

Securities Compliance and Examinations for Broker-Dealers, Advisors, and Funds

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I. INTRODUCTION¹

This outline describes several key topics relating to the securities regulatory examination process, sets forth recent SEC and FINRA enforcement developments and summarizes various enforcement actions that may be relevant to conference attendees.

II. BACKGROUND INFORMATION ON REGULATORY EXAMINATIONS

A. Types of Examinations

1. Routine examinations are the most common examination type and generally follow a set schedule and procedures. These examinations regularly involve an inspection of a firm's financial, operational and sales practice compliance to determine whether it is in compliance with applicable laws, rules and regulations.²
2. Cause examinations are typically triggered by events that would require firms to make certain filings such as on Forms U4 and U5 or pursuant to new FINRA Rule 4530. For example, a regulator may initiate a cause examination based upon an employee's termination for cause, as a result of a customer complaint or series of complaints regarding a broker or a particular type of investment (e.g., annuities or principal protected notes). Cause examinations may also result from arbitration referrals, surveillance triggers or referrals from other securities regulators.
3. Sweep or special examinations typically involve a large number of firms that are scrutinized relating to a specific industry issue. Recent examples of sweep examinations include those relating to sales of structured products to retail customers, advertisements and sales literature for exchange traded products, and bank broker-dealer services.
4. FINRA also conducts examinations of branch offices and market regulation exams focusing on compliance with various trading and market conduct rules.
5. In addition to routine, cause and sweep exams, the SEC also conducts "oversight" examinations of firms that have been recently inspected by FINRA. In an oversight examination, the SEC is evaluating a firm's

¹ This outline was drafted by Ben A. Indek, a partner of Morgan, Lewis & Bockius LLP. It is based upon prior outlines developed by Mr. Indek with the assistance of panelists at other conferences as well as several partners and associates at his Firm. Mr. Indek greatly appreciates their assistance. This outline does not reflect the views of the other panelists or their organizations.

² Both the SEC and FINRA have posted various written materials, webcasts and podcasts on their websites relating to the routine examination process. The materials provide an overview of their examination programs and practical guidance on preparing and handling inspections. Cites to such materials are included below.

compliance with relevant rules and the efficacy of FINRA’s examination program.³

III. THE EXAMINATION PROCESS

A. Notice of Commencement of Exam

1. Notice

a. SEC and FINRA rules do not require that notice be given in advance of an examination. Yet, notice is generally provided for routine examinations in order to facilitate advance production of requested material and an overall orderly examination. Cause and sweep examinations typically involve little or no notice. Often however, the SEC and FINRA will publicly hint at or actively announce impending or ongoing sweeps.

(i) Routine examinations initiated by FINRA generally will be announced up to 30 days in advance. Certain examinations may be announced earlier, up to 60 days, where additional time is necessary for pre-examination data gathering.⁴

(ii) Prior notice by SEC staff ranges from a few days to a few weeks for routine examinations. However, the staff may arrive unannounced to conduct cause examinations, the first examination of a firm, or certain other examinations focused on particular areas.⁵

2. Benefits of Notice

a. Documents can be located and organized in advance.

b. Supervisors and compliance personnel can be prepared for anticipated questions.

c. Individual schedules can be rearranged.

³ For an excellent overview of the SEC and SRO examination process *see* Clifford Kirsch & Holly Smith’s “SEC & SRO Inspections,” Chapter 23, contained in Kirsch’s “Broker-Dealer Regulation” published by PLI. Several of the practical suggestions noted in this outline came from this outstanding work.

⁴ *See* FINRA Compliance Boot Camp, “Preparing for an Exam/Responding to Regulatory Inquiries,” September 6-7, 2007; “What Dually Regulated Firms Should Expect Upon Consolidation,” September 20, 2007; and the “What to Expect” Webcast series: Preparing for a FINRA Cycle Examination.

⁵ *See* OCIE Examination Information for Broker-Dealers, Transfer Agents, Clearing Agencies, Investment Advisers and Investment Companies (Nov. 2007) and OCIE’s Examinations by Securities and Exchange Commission’s Office of Compliance Inspectors and Examiners (Feb. 2011) (“February 2011 OCIE Update”) on the SEC’s website.

- d. Firms can reduce the time that examiners are on site with good preparation.
 - e. Firms can focus their attention on the examination at hand rather than responding to requests for documents or information.
3. Benefits of No Notice
- a. Regulators believe that the integrity of the information provided by a firm is enhanced when it is produced by a firm with little or no notice.
 - b. Where a firm is able to effectively and efficiently respond to a surprise examination, it further supports the notion that the firm has good systems and controls in place.

B. Pre-Exam Work by a Regulator

- 1. Prior to the commencement of any regulatory examination, SEC and FINRA examiners spend considerable time and effort gathering and reviewing available data regarding the firm to be inspected. This process includes obtaining information from within the SEC or FINRA (including information relating to customer complaints, prior disciplinary history, litigation, statistical data, etc.) and requesting information and records from the firm.
- 2. As part of the pre-exam process, FINRA members are required to review and update their information on Web IR. FINRA also routinely asks for information regarding branch offices that the examiners may visit during their inspection. This provides information on a firm's structure and activities.
- 3. The pre-examination process is the opportunity for the regulator to gain an understanding of the firm, its registered persons and business activities in order to focus the inspection on relevant issues.

C. Handling the Day-to-Day Examination

- 1. Notification of Requested Material/Information
 - a. Documents that are typically requested for routine examinations are limited to a specified period of time and are usually standard in nature. Requests for internal audit reports, branch examination reports, records regarding internal disciplinary actions, extensive e-mail records and other related materials may raise issues that should be addressed with the staff.

2. Initial Meetings

Both FINRA and SEC examiners hold initial meetings with firms upon their arrival for the on-site portion of an examination. These meetings typically involve compliance professionals and may also include senior business executives.

3. The Duration of Regulatory Examinations

The duration of routine examinations varies based on the size of a firm and the number of examiners dedicated to the project. For large firms, routine examinations may take six months or longer to complete. (Of course, much of that time will be spent off-site analyzing materials and following-up on open issues.) Firms should keep in mind, however, that the more effort they put into producing requested material on a timely basis, and the more effort that is made to making sure that the examiner(s) understand the firm's business and methods of operation, the less time the regulators are likely to spend completing the examination.

4. Status Reports

- a. Generally, firm representatives involved in the examination process shy away from asking the regulators for interim status reports. Firms are concerned that by asking too many questions, the regulators may become overly suspicious. Yet, a reasonable and timely request for interim status reports may enable a firm to promptly respond to any open issues. A firm might then be in a position to explain or clarify certain information before it becomes part of the exit interview.
- b. The examiners will usually provide interim information or findings prior to the exit interview. This could be partly affected by the individual involved and the ability of each firm to establish an appropriate rapport with the examiners.

5. Exit Interviews and Examination Reports

- a. FINRA and the SEC typically hold an exit interview at the conclusion of a routine examination. To a great extent, this meeting has become a formality where the examination staff goes through the alleged violations with the firm's senior management on what was found during the course of the examination and what they may include in their written report to the firm.
- b. Firms should view the exit interview the same way they view status reports. In other words, every opportunity should be taken to demonstrate to the examiners the firm's commitment to the

compliance function and to advocate its position with respect to each of the preliminary findings.

- c. Who attends the exit interview from the firm's standpoint should be considered carefully. When a firm sends senior representatives to this meeting, it demonstrates respect and concern for the examination process.
- d. Regulatory examinations typically conclude with the delivery of a report to the firm identifying the results of the inspection. Such reports require a written response by the firm, typically within 30 days.

6. Examination Results

- a. At FINRA, the results of an examination can include:
 - (i) No further action
 - (ii) Cautionary action
 - (iii) Compliance conference
 - (iv) Referral to Enforcement for review and final disposition
- b. SEC examinations can result in:
 - (i) No further action
 - (ii) A deficiency letter
 - (iii) A meeting or conference call to emphasize the seriousness of the deficiencies identified above and beyond the sending of the deficiency letter
 - (iv) Referral to Enforcement for further review
 - (v) Referral to an SRO for further investigation

IV. PRACTICAL GUIDANCE FOR HANDLING REGULATORY EXAMINATIONS

A. Steps to Take Before the On-Site Portion of the Exam Begins

- 1. Notify senior management, compliance and legal of an upcoming examination. Review the examination notice and identify and notify parties responsible for responding to the request. Discuss with the examiners before they arrive any requests that are unclear or potentially over-broad.

2. Review records from prior examinations to confirm that noted deficiencies have been addressed.⁶
3. Designate a knowledgeable, cooperative and personable employee to be the primary interface with the examiners during the examination. Advise other personnel of the upcoming examination, and who the primary interface will be. Suggest that all communications with the examiners be handled by the primary interface.
 - a. A senior Compliance Department employee is ideal, but each firm should carefully identify the “right person.”
4. Organize and have ready for inspection the documents requested by the regulator. Have personnel available for the first meeting.
5. Set aside space in each of the firm’s offices visited by the examiners enabling them to work more efficiently to conclude their examination. Also, providing the examiners with their own designated space will minimize the disruption of normal business activity.
6. If possible, ask the examiners in advance what resources they will need from you (e.g., computer, printer, telephone, etc.).

B. Actions to Take During the Exam

1. Educate the examiner about the nature of the firm’s business activities, philosophy, and organizational structure. It is critical to make sure that the firm and the examiner(s) are “speaking the same language.”
2. Encourage communication between firm representatives and examiners to gauge the examiner’s progress and impressions.
3. Firms should cooperate and accommodate all reasonable requests by producing and reviewing requested documents as quickly as possible. Firms will not gain points by making the staff sit idly waiting for documents. In addition, the longer the examiners wait, the more time they have to come up with additional document requests.
 - a. While cooperative, firms should not give unfettered access to records or allow regulators to roam through files. Ask examiners to communicate all requests through the primary interface. Examiners should not ask administrative staff or other personnel for information.

⁶ See Kirsch & Smith at 23-4.

- b. SEC Rule 17a-4(l) requires firms to make and keep current, separately for each office, certain books and records relating to the office. Where a firm does not maintain the records at an office, the firm may choose to produce the records “promptly” at the request of the regulator. The term “promptly” is not defined in the rule. According to the SEC, requests for records should generally be filled on the day the request is made. The SEC has informed the industry that, “valid reasons for delays in producing the requested records do not include the need to send the records to the firm’s compliance office for review prior to providing the records.”
 - c. Particular care should be taken to withhold any record that is privileged or otherwise protected from disclosure, but be certain any information withheld is actually privileged. Just because a document may be labeled “privileged” or “confidential” does not make it so.
 - d. Copies of any records provided to a regulator should be maintained by the firm and appropriately labeled to maintain the confidential nature of such materials; this includes documents provided to regulators on CD or in any other electronic medium. Make sure to replace originals in the file from which they were obtained.
- 4. Where a firm is advised of a problem or concern perceived by a regulator during the course of an examination, the firm should consider taking prompt remedial steps to address the issue prior to the conclusion of the inspection.
 - 5. Prior to the examiners leaving the premises, attempt to locate any missing documents requested during the inspection and provide such materials to the staff.
 - 6. Where disagreements have occurred during the course of an examination, the firm should make clear their position on any such issue prior to the conclusion of the on-site portion of the inspection. If there is strong disagreement on an issue, consider the appropriateness of contacting the examiner’s supervisor for discussion before the issue is identified as a finding.

