA announced that the SEC had approved the repeal of NYSE Rule 312(f) and the adoption of new FINRA Rule 2262

that mirrored previous NASD Rule 2240. The rule change becomes effective December 14, 2009.¹²

These changes will require legacy NYSE firms and brokers to adjust their compliance, supervisory and surveillance protocols to allow for the solicitation of their own securities.

¹²

Excellent summaries of these changes from which this section was drawn can be found in two law firm publications: “FINRA Repeals Rule 312(f) Relating to Recommendation by NYSE Member Firms of Affiliate Securities; Retains Broader Disclosure Requirement” (Shearman & Sterling Client Publication, October 2009) and “FINRA Rulebook Consolidation Developments – Repeal of NYSE Rule 312(f)(1)” (Bingham Alert, October 19, 2009).