C. Responding to the Examination Report

- 1. Firms should consider the following in connection with the examination report:
 - a. Promptly review the report with senior executives.

- b. Continue to take remedial actions to address any identified concerns or begin the process with respect to issues raised only in the report.
- c. Draft and be prepared to provide revised procedures that address any identified concerns.
- d. Draft and circulate a detailed response.
- e. Include responses and any necessary attachments documenting corrective action to all items identified in the report.

D. Tracking Corrective Action Plans

- 1. A firm should consider developing and implementing a written plan that identifies and tracks the remedial actions to be taken as a result of deficiencies identified by an SEC, SRO or state examination.
- 2. The plan could identify the issue, describe the remedial steps, assign responsibility and define timelines for the action items.
- 3. A firm should consider testing for adherence to any recently implemented policies, procedures or systems prior to the onset of the next examination to confirm that any deficiencies are not repeated.

E. Using the Exam Process to Improve Compliance⁷

- 1. After an examination, firms should consider taking various steps to use the results of such inspections to enhance their compliance protocols, including:
 - a. Actively monitoring for compliance with any new procedures put in place;
 - b. Including the examination findings in supervisory control processes;
 - c. Training employees on examination findings; and
 - d. Incorporating the findings into continuing education plans and programs.

⁷ See “Leveraging the Exam Process to Improve Firm Compliance Practices,” FINRA PowerPoint presented at its Oct. 2008 Fall Securities Conference.

V. RECENT REGULATORY DEVELOPMENTS CONCERNING BROKER-DEALER EXAMINATIONS

A. FINRA

1. Personnel changes
 - a. Suzanne Axelrod has been appointed head of Member Regulation Sales Practice
 - (i) Michael Rufino was named Ms. Axelrod's Deputy.
2. FINRA's examinations are much more risk-based than in the past and now focus on detecting potential instances of fraud at member firms.
3. FINRA examiners will devote more time and effort to inspecting firms' branch offices.⁸

B. SEC

1. Personnel changes
 - a. Last year the SEC selected Carlo di Florio to run OCIE. Norman Champ was made the Deputy Director in this office. Gene Gohlke retired from the SEC after more than 35 years of service. He had been a long-time Associate Director of Examinations in OCIE.
2. OCIE's self assessment⁹
 - a. OCIE embarked on a wide-ranging "self assessment" of its entire examination program and operations. As a result of that exercise, OCIE has developed the following four core principles:
 - (i) Risk-based approach
 - (ii) Teamwork and collaboration
 - (iii) Ongoing improvement and accountability
 - (iv) Focus
 - b. Additionally, OCIE developed a new governance structure for its National Examination Program, which includes the creation of several steering committees tasked with focusing on personnel, the

⁸ See Officials Tell Registrants to Get Ready for SEC, FINRA's New Risk-Based Exams, BNA broker-dealer Compliance Report (Mar. 2, 2011).

⁹ See February 2011 OCIE Update.

exam process, technology, and compliance, ethics and internal controls.

VI. EXAMINATION PRIORITIES

A. FINRA 2011 Examination Priorities¹⁰

1. Fraud detection
2. Fraudulent activity associated with customer accounts
3. High-frequency trading, algorithms, sponsored access, direct market access and trading pauses
4. Short sales and Regulation SHO
5. Information barriers
6. Private placements and private self-offerings
7. Trading in non-public securities
8. High-yield investments
9. Municipal securities
10. Non-conventional investments
11. Exchange-traded funds and notes
12. Vulnerable customers
13. Electronic communications and social media
14. Consolidated account reports
15. Hiring and compensation practices
16. Outside business activities and private securities transactions
17. Master/sub-account relationships
18. Funding and liquidity risk management
19. Intercompany transactions/affiliate relationships and activities
20. Governance and control over margin lending

¹⁰ See February 8, 2011 Annual Regulatory and Examination Priorities Letter, available on FINRA's website.

B. SEC “Select Areas of Focus” for Broker-Dealers Examinations¹¹

1. Verification of assets and controls
2. Oversight of dually registered or affiliated entities
3. Manipulations
4. Structured products
5. Reasonable inquiry procedures
6. Compensation incentives and other compliance issues associated with registered representatives switching firms
7. Adequacy of broker-dealers’ branch office audits
8. Broker-dealers maintaining customer accounts utilizing a “master/sub-account” structure
9. Broker-dealers offering sweep arrangements to affiliated and non-affiliated banks
10. Exchange-traded fund sponsors, distributors and markets
11. Compliance with supervisory control requirements: Compliance with NASD Rule 3012 and FINRA Rule 3130
12. Oil and gas offerings
13. Prime brokerage
14. Regulation SHO
15. Sales to senior citizens
16. DMA
17. Misuse of non-public institutional order information
18. Anti-money laundering
19. Internal controls
20. Information barriers

¹¹ See February 2011 OCIE Update.

VII. SPECIAL ISSUES DURING REGULATORY EXAMINATIONS

A. Internal Audit Reports

1. SROs generally take the position that internal audit and other internal investigative reports will not be requested on a routine basis, but will be required to be produced when special circumstances dictate.
2. Attorney-Client Privilege
 - a. Requires a “communication” between the client and the attorney.
 - b. The privilege may extend to agents of the attorney, but only under certain limited circumstances.
 - c. This privilege would generally not apply to internal audit reports prepared by non-attorneys.
3. Self-Evaluative Privilege
 - a. The theory behind this privilege is to promote the public interest in encouraging institutional self-policing by protecting internal investigative reports of corporate wrongdoing. Criteria that must apply: (1) the information to be protected must result from critical self-analysis, (2) the free flow of this category of information must advance the public interest, (3) the absence of confidentiality would discourage the free flow of the information in question.
 - b. Courts have construed the application of this privilege narrowly and inconsistently.
4. Considerations when responding to a regulatory request for internal audit reports.
 - a. Authority of request.
 - b. Nature of documents requested.
 - c. Alternative arrangements to provide information.

B. Employee Interviews

1. SRO rules and regulations arguably permit examiners to conduct employee interviews during the course of an examination.
2. SEC provisions do not permit examiners to require an employee to submit to an interview during the course of an examination.

- a. Upon arriving at the firm, SEC examiners distribute a copy of SEC Form 1661 entitled “Supplemental Information for Regulated Entities Directed to Supply Information Other Than Pursuant to a Commission Subpoena.” The Form describes the obligation to provide “mandatory” information pertaining to books and records requirements contained within Sections 17(a) and (b) of the Securities Exchange Act of 1934, among other provisions. Failure to provide “mandatory” information may result in criminal, civil or other sanctions. Information outside the scope of the “mandatory” information is voluntary.
3. If an examiner requests conducting an employee interview, firms and their employees arguably have the right to be represented by counsel or other representatives during interviews conducted by examiners. Potential collateral consequences and/or a potential disciplinary action may require that firms and individuals be afforded the opportunity to seek advice of counsel prior to responding to requests for interviews from an examiner. This is particularly true if the area of inquiry is anticipated to proceed to enforcement or involves privileged information.
4. Firms should maintain strict control over the examiner’s access to firm employees. A senior compliance employee or other qualified person should be assigned the task of serving as the liaison for the examiner. In the branch, the branch manager or operations manager should be assigned that task. The examiner should be informed that all requests for information and documentation be directed to the appointed liaison. Should an examiner seek to interview a firm employee, the firm should insist on being given sufficient notice so it may discuss the issue with the employee and allow the employee to decide if he or she wishes to seek advice of counsel.
5. Firms should insist that examiners do not interview brokers concerning pending complaints and arbitration proceedings. Such inquiries should be directed to the liaison assigned to respond to inquiries from the examiner. Attorney-client privileged communications may have taken place between the employee and counsel. The employee and the firm may be deemed to have waived the privilege if the employee responds to question asked by the examiner.

VIII. FINRA ENFORCEMENT DEVELOPMENTS AND CASES

A. Personnel Changes

Late last year, FINRA announced that it had appointed J. Bradley Bennett as the new Head of Enforcement, effective January 1, 2011. Mr. Bennett joined FINRA from Baker Botts in Washington, D.C.

In May 2011, two senior Enforcement officials left FINRA. Chief Counsels Linda Riefberg and Suzanne Elovic, who each led an enforcement unit in New York, departed from FINRA after serving with the organization and its predecessor (NYSE Regulation, Inc.) for many years. Richard Best, a Director of Enforcement, was elevated to Acting Chief Counsel.¹²

B. Enforcement Statistics

Through June 2011, FINRA appears to be off to a fast start in bringing cases with large fines. Specifically, as shown in the following table, in the first half of this year, FINRA imposed fines of more than \$100,000 in a greater number of cases than it had during the same period in 2010. This is particularly true with respect to fines over \$1.5 million.¹³

Fine Range	2010 (Jan. – June)	2011 (Jan. – June)
\$100,001 to \$250,000	14	10
\$250,001 to \$500,000	7	10
\$500,001 to \$750,000	4	5
\$750,001 to \$1,000,000	0	3
\$1,000,001 to \$1,500,000	1	1
\$1,500,001 or more	1	5
Total	27	34

For context, in 2010, FINRA filed 1,310 new disciplinary actions – an increase of 13% from the 1,158 in the prior year. FINRA also resolved 1,178 formal actions last year; in 2009, it had concluded 1,090 such cases. Last year, FINRA expelled 14 firms from its membership (compared to 20 in the prior year), barred 288 people (versus 383 in 2009) and suspended 428 individuals (an increase over the 363 such actions in the prior year).¹⁴

Last year, FINRA reported that it had levied fines of almost \$42.2 million. That figure represents a decline from the \$47.6 million in fine revenue in 2009, a decrease of \$5.4 million or 11.3%. According to FINRA, the number of fines it levied in 2010 remained flat compared with the prior year (643 fines imposed in 2010 versus 644 in 2009). The average fine, however, decreased from about \$73,900 in 2009 to approximately \$65,600 in 2010. In 2010, FINRA ordered firms and individuals to provide nearly \$6.2 million in restitution to customers.¹⁵

C. Enforcement Policy Developments

¹² Compliance Reporter, May 2011.

¹³ The information in the table was collected based on our review of FINRA’s monthly “Disciplinary and Other FINRA Actions” publications and FINRA news releases issued between January and June 2010 and 2011.

¹⁴ See FINRA Statistics page available at: <http://www.finra.org/Newsroom/Statistics/>.

¹⁵ See FINRA 2010 Year in Review and Annual Financial Report, available at: <http://www.finra.org/>.

Although Mr. Bennett has only been in place since January, there have been several interesting enforcement developments in that short time.

In one of his earliest press interviews, Mr. Bennett provided three insights to his enforcement approach. Mr. Bennett indicated that he expected his team to be “tough but fair,” that was going to attempt to “streamline the processes that may be bogging down important matters,” and warned that although he had recently switched sides from defending the industry to being its chief prosecutor, “he will not go easy” on financial services firms.¹⁶ In a subsequent interview, Richard G. Ketchum, FINRA’s Chairman and CEO, commented that Mr. Bennett had “brought a renewed passion” to the Department of Enforcement and predicted that the industry will see both more cases and cases brought more quickly.¹⁷

At a spring ABA SRO Sub-Committee of the Securities Litigation Committee panel session, Mr. Bennett described his views regarding sanctions. He emphasized that fines should be proportional to the case under review and the violations being alleged. Mr. Bennett further indicated that fines will have a logic and framework that should provide guidance to firms reviewing such actions. This approach is intended to provide clarity and guidance to the industry.¹⁸

In further comments at the ABA SRO Sub-Committee meeting, Mr. Bennett offered some thoughts concerning the enforcement process. He noted that although he would be generally accessible to defense counsel, he cautioned firms about requesting meetings to discuss “administrative” issues like document production. Rather, Mr. Bennett suggested saving such requests for meetings to discuss important policy and legal issues, after the record in the investigation has been sufficiently developed.¹⁹ Additional issues addressed by Mr. Bennett are described in the following sections.

D. New Self-Reporting Requirements

After several years of operating under two regimes (i.e., NYSE Rule 351 and NASD Rule 3070), effective July 1, 2011, FINRA significantly changed its reporting requirements with the implementation of new Rule 4530.

Perhaps the most important modification concerns firms’ requirement to report certain internal conclusions of rule violations. New Rule 4530(b) obligates a firm to promptly report to FINRA (but in no event later than 30 calendar days) after it has concluded or reasonably should have

¹⁶ “After Years of Defending Wall Street Firms, A Transition to Policing Them,” Ben Protess, New York Times (Jan. 18, 2011).

¹⁷ “Postcrisis, A Regulator Moves to Expand Power Over Wall Street,” Ben Protess, New York Times (Apr. 26, 2011).

¹⁸ See “ABA SRO Sub-Committee of Securities Litigation Committee Sponsors Presentation Featuring New FINRA Enforcement Management,” Memorandum prepared by Mark Knoll and Cristina R. Ryfa of Bressler, Amery & Ross, P. C. (“Knoll and Ryfa Memorandum”).

¹⁹ *Id.*

concluded that the firm or an associated person has violated certain laws, rules, regulations or standards of conduct.

In a major change for both legacy NYSE and NASD firms, with respect to violations by a member firm, broker-dealers are expected to report “only conduct that has widespread or potential widespread impact to the [firm], its customers or the markets, or conduct that arises from a material failure of the [firm’s] systems, policies or practices involving numerous customers, multiple errors or significant dollar amounts.”

The new Rule also provides for the reporting of violations by associated persons. Here, FINRA expects a firm to “report only conduct that has widespread or potential widespread impact to the member, its customers or the markets, conduct that has a significant monetary result with respect to a member(s), customer(s) or market(s), or multiple instances of any violative conduct.”

Senior officials at FINRA have tried to allay industry concerns regarding the new provision by indicating that the Department of Enforcement will not be looking to initiate stand-alone cases under the new Rule and that, when such actions are brought, it will be clear that a pattern of serious misconduct had occurred but was not reported to FINRA.²⁰

Commenting on the new Rule, Mr. Bennett indicated that credit for extraordinary cooperation will continue to be available to firms in instances where such efforts save FINRA significant time and effort and/or those where firms provide the Staff with information that it would otherwise not be able to obtain on its own.²¹

Guidance concerning these new reporting requirements is set forth in FINRA’s Regulatory Notices 11-06 and 11-32.

E. Current FINRA Enforcement Priorities

Based upon our review of currently available public information, we believe that the following list reflects some of FINRA’s top enforcement priorities.

- **Anti-Money Laundering:** FINRA continues to review anti-money laundering issues, including examining master/sub accounts.
- **Regulation D offerings:** FINRA is concerned about suitability, supervision, advertising and potential fraud in these kinds of offerings. FINRA is reportedly looking closely at the potential liability of individual registered representatives who may have engaged in inadequate due diligence and the suitability of recommendations made by brokers.
- **Structured products:** Continuing its emphasis on the sales practices and supervision regarding structured product offerings to retail investors, FINRA

²⁰ See Knoll and Ryfa Memorandum and “Prospect Unclear This Year Of Congress Moving on Adviser Oversight, Ketchum Says,” Broker-Dealer Compliance Report (May 25, 2011).

²¹ See Knoll and Ryfa Memorandum.

remains focused on reverse convertibles, principal protected notes and other structured products.

- **Regulation S-P**
- **Non-traditional ETFs:** FINRA is reportedly probing advertisements relating to these products and sales practices regarding leveraged, inverse or leveraged inverse ETFs.
- **Routine fees:** Senior FINRA officials have indicated that there may be cases involving excessive charges for routine fees (e.g., postage and handling fees in connection with transactions) in its enforcement pipeline.
- **Municipal securities:** FINRA’s activities appear to be homing in on sales practices, disclosures, suitability, and pricing. Moreover, FINRA has indicated interest in the delivery of official statements and firms’ procedures for disclosing material information to investors.
- **Municipal securities underwriting:** FINRA has publicly commented that it is reviewing the pricing and fees connected with municipal bond underwritings. Enforcement is also reportedly investigating member expenses related to the entertainment of issuers and rating agency officials.
- **Auction rate securities:** Recent comments from senior staff suggest that these cases may be coming to an end.
- **Credit crisis:** FINRA officials have remarked that its credit crisis investigations should be wrapped up by next year.

Key topics for FINRA’s Enforcement, Member Regulation and Market Regulation Departments are also set forth in detail in the lengthy 2011 Annual Regulatory and Examination Priorities Letter.²²

F. Revisions to FINRA’s Sanction Guidelines

In March 2011, FINRA announced four revisions to its Sanction Guidelines. First, the Sanction Guidelines now make clear that “proximate causation” is the required standard for restitution orders in FINRA disciplinary actions. Second, the Sanction Guidelines have been revised to recognize that, where appropriate, adjudicators may order the use of disgorged funds to remedy customer harms, rather than adding those moneys as a fine payable to FINRA. Third, the Sanction Guidelines now reflect that not every factor in the Principal Considerations in Determining Sanctions section have the potential to be aggravating and mitigating considerations. Rather, the use of a factor is dependent upon the facts and circumstances of the particular case and the type of violation under consideration. Finally, the Sanction Guidelines have been amended to instruct adjudicators to also consider sanctions imposed by other

²² See 2011 Annual Regulatory and Examination Priorities Letter (Feb. 8, 2011).

regulators for the same misconduct and to determine whether that sanction was sufficiently remedial in nature.²³

G. Revolving Door Restrictions Proposal

Recently, FINRA submitted a proposed rule change to the SEC that would impose certain restrictions on former officers. The proposed rule change would amend Rule 9141 to prohibit a former senior FINRA officer from appearing on behalf of clients before certain adjudicators (i.e., Hearing Officers, Hearing Panels, the National Adjudicatory Council, and the Board of Governors) for a period of one year after leaving the organization. The proposal would also modify Rule 9242 to bar a former officer, for a period of one year after termination, from providing expert testimony for a respondent in a litigated matter. For purposes of both amendments, FINRA officers include Vice Presidents, Senior Vice Presidents, and higher ranking executives.²⁴

H. Targeted Examination Letters

In 2010, FINRA appeared to have significantly slowed its use of this examination/investigative technique, as only four letters were posted to the Targeted Examination Letters page on its website versus eight in the prior year.

Continuing this trend, in the first six months of 2011, only one such letter was published by FINRA. In March 2011, FINRA posted a letter indicating that it was engaging in a review of reverse convertible advertising and sales literature. This is not surprising in light of the enforcement activity surrounding this product.

In a panel discussion earlier this year, Mr. Bennett commented that FINRA would consider increasing the number of Targeted Examination Letters to provide firms with more information about such reviews, which in turn could help firms in examining their own protocols relating to the product or issue that is the subject of the sweep letter.²⁵

I. Disciplinary Actions Database

Prior to April 2010, persons interested in obtaining copies of Letters of Acceptance, Waiver and Consent (“AWCs”) and complaints described in press releases were obligated to request those documents from FINRA. Beginning April 7, 2010, FINRA routinely started to attach copies of AWCs and complaints to its press releases. For all other disciplinary actions, individuals had to contact FINRA to obtain copies of such cases.

In May 2011, FINRA announced the launch of the Disciplinary Actions online database, which makes disciplinary actions available through a web-based searchable system. The new database provides access to AWCs, settlements, National Adjudicatory Council decisions, Office of

²³ See Sanction Guidelines – FINRA Revises Sanction Guidelines, Regulatory Notice 11-13 (Mar. 2011).

²⁴ See Proposed Rule Change to Implement Revolving Door Restrictions on Former Officers of FINRA (Jul. 1, 2011).

²⁵ Knoll and Ryfa Memorandum.

Hearing Officer decisions and complaints. Recently, FINRA linked its Monthly Disciplinary Actions case description summary to the corresponding action in its database.

Taken together, these steps significantly promote transparency and make it easier for counsel to both search for and obtain copies of relevant precedent when engaged in discussions with the staff about the potential sanctions to be imposed in a matter under investigation.

J. Enforcement Actions

Outlined below are summaries of several key cases that may be of interested to the attendees of this conference.

529 Plans²⁶

In 2006, the NASD brought two cases involving 529 plans. Earlier this year, FINRA brought another case in this area.

1. *Merrill Lynch, Pierce, Fenner & Smith Incorporated* (“Merrill Lynch”) (Mar. 2011)²⁷
 - a. FINRA settled a matter with Merrill Lynch in which it alleged that the firm failed to establish and maintain procedures that were reasonably designed to achieve compliance with its suitability obligations for over \$3 billion in sales of Section 529 college savings plans (“529 plans”) from June 2002 through February 2007.
 - b. FINRA alleged that Merrill Lynch’s written supervisory procedures did not adequately ensure that the firm’s registered representatives were considering customer state income tax benefits during their 529 plan suitability analyses.
 - c. FINRA also alleged that Merrill Lynch failed to establish and maintain written supervisory procedures requiring supervisors to perform and document reviews to determine if registered representatives were complying with the suitability requirements before recommending a 529 plan purchase and did not have effective procedures for documenting suitability determinations.
 - d. Merrill Lynch consented to a censure and a fine of \$500,000.

²⁶ Unless otherwise apparent from the context of the descriptions of the actions, the cases described herein are settlements in which respondents neither admitted nor denied the allegations against them.

²⁷ Where the date is cited as a month only (e.g., “Mar. 2011”), the date reflects the month that the case was included in FINRA’s Monthly Disciplinary Actions Publication. Exact dates indicate the day on which FINRA issued a press release about the action.

- e. Merrill Lynch also consented to an undertaking that required it to distribute a stand-alone letter to each current customer who resided in a state that offered 529-related state tax benefits when the customer opened an affected account at Merrill Lynch at any time during the period from June 2002 through February 2007. If requested by the customer within 180 days of mailing the letter, Merrill Lynch must assist in transferring or rolling over the customer's account into a 529 plan of the customer's choice within the customer's home state, waiving any fees in connection with the sale, transfer, rollover, and initial purchase. Merrill Lynch must also provide semi-annual reports to the Enforcement staff describing customer inquiries, concerns, or complaints relating to the letter.

Customer Confidential Information

FINRA remains focused on firms' obligations to maintain the confidentiality of customer information. In addition to a significant action last year, FINRA brought the two cases below on the same date in early 2011. Of note, all three cases indicate that FINRA will take into account significant remedial actions undertaken by a firm to promptly address any customer information breaches.

1. *Lincoln Financial Securities Inc. ("LFS") and Lincoln Financial Advisors Corporation ("LFA")* (Feb. 16, 2011)
 - a. FINRA settled separate matters with LFS and its affiliate, LFA, in which FINRA alleged that they violated privacy rules requiring firms to protect customer information and also failed to adequately supervise their personnel.
 - b. According to FINRA, the firms failed adequately to protect customer records and information in their electronic portfolio management system, OmniSource, and specifically allowed certain employees to share computer sign-on credentials to access OmniSource files for the purpose of conducting business on behalf of the firms. OmniSource contained customer account records consisting of confidential information including names, addresses, Social Security numbers, account numbers, account registrations, transaction details, account balances, birth dates, and e-mail addresses. OmniSource contained approximately 513,559 LFS customer account records and 1,148,874 LFA customer account records as of August 20, 2009.
 - c. FINRA alleged that the firms did not place adequate controls and procedures on the use or dissemination of sign-on credentials, allowing access to customer information outside of the firms' control and management. According to FINRA, the firms also did

not have procedures to disable or change the sign-on credentials after an employee was terminated.

- d. During a portion of the period from 2002 to 2009, the common user names and passwords were used to access approximately 513,559 LFS customer account records. From 2007 to 2009, the common user names and passwords were used to access approximately 800,661 LFA customer account records.
- e. FINRA also alleged that LFS failed to establish procedures mandating that its representatives in the field install antivirus software and other protection on representative-owned computers that were used to conduct LFS securities-related business away from the home office and failed to audit the computers to confirm the installation of such security software. As a result, nonpublic personal information was not properly safeguarded and was at risk of hacking or intrusion schemes.
- f. LFS consented to a censure and a fine of \$450,000 and LFA consented to a censure and a fine of \$150,000.
- g. In setting the sanction, FINRA noted that once the firms became aware of the potential vulnerability of their sign-on credentials within the OmniSource system, they immediately disabled access to the system through the use of common sign-on credentials and transferred oversight to an information security team, established procedures, hired a technology consultant to investigate whether any security breaches had occurred, notified customers and offered credit monitoring and restoration services for one year, established antivirus and other protections, and implemented auditing and inspection plans.

Directed Brokerage

In 2005 and 2006, the NASD brought at least 30 disciplinary actions regarding directed brokerage commissions. As part of that sweep effort, the NASD commenced litigation against the American Fund Distributors. After decisions by an NASD Hearing Panel and the National Adjudicatory Council, a divided SEC struck down the NASD's claims on the case.

1. *In the Matter of Department of Enforcement v. American Fund Distributors, Inc.* ("AFD") (Jun. 24, 2011)
 - a. The SEC set aside a FINRA National Adjudicatory Council ("NAC") decision affirming that AFD violated FINRA's Anti-Reciprocal Rule intended to prevent "conflicts of interest that might cause retail firms to recommend investment company shares based upon the receipt of commissions from that investment company." Commissioners Casey and Paredes issued the opinion,

Commissioner Aguilar dissented, and Chairman Schapiro and Commissioner Walter (both of whom were senior executives at the NASD when the case was originally brought) did not participate.

- (i) In the proceedings below, the NAC held that AFD violated the rule by arranging for its subsidiary to direct over \$98 million brokerage in commissions to 46 retail securities firms between 2001 and 2003 based on those firms' sales of American Funds.
 - (ii) Notably, the NAC disagreed with the Hearing Panel's conclusion that AFD's violations were negligent. Rather, the NAC found that AFD's violations were intentional. The NAC also found additional aggravating factors that the Hearing Panel did not find, including that AFD's reciprocal arrangements undermined fair competition in the industry and could have harmed the brokerage firm's clients.
 - (iii) The NAC rejected certain mitigating factors that the Hearing Panel accepted, such as that directed brokerage was widespread in the industry. The NAC found no evidence in the record to support that conclusion and, in any event, found that it would not excuse the failure to follow FINRA's rules. The NAC also rejected the Hearing Panel's determination that FINRA's subsequent modification of its directed brokerage rules was a mitigating factor. The NAC determined that subsequent rule modifications did not affect AFD's obligations to follow rules that were in effect during the relevant period.
 - (iv) Although FINRA Enforcement had sought a \$98 million fine from the Hearing Panel, the Hearing Panel imposed only a \$5 million fine and a censure, and the NAC upheld the sanctions.
- b. In setting aside the decision and sanctions, the Commission focused on the text of the rule during the relevant period, which prohibited requesting or arranging for the direction of a specific amount or percentage of brokerage commissions **conditioned upon** that member's sales or promises of sales of investment company shares. The SEC agreed with AFD that the commissions were non-binding targets, not obligations, and it was ambiguous whether the rule prohibited such arrangements until a subsequent rule amendment clearly prohibited such practices.
- c. Commissioner Aguilar's dissent noted that while the rule may not have been a model of clarity, he found FINRA's interpretation that the "conditioned upon" phrase prohibited fund sales as a

prerequisite to directing brokerage commissions more reasonable and that it was not necessary that there be a binding obligation. He further found that FINRA had provided sufficient guidance with respect to its interpretation in a Notice to Members.

Prospectus Delivery

Since at least 2004, regulators have been focused on firms' deficiencies regarding delivery of prospectuses. This is another case in this area.

1. *In the Matter of Wells Fargo Advisors, LLC*. (“WFA”) (May 5, 2011)
 - a. FINRA alleged that WFA failed to deliver prospectuses on a timely basis and failed timely to file certain amendments to Forms U4 and U5.
 - b. Specifically, FINRA alleged that WFA failed to deliver prospectuses within three days of purchase with respect to 934,074 mutual fund transactions occurring between January 1, 2009 and December 31, 2009. The customers received the prospectuses between one and 153 days late; 94% of the prospectuses were delivered within 14 days of settlement. FINRA noted that the primary cause of the late deliveries was that certain fund companies did not maintain adequate supplies of paper copies of prospectuses.
 - c. FINRA noted that WFA used a third-party service provider to deliver prospectuses. The service provider had a “print on demand” service whereby it would print an electronic copy of a fund’s prospectus when paper copies were unavailable, but WFA did not use the service extensively. FINRA further alleged that WFA was aware of the deficiencies because the service provider sent daily exception reports to WFA and met quarterly with WFA to review delivery statistics and WFA conducted monthly reviews, all of which showed that prospectuses were not timely sent.
 - d. FINRA further alleged that from July 1, 2008 through June 30, 2009, WFA filed 147 late Form U4 amendments and 40 late Form U5 amendments, representing 7.6% and 8.1%, respectively, of amendments to such forms required in the period.
 - e. WFA consented to a censure, a fine of \$1 million, and an undertaking to adopt and implement systems and procedures reasonably designed to achieve compliance with the filing requirements for Forms U4 and U5 and provide a written certification of such compliance.

- f. In setting the sanction, FINRA noted that WFA had previously paid a fine of \$1.4 million for prospectus delivery and related supervisory violations, and that WFA and an affiliate paid a fine of \$1.1 million for failing to provide approximately 800,000 required customer notifications.

Real Estate Investment Trusts (“REITs”)

Below is a description of a matter involving REITs that is currently being litigated.

1. *Department of Enforcement v. David Lerner Associates, Inc.* (“DLA”) (May 31, 2011)
 - a. In this complaint filed with the Office of Hearing Officers (“OHO”), FINRA alleged that DLA had marketed and sold \$300 million of a REIT without performing adequate due diligence in violation of its suitability obligations.
 - b. According to FINRA, since 2004 DLA had valued the shares in certain REITs consistently and falsely at \$11 per share, despite a fluctuating market. DLA also consistently charged a ten percent fee on all REIT shares sold.
 - c. Further, DLA acted as best efforts underwriter and sole distributor of a series of REITs and FINRA’s complaint alleges that DLA failed to perform sufficient due diligence on the valuation and suitability of the REIT, instead relying on information provided in the REIT’s security filings and opinions issued by outside auditors that did not address valuation practices. FINRA noted that DLA’s undertaking to be best efforts underwriter and sole distributor carried extra responsibility, making it inappropriate to rely on outside sources for due diligence.
 - d. FINRA further alleged that in marketing and soliciting customers for the REIT, DLA presented performance information for earlier REITs, implying that the current REIT would be able to perform similarly. DLA also allegedly mischaracterized the source of distributions of the REIT on its website as well. FINRA noted that these advertising practices had been the subject of two warnings by FINRA’s Advertising Regulation Department in the past year.
 - e. In its complaint, FINRA sought monetary sanctions, disgorgement and any other sanctions OHO deemed appropriate.

Structured Products

While the SEC has seemingly targeted alleged misconduct regarding the marketing and sale of structured products to institutional investors, FINRA has focused its efforts on the sale of these investments to retail customers. Two cases brought earlier this year are summarized below.

1. *Santander Securities Corporation* (“Santander”) (Apr. 12, 2011)
 - a. FINRA settled a matter with Santander in which it alleged unsuitable sales of reverse convertible securities to retail customers, inadequate supervision of sales of structured products, inadequate supervision of accounts funded with loans from its affiliated bank, and other violations related to the offering and sale of structured products.
 - b. According to FINRA, for most of the period from September 2007 to September 2008 the firm had no formal procedures for reviewing or approving structured products before offering them to customers. Instead, individual brokers evaluated the products, but received limited and inadequate training, guidance and supervision related to structured products, including their risks and their suitability for individual clients. During the relevant period, Santander customers invested \$130 million in reverse convertibles and the firm earned more than \$1.7 million in commissions.
 - c. According to FINRA, the firm also failed adequately to follow up on compliance reports of accounts over-concentrated with positions in reverse convertibles, including identification of 108 accounts holding more than 20% of the accounts’ value in a single reverse convertible product, accounting for approximately \$17.8million in reverse convertibles.
 - d. FINRA also found that the firm actively solicited account holders to borrow money from its banking affiliate using securities pledged in their brokerage accounts as collateral, and some brokers then assisted clients in using the borrowed funds to buy reverse convertibles, even though the clients did not understand the products or risks. When the stock market declined precipitously in 2008, some clients were left with large debts to the bank.
 - e. FINRA alleged other violations by Santander, including (i) failing to comply with certain public offering and corporate financing requirements, (ii) inserting confidentiality provisions inconsistent with FINRA guidance in five customer settlement agreements, and (iii) filing six Forms U4 or U5 for brokers that inaccurately reported broker contributions to reverse convertibles settlements when no such contributions were made.

- f. Santander consented to a censure, a fine of \$2 million and an undertaking to (i) review its written policies and procedures, training and available tools in the areas of product suitability, sales supervision, and intrastate offerings; (ii) establish written policies and procedures for the development and vetting of new products; and (iii) train personnel with responsibility for FINRA regulatory filings.
 - g. In setting the sanction, FINRA noted that Santander had provided over \$7 million in restitution to customers.
2. *In the Matter of UBS Financial Services, Inc.* (“UBSFS”) (Apr. 11, 2011)
- a. FINRA alleged that between March 2008 and June 2008, UBSFS made statements and omissions that effectively misled some investors regarding the “principal protection” feature of “100% Principal Protection Notes” (“PPNs”) Lehman Brothers Holdings Inc. issued prior to its September 2008 bankruptcy.
 - b. According to FINRA, some UBSFS financial advisors described the structured notes as principal-protected investments and failed to emphasize that the investments were unsecured obligations of Lehman Brothers subject to issuer credit risk.
 - c. FINRA alleged that UBSFS failed to establish an adequate supervisory system for the sale of these notes and failed to provide sufficient training and written supervisory policies and procedures, noting that some of the financial advisors did not understand the product.
 - d. FINRA also alleged that the firm did not adequately analyze the suitability of the sales of Lehman-issued PPNs to certain customers and created and used advertising about the PPNs that was effectively misleading to customers.
 - e. UBSFS consented to a censure, a fine in the amount of \$2.5 million, and customer restitution of \$8.25 million.

Supervision

Year in and year out, FINRA brings a number of supervisory cases. Below are five such actions initiated in the first six months of 2011.

- 1. *In the Matter of BNP Paribas Securities Corp.* (Feb. 2011)
 - a. FINRA alleged that BNP Paribas Securities Corp. (“BNPP”) failed to establish and maintain adequate systems and procedures regarding its Listed Option Desk (“LO Desk”) and Stock Loan and

Borrow (“SLAB”) desks, maintained certain inaccurate books and records, and filed an inaccurate Form U5 during 2007.

- b. According to FINRA, the LO Desk was one of only a few desks at BNPP that was allowed to mark positions manually throughout the trading day on a case-by-case basis by individual traders. However, no supervisor on the LO Desk or in the larger department housing the LO Desk reviewed the manual valuations and, although there was a procedure in place to create a report of such valuations, none was ever generated.
- c. Because of this deficiency, BNPP was unaware of losses, caused by one trader, of more than \$18 million incurred over an 11-week period in 2007 on the LO Desk. When another trader was promoted to supervisor of the desk in late 2007, he undertook a review of the manual positions and discovered the issues with this trader. Following this discovery, BNPP sought the trader’s resignation, in lieu of termination. At that time, BNPP filed a U5 for the trader.
- d. FINRA alleged that failures stemming from the LO Desk caused certain of BNPP’s books and records to be inaccurate prior to November 2007. In addition, FINRA alleged that, when BNPP filed its U5 form for the trader responsible for the inaccurate marks on the LO Desk, it incorrectly indicated that the trader’s termination was “voluntary” when in fact the trader was “permitted to resign.” That trader was also under internal review at the time of his termination, but BNPP further incorrectly indicated that he was not. In May 2008, when BNPP’s internal investigation was completed, the Firm filed an amended U5 and self-reported the LO Desk incident to FINRA.
- e. In addition, in February 2007, BNPP’s SLAB desk pursued an arbitrage opportunity in which it borrowed shares of a stock from a custodial bank and loaned them to a BNPP affiliate. However, the arbitrage opportunity was lost when there was an over-subscription of the cash option of the tender offer of the stock, and BNPP lost approximately €3.4 million. FINRA alleged that BNPP failed to have a system or procedure in place to track and assess the risk of loss for such arbitrage trades.
- f. BNPP consented to a censure and fine in the amount of \$650,000.
- g. In determining the appropriate sanctions, FINRA considered the fact that BNPP self-reported the inaccurate U5 filing prior to filing an amended U5, and also provided substantial assistance to the staff’s investigation of the circumstances that led to the mismarking and improper filing. BNPP was specifically

recognized for its efforts in providing witnesses [for?] on-site for interviews and for creating and providing to the Staff a compendium of highly-relevant documents.

2. *UBS Securities LLC* (“UBS Securities”) (Feb. 2011)
 - a. FINRA settled a matter with UBS Securities in which FINRA alleged that from January to May 2006 UBS Securities failed to (i) monitor adequately the trading activity of a junior trader on its Fixed Income Emerging Markets Latin American Desk (“LatAm Desk”), (ii) provide the trader’s supervisors with reports and information necessary to supervise the trader’s activity, (iii) establish and maintain adequate written procedures, and (iv) maintain accurate books and records.
 - b. FINRA alleged that the trader made false and inaccurate entries into the firm’s trading systems for transactions in Brazil 40 bonds and nondeliverable forward (“NDF”) contracts involving Brazilian Reals and U.S. Dollars, causing the trader’s risk positions to be incorrectly calculated and his profits to be overstated and losses to be understated. The trader lost more than \$28.7 million during the period.
 - c. While most traders on the LatAm Desk used NDFs for hedging, the trader in question was permitted to trade NDFs as a primary product on a proprietary basis for the firm. UBS Securities authorized the trader to enter his own NDF transactions into two trading systems, although other traders on the desk were permitted to use only one. These trading systems belonged to and were maintained on the servers of UBS AG in Zurich, Switzerland.
 - d. While UBS Securities did provide the trader’s supervisor with daily supervisory reports, these reports did not capture NDF trade data, and UBS Securities did not advise the supervisor of the lack of such detail. UBS AG personnel created daily NDF-related profit and loss reports and exception reports, but the majority of the reports were not provided to the firm or the supervisor. In other instances UBS Securities provided reports to the trader himself detailing his own activity, but not to his supervisor.
 - e. According to FINRA, the firm failed to make and keep a memorandum of each NDF transaction; instead, such records were created and maintained by UBS AG. In addition, UBS Securities’ books and records contained false, delayed, and fictitious entries made by the trader.
 - f. FINRA also alleged that UBS Securities failed to have adequate written supervisory procedures for supervising the trader and the

transactions and for maintaining required books and records for the LatAm Desk.

- g. UBS Securities consented to a censure and a fine of \$600,000.
- h. In setting the sanction, FINRA noted that UBS Securities conducted an internal investigation after the trader's activity came to light and that the Firm subsequently instituted remedial measures to prevent the same activity from recurring.
- i. In separate actions, the NYSE barred the trader from the securities industry and the Board of Governors of the Federal Reserve barred him from the banking industry.

3. *NEXT Financial Group, Inc.* ("NEXT") (Jan. 2011)

- a. FINRA settled a matter with NEXT in which it alleged that during the period from February 2008 to March 2009, NEXT failed to detect excessive trading of certain customer accounts and engaged in other supervisory and reporting violations.
- b. According to FINRA, the most significant violation concerned the firm's failure to detect excessive trading by one of its registered representatives in five customer accounts, resulting in unnecessary sales charges totaling approximately \$102,376. FINRA further alleged that 13 other registered representatives engaged in transactions in 38 customer accounts that, based on turnover to cost-to-equity ratios, raised the possibility that they were improperly excessive, but the firm failed to detect or inquire about the transactions. FINRA noted that the firm relied on OSJ branch managers and home office compliance personnel to review weekly blotters of registered representatives' transactions but did not utilize exception reports or any other reasonable system for detecting improper and excessive trading. As such, FINRA found NEXT failed to properly supervise its trading.
- c. With respect to the other supervisory and reporting violations, FINRA alleged the following:
 - (i) NEXT failed reasonably to supervise variable annuity transactions in that the firm was unable to provide evidence of principal approval of 27 of 115 transactions reviewed by FINRA.
 - (ii) NEXT failed reasonably to supervise municipal bond markups and markdowns with respect to 19 riskless municipal bond transactions in which the markups or markdowns ranged from 3.01% to 4.58%.

- (iii) NEXT failed to establish a reasonable branch audit program. FINRA reviewed 60 branch audits and found that in certain instances, firm auditors left audit questions unanswered, there was no home office follow-up on potentially problematic activity, the branch's response to deficiencies was not obtained or maintained, and the audit did not include a review of the branch's checking account.
 - (iv) The firm failed to put two registered representatives on heightened supervision in accordance with its procedures and failed to follow the heightened supervision plan for two other registered representatives.
 - (v) The firm also failed to perform adequate Rule 3012 tests or submit an adequate Rule 3012 report, reasonably supervise private securities transactions in 36 registered representatives' accounts, make certain Rule 3070 and Form U4 and U5 filings in a timely and accurate manner, and properly follow up on certain AML exception reports.
- d. NEXT consented to a censure, a fine of \$400,000 and restitution to customers in the amount of \$103,179.84.

4. *Morgan Stanley & Co. Incorporated* ("Morgan Stanley") (Jun. 2011)

- a. FINRA settled a matter with Morgan Stanley in which it alleged that from August 1999 to December 2008, a firm employee responsible for processing corporate actions misappropriated \$2.5 million from the firm, its institutional customers, and a firm counterparty, and the firm failed to have adequate systems and procedures to prevent such conduct.
- b. According to FINRA, the employee, who was terminated, made numerous false journal entries into the firm's electronic system to transfer and credit money associated with corporate actions and caused 50 checks to be issued to a shell company created by the employee. The employee entered check requests himself, which were approved by persons who reported to him. The employee also caused other employees to enter check requests or used another employee's identification to do so, and then approved the requests.
- c. FINRA alleged that Morgan Stanley did not have a system for reviewing journal entries prior to April 2003. Thereafter, the firm established certain processes and systems, but the employee continued to review and approve his own entries. According to FINRA, from June 2007 to December 2008, the employee made at least 450 journal entries, at least 168 of which were flagged high

priority; the employee approved 57 of them and 111 were not reviewed.

- d. FINRA also found that the firm did not require persons approving check requests to be supervisors and did not confirm that a check request was associated with a corporate action.
- e. Morgan Stanley consented to a censure and a fine of \$375,000.
- f. In determining the appropriate sanctions, FINRA noted that Morgan Stanley discovered and self-reported the employee's misconduct, investigated and corrected its systems and procedures, made remediation to its customers, and provided substantial assistance to FINRA's investigation.

5. *KeyBanc Capital Markets Inc.* ("KeyBanc") (Jan. 31, 2011)

- a. FINRA, on behalf of NYSE Regulation, settled a matter with KeyBanc in which FINRA alleged that the firm failed to (i) establish adequate controls and a reasonable supervisory system with respect to its Control Room procedures, Watch and Restricted Lists, and related trading activities from January 2007 to December 2009; (ii) disclose that it had completed an internal investigation into potentially violative insider trading; and (iii) obtain, review, and monitor certain employee trade confirmations and account statements.
- b. FINRA alleged that KeyBanc had in place written policies and procedures pertaining to its Control Room, Watch and Restricted Lists, and related trading activities which required, among other things, employees to report material nonpublic information to the Control Room for inclusion on the Watch and Restricted Lists; however, KeyBanc failed to establish adequate controls to ensure that its employees were adhering to such policies and procedures. As a result, KeyBanc failed to report a significant number of companies, issuers and event updates to its Watch and Restricted Lists.
- c. FINRA also alleged that KeyBanc failed to disclose to the NYSE in its July 2008 Quarterly Insider Trading Attestation that, in the second quarter of 2008, it conducted and completed an internal investigation into potentially violative insider trading activity. The internal investigation concluded that there was insufficient evidence of violative insider trading.
- d. According to FINRA, KeyBanc also failed to obtain, review, and monitor trade confirmations for certain employee and employee-related accounts from January 2007 to June 2008 in a manner

reasonably designed to ensure compliance with prohibitions against insider trading and manipulative activity.

- e. KeyBanc consented to a censure and a fine of \$350,000.
- f. In setting the sanction, FINRA noted that KeyBanc undertook a comprehensive review and overhaul of its Control Room compliance procedures and increased its compliance resources and that there was a lack of evidence related to the misuse of material nonpublic information in connection with securities on KeyBanc's Watch and Restricted Lists.

Variable Life Settlements

Last year, the SEC published a staff report regarding, among other things, the risks of investments in life settlements. Similarly, FINRA appeared focused on this issue from an enforcement perspective. Earlier this year, FINRA resolved a case in this area.

- 1. *USA Advanced Planners, Inc., et al.* ("USAAP") (Jan. 2011)
 - a. FINRA settled a matter with USAAP in which it alleged that between September 2005 and April 2007, USAAP, acting through its registered principals Michael Rodman ("Rodman") and Dennis Tubbergen ("Tubbergen"), effected five variable life settlement transactions²⁸ in which it charged customers, who ranged in age from 69 to 81 years old, excessive commissions.
 - b. FINRA alleged that USAAP failed to disclose the source and amount of remuneration it received in connection with the life settlement transactions. USAAP received commissions for each of the transactions that ranged from 17% to 36% of the highest gross offer for the variable life policy and in turn paid approximately 90% of that amount to the registered principals.
 - c. FINRA also alleged that USAAP did not provide the customers with a confirmation of each transaction.
 - d. FINRA further alleged that USAAP's supervisory systems, including its written supervisory procedures, were not reasonably designed to achieve compliance with FINRA rules related to the firm's variable life settlement business.
 - e. USAAP and Tubbergen consented to a censure, Rodman consented to a 10-day suspension, and USAAP and Rodman were ordered to

²⁸ A life settlement involves the sale of an existing life insurance policy to a third party for more than the policy's cash surrender value but less than the net death benefit.

pay, jointly and severally, partial restitution to customers of \$351,995 plus interest. Of that amount, \$52,647 was imposed jointly and severally against all three respondents for the transaction that involved the 36% commission. USAAP is also paying all of its outstanding shareholder equity to the five customers as partial restitution, and consequently will have no remaining assets to distribute to its stockholders at its pending dissolution.

IX. SEC ENFORCEMENT DEVELOPMENTS AND CASES

A. Dodd-Frank Whistleblower Provisions²⁹

On May 25, 2011, the Securities and Exchange Commission voted to approve final rules to implement the SEC whistleblower provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”), enacted by Congress on July 21, 2010. The vote was split, with three Commissioners voting in favor of implementation and two voting against. According to the majority of the Commissioners, the final rules attempt to balance the tension between encouraging whistleblowers to come forward to the SEC while simultaneously discouraging them from bypassing internal company compliance programs. The dissenting Commissioners disagreed, taking the position that the failure to require mandatory internal reporting would have a detrimental effect on internal compliance and spur whistleblowers to bypass those internal mechanisms in favor of directly reporting to the SEC.

The Commission’s whistleblower program officially became effective on August 12, 2011.

1. Whistleblowers Protected from Retaliation

A key component of the final rules is the definition of “whistleblower,” which reflects the SEC’s view that the antiretaliation protections of the Dodd-Frank Act do not depend on a finding of an actual violation of securities laws. The final rules provide that “[y]ou are a whistleblower if, alone or jointly with others, you provide the Commission . . . and the information relates to a possible violation of the federal securities laws (including any rules or regulations thereunder) that has occurred, is ongoing, or is about to occur” (emphasis added). This definition tracks the statutory definition, but adds the “possible violation” language, a standard that does not require an actual violation for the antiretaliation protections to apply. In its proposed rules, the SEC had included the phrase “potential violation”; it replaced that phrase with “possible violation” in the final rules.

However, the final rules also require that, to be afforded protection from retaliation, the whistleblower must possess a “reasonable belief” that the employer is violating the securities

²⁹ This section of the Outline was drawn from “SEC’s Final Rules for Implementing Dodd-Frank Whistleblower Provisions: Important Implications for Covered Entities,” by Sarah Bouchard and Thomas Linthorst published May 25, 2011 available at: http://www.morganlewis.com/pubs/FRR_LEPG_LF_SECFinalRulesForDodd-FrankWhistleblowerProvisions_25may11.pdf.

laws. The SEC has defined “reasonable belief” in three ways: (1) specific, credible, and timely information; (2) information related to a matter already under investigation by the SEC, but that makes a “significant contribution” to the investigation; or (3) information that was provided through the employer’s internal compliance mechanisms, which is subsequently reported to the SEC by the employer, and which satisfies the first or second prong of the definition. This standard is a significant change from the proposed rules (which included no such requirement), and the final rules echo and cite to specific comments and proposals that Morgan Lewis submitted to the Commission on December 17, 2010.

Finally, the SEC makes clear that the antiretaliation provisions do not depend on whether the whistleblower ultimately qualifies for an award (see below). An otherwise-eligible whistleblower is protected from retaliation even if the award requirements are not met.

2. Rules Relating to Eligibility for an Award

To be considered for an award, the whistleblower must (1) voluntarily provide the SEC (2) with original information (3) that leads to the successful enforcement by the SEC of a federal court or administrative action (4) in which the SEC obtains monetary sanctions totaling more than \$1 million.

The final rules provide that an individual whistleblower may be eligible for an award of 10% to 30% of the recovery, depending on a number of factors. This range reflects the SEC’s attempt to balance competing interests: receiving high-quality information directly from whistleblowers and encouraging whistleblowers to utilize internal compliance procedures.

3. Reporting Through Internal Compliance Procedures

As an initial matter, a whistleblower need not report information through an employer’s internal compliance procedures in order to be eligible for an award. This issue was left undecided under the proposed rules. In the final rules, however, the SEC has left the decision of whether to use internal compliance up to the individual whistleblower. This reflects the SEC’s belief that whistleblowers will utilize robust internal compliance measures if they exist, despite having no requirement that they do so.

The SEC has set up financial incentives as a further effort to encourage the use of internal compliance measures. In determining the amount of an award, voluntary participation in corporate internal reporting programs can increase the reward, while interference with corporate internal reporting programs can decrease the reward. These incentives had not been included in the proposed rules.

Moreover, if any individual reports information to the company’s internal compliance team or other similar department, the individual has 120 days from the original date of submission to report the information to the SEC. The individual will receive credit as if he or she had reported “original” information to the SEC on the date he or she disclosed it internally. This provision is also designed to promote internal compliance measures.

Similarly, the final rules provide that if a whistleblower reports information through the employer's internal compliance systems, and if the company subsequently self-reports to the SEC, the original whistleblower is credited with the report and any resulting award.

4. Original and Voluntary Information

Further, to obtain an award, the final rules require that the whistleblower come forward voluntarily. The SEC has defined "voluntarily" to exclude information provided pursuant to a subpoena, judicial order, demand from government authority or the Public Company Accounting Oversight Board, or preexisting legal obligation (such as those of certain corporate officers). The whistleblower must also provide "original information" to qualify for an award. "Original information" must be derived from the whistleblower's "independent knowledge or independent analysis."

The final rules exclude certain categories of information from the definition of "original information." For example, the SEC would not generally consider information obtained through an attorney-client privileged communication to be derived from independent knowledge or analysis. The carveout for attorneys reflects the SEC's concern that the monetary incentives of the SEC whistleblower program may deter companies from consulting with attorneys about potential securities laws violations. The final rules also exclude any information gained through the performance of an engagement required under the securities laws by an independent public accountant if the information relates to a violation by the engagement client or its directors, officers, or other employees. This exception reflects the SEC's recognition of the role of independent public accountants and their pre-existing duty under securities laws to detect illegal acts. The SEC also excludes from "original information" any information the whistleblower obtained as a person with legal, compliance, audit, supervisory, or governance responsibilities for an entity, such as an officer, director, or partner, if the information was communicated to the whistleblower through the company's internal compliance mechanisms. However, this exclusion is not absolute, and several exceptions allow such individuals to still be whistleblowers (e.g., if the person believes that disclosure is needed because the company is engaging in conduct likely to cause substantial injury to the financial interest or property of the entity or investors). Here, the SEC attempts to reconcile the tension between the potential bounty available to whistleblowers and its recognition that effective internal compliance programs can promote the goals of federal securities laws.

5. Misconduct and Aggregation

Finally, the final rules do not necessarily disqualify a whistleblower who has engaged in fraud or misconduct, even if it is the same fraud or misconduct the whistleblower is reporting. The degree and nature of the misconduct is simply a factor the SEC will consider in determining the award to a whistleblower. In determining whether the \$1 million in monetary sanctions threshold has been satisfied (a necessary precondition for award eligibility), the SEC will aggregate awards from separate proceedings if the proceedings were based on the same nucleus of operative facts.

6. Impact on FCPA Investigations

The whistleblower provisions of the Dodd-Frank Act will almost certainly result in a significant increase in the number of Foreign Corrupt Practices Act (“FCPA”) investigations initiated by current and former employees through allegations related to bribery of foreign officials. In recent years, some of the highest SEC recoveries have been in FCPA books and records cases, including, in recent months, settlements of \$77 million, \$137 million, and \$218 million. Whistleblowers, who stand to obtain awards of 10% to 30% of those staggering amounts, will be highly incentivized to report allegations of the books and records provision of the FCPA, which the SEC enforces through civil enforcement proceedings.

7. Impact on Covered Entities

According to the SEC, through these final rules it has attempted to “incentivize” whistleblowers to use company internal compliance programs while simultaneously offering whistleblowers the right to contact the SEC directly. Although this compromise may dissuade some from reporting internally, having robust internal mechanisms is still of utmost importance. In light of these rules, companies should undertake a thorough review of their internal compliance programs and assess their effectiveness. The quality of these programs may significantly impact whether (1) a whistleblower approaches the SEC in the first instance, or (2) the employee complains internally and waits to see how effectively the company handles the internal complaint. Further, the availability and quality of these programs will have a significant effect on whether the SEC decides to initiate an investigation, or whether it believes that the company has cured any problematic conduct such that no investigation or enforcement action is necessary.

It is too early to tell whether the final rules will lead to a flood of tips to the SEC that may lack depth and credibility, or if the rules will enhance the quality of information and enforcement. Since the passage of the Dodd-Frank Act, the SEC has reported that it has seen an increase in high-quality tips. It remains to be seen, however, whether increased publicity around whistleblower awards will have an adverse impact on the quality of the reports the SEC receives.

B. Enforcement Docket

Several metrics traditionally used to measure enforcement activity demonstrated that, in FY 2010, the Division of Enforcement actively and aggressively pursued misconduct affecting the U.S. markets. As examples, last year the SEC brought 681 cases; this is its highest total since at least FY 2001. The SEC also brought 53 insider trading cases (up from 37 in FY 2009) that ensnared 138 defendants (versus 85 in FY 2009). For FY 2010, the SEC reported that it had obtained orders requiring payment of approximately \$1.03 billion in penalties – almost three times the amount it had obtained in FY 2009.

Until the SEC’s fiscal year ends on September 30 and the Commission releases its statistics, there is currently no publicly available data on the number of cases brought this year or the

amount of fines imposed. Nevertheless, as early as February 2011, SEC Chairman Schapiro commented that the Commission's "pipeline of significant cases remains full."³⁰

C. Focus on Individuals

Over the last year, it appears that the SEC has increasingly focused on the potential liability of individuals in its investigations. That scrutiny seems to be borne out by the statistics. For example, in connection with financial crisis cases, through August 10, 2011 the Commission reported that it had charged 35 CEOs, CFOs, and other senior corporate officers. It also noted that 21 officer and director bars, industry bars, and Commission suspensions had been imposed on 21 individuals.³¹ This trend can also be seen in several cases summarized below, including those relating to alleged fraudulent sales practices supervision, municipal bond transactions and privacy and confidentiality of customer information.

D. Cooperation Initiatives/New Enforcement Tools³²

In 2010, the Commission announced a series of new measures designed to encourage individuals and companies to cooperate in Enforcement Division investigations and enforcement actions. As we summarized in our 2010 Year in Review, these initiatives include formal guidelines to evaluate and potentially reward cooperation by individuals, and incentives for individuals and companies to cooperate with the Division such as cooperation agreements, deferred prosecution agreements, and nonprosecution agreements.³³ These tools seek to provide the SEC with some of the same methods available to federal prosecutors in fighting white collar crime, and are consistent with the philosophy that Enforcement Director Robert Khuzami and Deputy Enforcement Director Loren Reisner, both former federal prosecutors, have brought to the Division. Below are the developments in these areas that occurred in the first half of 2011.

E. Cooperation Agreements

The Enforcement Division has trumpeted its use of these cooperation tools during the first half of 2011. According to the most recently available statistics, the SEC has entered into

³⁰ "Evolving to Meet the Needs of Investors," Address to Practising Law Institute's SEC Speaks in 2011 program (Feb. 4, 2011)

³¹ See "SEC Enforcement Actions Addressing Misconduct that Led to or Arose from the Financial Crisis," available at: www.sec.gov.

³² Parts of this section of the Outline were drawn from "The Securities and Exchange Commission Announces New Cooperation Initiative," by Patrick D. Conner and E. Andrew Southerling, published January 2010 available at: <http://www.morganlewis.com/index.cfm/publicationID/66edba61-e068-4a7e-8f1a-694da513d7ae/fuseaction/publication.detail>.

³³ The full text of the Commission's release can be found at: <http://www.sec.gov/news/press/2010/2010-6.htm>; the Commission's policy statement is set forth in Release No. 34-61340 (Jan. 13, 2010) at <http://www.sec.gov/rules/policy.shtml>; and the full text of the Division's Enforcement Manual can be found at: <http://www.sec.gov/divisions/enforce/enforcementmanual.pdf>.

approximately 25 cooperation agreements with individuals since its program began, and officials expect that number to increase as the program becomes more established.³⁴

1. Deferred Prosecution Agreements

In May 2011, the SEC announced its first ever deferred prosecution agreement (“DPA”) in connection with a Foreign Corrupt Practices Act (“FCPA”) investigation involving Tenaris S.A., a global steel pipe manufacturer and supplier. DPAs are formal written agreements in which the Commission agrees to forego an enforcement action against a cooperator. These agreements are executed only if the individual or company agrees, among other things, to cooperate fully and truthfully, including producing all potentially relevant nonprivileged documents and materials, and to comply with express prohibitions and undertakings during a period of deferred prosecution, which generally should not exceed five years.

In announcing the Tenaris DPA, Mr. Khuzami stated in the SEC’s press release that the SEC agreed to a deferred prosecution agreement because of Tenaris’ “immediate self reporting, thorough internal investigation, full cooperation with SEC staff, enhanced anti-corruption procedures, and enhanced training made it an appropriate candidate for the Enforcement Division’s first deferred prosecution agreement.”

Pursuant to the terms of the agreement, the SEC agreed not to bring any enforcement action against Tenaris arising from the alleged FCPA violations in exchange for Tenaris’ agreement to, among other things, pay \$5.4 million in disgorgement and prejudgment interest and to perform certain express undertakings. The Tenaris deferred prosecution agreement contains notable provisions, many of which mimic the Department of Justice’s (“DOJ”) deferred prosecution program, including:

- *Acceptance of responsibility.* The Tenaris DPA includes an introductory paragraph that states that “[p]rior to a public enforcement action being brought by the Commission against it, without admitting or denying these allegations, [Tenaris] has offered to accept responsibility for its conduct....”
- *Term.* The Tenaris DPA, as is typical of DOJ DPAs, contains a term for the agreement – in this case, two years.
- *Statute of limitations.* The Tenaris DPA, as is typical of DOJ DPAs, includes a provision that the statute of limitations is tolled during the term of the DPA.
- *Statement of Facts.* Similar to DOJ DPAs, the Tenaris DPA includes a detailed statement of facts. In contrast to typical DOJ DPAs, however, Tenaris does not admit these facts. Instead, the DPA includes a footnote that these facts are made pursuant to settlement negotiations and are not binding against Tenaris in any other legal proceeding.

³⁴ This figure comes from the remarks of Robert Khuzami at a late June 2011 SIFMA Compliance & Legal Society luncheon.

- *Prohibitions.* The Tenaris DPA includes a set of prohibitions that are reminiscent of standard DOJ DPAs, including that Tenaris agrees to refrain from: 1) violating the federal and state securities laws; 2) seeking a federal or state tax credit or deduction for any monies paid pursuant to the DPA; and 3) seeking or accepting reimbursement or indemnification from any source with respect to monies paid pursuant to the DPA.
- *Undertakings.* Standard DOJ DPAs usually include requirements to disclose any later investigations or misconduct to DOJ and to enhance existing compliance programs. Tenaris agreed to similar requirements here.

F. Commissioner Paredes Sounds a Cautionary Note Regarding SEC Enforcement

Although the SEC continues to tout its new enforcement tools, at least one Commissioner has observed that the Enforcement staff must not forget that “sometimes the best choice is not to bring a particular case or advance a particular charge.” In a May 2011 speech, Commissioner Troy A. Paredes cautioned that Enforcement cannot pursue each and every possible violation of the securities laws, and proposed several “guideposts” for the Enforcement staff to follow in deciding how to allocate its limited resources. These guideposts include:

- How and to what extent did the misconduct harm investors?
- Have certain enforcement-related objectives already been satisfied? The staff should consider, for example, whether a party has already undertaken appropriate remedial steps.
- Has the alleged wrongdoer been, or will the individual or entity be, meaningfully sanctioned through means other than an SEC enforcement action, thus reducing the marginal value of our bringing a case?
- What is the impact of bringing one more case of a particular type? Is there any appreciable general deterrence benefit of bringing another case of this type or have diminishing returns already set in?

Commissioner Paredes also observed that the SEC should give “meaningful credit” to those who cooperate with its investigations. In elaborating on what constitutes “meaningful” credit, Commissioner Paredes opined that the SEC “cannot be stingy” and that parties should receive “enough credit to make cooperating worth it.”³⁵

G. SEC Enforcement Priorities Regarding Broker-Dealers

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

- The marketing and sale of CDOs and asset-backed securities

³⁵ Available at: <http://www.sec.gov/news/speech/2011/spch050611tap.htm>.

- The valuation of and disclosures relating to subprime securities
- IPO valuations and allocations
- High frequency/electronic trading activities, including spoofing and layering
- Structured products, including principal protected notes, reverse convertible notes, and ETFs and the pricing and conflicts related to these products
- Sales of unsuitable securities to retail investors
- Municipal securities and political contributions
- Insider trading by Wall Street professionals
- Failure to supervise registered representatives
- Microcap fraud
- The setting of the London Interbank Offer Rate (“Libor”)
- Insider trading regarding exchange-traded funds

H. Enforcement Actions

Outlined below are summaries of several key cases that may be of interested to the attendees of this conference.

Misappropriation of Fund Assets

1. *SEC v. Steven T. Kobayashi*, CV-11-0981 (N.D. Cal. Mar. 3, 2011)
 - a. On March 3, 2011, the SEC filed an action against Steven T. Kobayashi, a broker at UBS Financial Services, Inc., alleging fraud in connection with the operation of a private pooled life insurance investment fund he established.
 - b. The SEC alleged that between 2006 and 2007, Kobayashi siphoned approximately \$4 million from this fund for luxury cars, prostitutes, and paying off large gambling debts. This fund was created by Kobayashi in response to a stated desire by some of his UBS customers to invest in life insurance policies. Kobayashi did not disclose his role as manager and advisor of this fund to UBS, placing it outside the scope of his UBS employment.
 - c. The fund had an initial investment of \$1.4 million. Kobayashi later established a \$3 million line of credit, most of which he improperly drew down. When the initial investors began asking for returns, Kobayashi convinced several other UBS customers to

liquidate \$1.9 million in securities, some of which he transferred to the initial investors as purported returns.

- d. Kobayashi settled the charges without admitting or denying the allegations, agreed to enjoinder of further violations, and consented to be permanently barred from associating with entities in the securities industry. The Court will determine the amount to be disgorged at a later date.
- e. There is also a pending investigation by the U.S. Attorney's Office.

Privacy and Confidentiality of Client Information

1. *In the Matter of Merrill Lynch, Pierce, Fenner & Smith Incorporated* (“Merrill Lynch”), Admin. Proc. File No. 3-14204 (Jan. 25, 2011)
 - a. The SEC settled fraud charges brought against Merrill Lynch concerning the misuse of confidential client information and improper mark-ups and mark-downs on certain riskless principal trades.
 - b. The SEC alleged that between February 2003 and February 2005, a Firm proprietary desk used information regarding institutional customer orders from traders on Merrill Lynch's market making desk to place proprietary orders. The Firm had represented to its customers that such information would remain confidential.
 - c. According to the SEC, Merrill Lynch had agreements with certain customers that it would charge a commission equivalent for executing riskless principal trades. The SEC charged, however, that between 2002 and 2007 and contrary to those agreements, the Firm also charged those customers undisclosed mark-downs and mark-ups by filling customer orders at lower or higher price than it paid for the securities in the market.
 - d. Merrill Lynch was also charged with failing to supervise its proprietary and market-making desks. The SEC also alleged that the Firm failed to keep records of price guarantees that were part of certain customer orders.
 - e. In considering the settlement, the SEC took into account “significant” remedial actions the Firm voluntarily undertook.
 - f. Merrill Lynch consented to a censure and a fine of \$10 million.
2. *In the Matter of Frederick O. Kraus*, Admin. Proc. File No. 3-314326 (Apr. 7, 2011); *In the Matter of David C. Levine*, Admin. Proc. File No.

3-314327 (Apr. 7, 2011); *In the Matter of Marc A. Ellis*, Admin. Proc. File No. 3-314328 (Apr. 7, 2011)

- a. The SEC filed settled administrative proceedings against three former brokerage executives of Tampa-based GunnAllen Financial Inc. (“GunnAllen”) for failing to protect confidential information about their customers.
- b. The SEC’s order alleged that as GunnAllen was winding down its business operations in 2010, its former president, Frederick O. Kraus, and former national sales manager, David C. Levine, violated customer privacy rules by improperly transferring customer records to another firm. Kraus allegedly authorized Levine to take customer information from more than 16,000 GunnAllen accounts, including customer names, addresses, account numbers, and asset values, to Levine’s new employer. The SEC’s order charged Kraus and Levine with violating Regulation S-P, an SEC rule that requires firms to protect confidential customer information from unauthorized release to unaffiliated third parties.
- c. The SEC also charged Marc A. Ellis, GunnAllen’s former chief compliance officer, with failing to ensure that the firm’s policies and procedures were reasonably designed to safeguard confidential customer information. Among other things, Ellis allegedly failed to revise or supplement GunnAllen’s policies and procedures for safeguarding information despite several serious security breaches at the firm between 2005 and 2009, including the theft of three laptop computers and unlawful access to its e-mail system by a terminated employee.
- d. Kraus, Levine, and Ellis each consented to the entry of cease and desist orders, as well as monetary penalties in the amount of \$20,000 (for both Kraus and Levine) and \$15,000 (for Ellis).

Record Keeping

1. *In the Matter of Legend Securities, Inc. and Salvatore Caruso*, Admin. Proc. File No. 3-14389 (May 16, 2011)
 - a. In an enforcement action arising out of the production of documents and information during an examination, the SEC charged a broker-dealer and its chief compliance officer with providing false documents to the examination staff.
 - b. In 2009, the SEC examination staff commenced an examination of Legend Securities, Inc. (“Legend”). As part of its examination, the staff requested that Legend produce various employment records

for its associated persons. When Legend discovered that it did not have certain forms, including compliance-related documents, relating to one of its associated persons, Legend's chief compliance officer, Salvatore Caruso, asked the associated person to sign forms that were backdated to appear as though they were signed when the associated person began his employment at Legend. Caruso then provided these backdated forms to the examination staff.

- c. The Commission entered an order directing Legend and Caruso to cease and desist from committing violations of Section 17(a) of the Exchange Act and Rules 17a-3 and 17a-4 thereunder and imposing a civil penalty of \$50,000 on Legend and \$25,000 on Caruso.

Sales Practices

The SEC continues to be vigilant against fraudulent sales practices

1. *SEC v. Charles Schwab Investment Management, Charles Schwab & Co., Inc., and Schwab Investments*, CV-11-0136 (N.D. Cal. Jan. 11, 2011); *In the Matter of Charles Schwab Investment Management, Charles Schwab & Co., Inc., and Schwab Investments*, Admin. Proc. File No. 3-314184 (Jan. 11, 2011)
 - a. The SEC filed a settled action against Charles Schwab Investment Management ("CSIM") and Charles Schwab & Co., Inc. ("CS&Co.") charging the companies with making misleading statements regarding the Schwab YieldPlus Fund and failing to establish, maintain and enforce policies and procedures to prevent the misuse of material, nonpublic information. The SEC also charged CSIM and Schwab Investments with deviating from the YieldPlus Fund's concentration policy.
 - b. Specifically, the SEC alleged that CSIM and CS&Co. failed to adequately inform investors about the risks of investing in the YieldPlus Fund, including misleading investors about the maturity and credit quality of the YieldPlus Fund's securities as compared to a money market fund.
 - c. The SEC also alleged that the YieldPlus Fund deviated from its concentration-policy when it invested approximately 50% of the fund's assets in private issuer-mortgage backed securities, well over the fund's stated policy of not concentrating more than 25% of assets in any one industry.
 - d. CSIM and CS&Co. agreed to pay a total of \$118,944,996, including \$52,327,149 in disgorgement of fees by CSIM, a

\$52,327,149 penalty against CSIM, a \$5,000,000 penalty against CS&Co., and pre-judgment interest of \$9,290,698.

- e. In a separate administrative proceeding, the SEC instituted settled cease-and-desist proceedings against CSIM, CS&Co, and Schwab Investments for the same conduct. CSIM, CS&Co., and Schwab Investments consented to a cease-and-desist order which requires, among other things, that they correct all disclosures regarding the fund's concentration policy and retain an independent consultant to review and make recommendations about their policies and procedures to prevent misuse of material, nonpublic information.
2. *SEC v. Kimon P. Daifotis and Randall Merk*, CV-11-0137 (N.D. Cal. Jan. 11, 2011)
 - a. The SEC filed a civil action against Kimon Daifotis and Randall Merk charging them with securities fraud and other securities law violations in connection with Charles Schwab's YieldPlus Fund (*see above*).
 - b. The SEC alleged that Daifotis, former lead portfolio manager for the Schwab YieldPlus Fund, and Merk, formerly President of Charles Schwab Investment Management (CSIM) and a trustee of the YieldPlus Fund, misled investors about the risks of investing in the YieldPlus Fund, which experienced a significant decline in assets from \$13.5 billion to \$1.8 billion during an eight-month period during the credit crisis of 2007-08.
 - c. Specifically, the SEC alleged that during this period, Daifotis and Merk allegedly made false and misleading statements about the rate at which the fund was experiencing investor redemptions.
 - d. The SEC also charged Daifotis with aiding and abetting the YieldPlus Fund's deviation from its concentration policy by directing the investment of more than 25% of the Fund's assets in private-issuer mortgage-backed securities. Merk is alleged to have aided and abetted violations of anti-fraud provisions by approving other Schwab funds' redemptions of their investments in YieldPlus by a portfolio manager who allegedly was in possession of material, nonpublic information about the YieldPlus fund.
 - e. The complaint seeks permanent injunctive relief, civil penalties, and disgorgement against both Daifotis and Merk. The case is ongoing.
 3. *SEC v. Warren D. Nadel, Warren D. Nadel & Co. and Registered Investment Advisers, LLC*, 11-CV-0215 (E.D.N.Y. Jan. 13, 2011)

- a. On January 13, 2011, the SEC filed a civil action against Warren D. Nadel, his broker-dealer, Warren D. Nadel & Co. (“WDNC”), and his investment advisory firm, Registered Investment Advisers, LLC (“RIA”), alleging that the defendants fraudulently induced clients to invest millions of dollars in a purported investment program, thereby generating in excess of \$8 million in commissions and fees from 2007 to 2009.
- b. Specifically, the SEC alleged that defendants misrepresented the value and liquidity of security holdings in the investment strategy by, in many instances, executing trades between advisory accounts at significant markups, rather than executing trades on the open market at fair market value. The defendants’ trading pattern created the false impression that there was a liquid market for the securities in question.
- c. The Commission is seeking a permanent injunction, disgorgement, and civil monetary penalties. The case is ongoing.

Supervision

1. *In the Matter of Theodore W. Urban*, Admin Proc. No. 3-13655 (Sep. 8, 2010)
 - a. In 2009, the SEC settled proceedings brought against Ferris, Baker Watts, Inc. (“Ferris”), its former CEO, its former director of retail sales and a registered representative, Stephen Glantz (“Glantz”), who was engaged in market manipulation. The former CEO and former director of retail sales settled failure to supervise charges regarding the activities of Glantz, the registered representative.
 - b. As to Ferris, the SEC’s settlement described its alleged failure 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”).
 - c. Contemporaneously with the filing of the settled actions against Ferris and the three former employees, the SEC instituted a failure to supervise proceeding against Theodore Urban (“Urban”). Mr. Urban was Ferris’ general counsel and headed three departments: Compliance, Human Resources and Internal Audit. The SEC alleged that Urban ignored and/or failed to adequately follow up on numerous red flags concerning the registered representative’s trading, including several issues to which he was alerted by the Compliance Department.

- d. On September 8, 2010, following a lengthy hearing, Chief Administrative Law Judge Brenda Murray issued a fifty-seven page decision. Although Chief Judge Murray found that Urban “did not have any of the traditional powers associated with a person supervising brokers,” she nevertheless concluded that he was Glantz’s supervisor because his “opinions on legal and compliance issues were viewed as authoritative and his recommendations were generally followed by people in [his firm’s] business units, but not by Retail Sales.”
- e. Chief Judge Murray determined, however, that Urban had acted reasonably under the facts and circumstances presented and dismissed the proceeding.
- f. The Division of Enforcement petitioned the Commission for a review of the dismissal; Urban cross-petitioned for a review of Chief Judge Murray’s ruling that he was Glantz’s supervisor.
- g. Urban also petitioned for the Commission to summarily affirm Chief Judge Murray’s decision. On December 7, 2010, the Commission denied Urban’s motion because “a normal appellate process” rather than a summary affirmance was appropriate as “the proceeding raises important legal and policy issues, including whether Urban acted reasonably in supervising Glantz and responded reasonably to indications of his misconduct, whether securities professionals like Urban are, or should be legally required to “report up,” and whether Urban’s professional status as an attorney and the role he played as FBW’s general counsel affect his liability for supervisory failure.”
- h. Oral argument on the appeal of this matter is set for December 6, 2011.
- i. This matter is being closely watched by the industry in light of Chief Judge Murray’s holding that significantly expands potential supervisory liability for legal and compliance personnel.³⁶

³⁶ Demonstrating the importance of this case, the SIFMA Legal and Compliance Society and the National Society of Compliance Professionals (“NSCP”) both filed amicus briefs with the SEC supporting Urban. We note that Morgan Lewis acted as counsel for the NSCP in this matter.