

IV(e) GI — The Regulatory Enforcement Process

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I. INTRODUCTION¹

This outline is intended to highlight certain issues involved in the evolution of enforcement matters, both at the SEC and FINRA.² The outline is not intended to be an exhaustive survey of the enforcement process, but rather to generally describe the stages of an investigation and to identify key issues that arise in those matters. In this presentation, we address: (1) the investigation process; (2) deciding whether to settle or litigate; and (3) recent cases and developments in broker-dealer enforcement.

II. EVOLUTION OF THE ENFORCEMENT PROCESS

A. Opening an Investigation

1. Sources of an investigation

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

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

¹ This outline was created by Ben A. Indek and Julia N. Miller of Morgan Lewis & Bockius LLP. The views expressed herein are their own and not those of their firm or the other panelists or their organizations. As noted below, Section II.D. is taken from "Litigating with the SEC and SROs" by Anne C. Flannery and John Shin presented at the SIFMA Compliance & Legal Division 2007 Annual Seminar. The descriptions of enforcement developments and case summaries in Section III are from "U.S. SEC, FINRA and NYSE Regulation: Mid-Year Review – Selected Broker-Dealer Enforcement Cases and Developments" by Ben A. Indek, Anne C. Flannery, Michael S. Kraut, Bonnie L. Altro, Kurt W. Rademacher and Kerry J. Land. This outline is current as of August 29, 2008. Copyright Morgan Lewis & Bockius LLP.

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

2. Commencing an investigation at the SEC
 - a. In 2007, Walter Ricciardi, then Deputy Director of Enforcement, described in a speech a new SEC Enforcement Management Plan, which, among other things, requires that a Deputy Director approve an investigation before it is opened.³

B. Fact investigation

1. Document requests – Regulators routinely request numerous categories of documents during the course of an investigation. Several considerations for counsel to consider when they receive and respond to such requests include:
 - Upon receipt of the requests, the firm should attempt to ascertain the documents the company has in its possession, those documents that can be obtained for production and determine when production can reasonably be made.
 - Where it is determined that documents cannot be reasonably obtained or produced, company counsel should consider developing a counter-proposal for production and discuss it with the enforcement staff. Counsel and staff should also negotiate any modifications to the request, including any necessary extensions of time.
 - It is critical for counsel to keep the regulators informed of the progress of the document production process.
 - Productions of documents and information should be accompanied by requests for confidential treatment.

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

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

2. Creation of information for regulators – Recently, there has been an increase in requests from certain regulators that ask companies to create and provide analyses of data and information that are not kept in the ordinary course of business. Examples of materials created for regulators include chronologies of key events,

³ Notes on the speech Mr. Ricciardi gave in July 2007, outlining the Enforcement Management Plan, are available at: <http://www.sifmacl.org/attachments/files/24/July%20Monthly%20Luncheon%202007.pdf>

databases populated with various information, spreadsheets sorting and analyzing transaction data, and summaries of relevant facts.

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

3. Testimony – Many investigations will require the testimony (or informal interviews) of relevant individuals at the company. Requests for such testimony may come in the form of a subpoena or a request letter. Some of the steps involved in preparing a witness for testimony, include:
 - Gather and review key materials, including produced documents that refer to or relate to the witness; references to the witness in prior testimony of others and; and a chronology or outline of key facts and events.
 - Attempt to ascertain the anticipated scope of the testimony from counsel for other witnesses, where possible without compromising confidentiality, and from enforcement counsel.
 - In preparing the witness: review and develop the facts of the case; evaluate whether the testimony is likely to evoke answers that could be privileged and discuss how to approach; and provide the witness with the “rules of the road.”
 - In this environment where there is significant overlap and coordination between the SEC and criminal prosecutors, counsel should be aware of any potential issues that might arise in the criminal context (e.g., the need to advise a witness to assert her Fifth Amendment rights).
4. Cooperation with Regulators – Throughout the investigation process, companies should be mindful of the cooperation they provide regulators. Both the SEC and FINRA evaluate a company’s cooperation in determining whether and how to charge violations:
 - In October 2001, the SEC issued a Section 21(a) report (commonly referred to as the “Seaboard Report”) that established certain criteria that the Commission indicated it would consider in determining “whether and how much to credit self-policing, self-reporting, remediation and cooperation.⁴ Those criteria include: What is the nature of the misconduct involved?; How long did the misconduct last; How long after the discovery of the misconduct did it take to implement an effective strategy?; Did the company commit to learn the truth, fully and expeditiously?; Did the company make available to the SEC the results of

⁴ See Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission statement on the Relationship of Cooperation to Agency Enforcement Decisions, SEC Release No. 34-44969 (October 23, 2001), *available at*: <http://www.sec.gov/litigation/investreport/34-44969.htm>

its own internal investigation?; Did the company provide information to the staff that was not explicitly requested?; and What assurances are there that the conduct is unlikely to recur?

- FINRA’s Sanction Guidelines also list a number of factors that the staff will consider in resolving a matter, including: a company’s relevant regulatory history; whether a firm voluntarily employed corrective measures prior to detection or intervention by a regulator; whether the firm provided substantial assistance to FINRA in connection with its investigation; and whether the misconduct was the result of an intentional act, recklessness or negligence.
- NYSE Regulation Information Memos 05-65 and 05-77 continue to provide relevant guidance on the topic of cooperation.⁵ As contemplated in these information memos, extraordinary cooperation by a firm plays a role in whether and how to bring an action against the firm. Information Memo 05-65 defines “extraordinary cooperation” as: “cooperation that goes beyond that required by the rules of the Exchange and federal securities laws, and that has the potential, in appropriate cases, to influence the outcome of an investigation, for instance by causing the Exchange to seek a reduced sanction, to decide to bring reduced or less serious charges, to obviate the need for an undertaking, or to decide to forgo bringing charges altogether.”

Issue: Waiver of Attorney-Client Privilege. A key issue to be considered by counsel is whether a company will waive the attorney-client privilege in producing documents and information to a regulator. This issue and regulators’ views on it is constantly changing and must be carefully tracked by counsel. Indeed, the day before this outline was finalized, the Department of Justice revised its guidelines concerning, among other things, the handling of attorney-client privilege waivers.

C. Wells Process

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

1. If at the conclusion of an investigation, the regulator determines that a firm may be subject to charges, it will often send the company a “Wells notice,” which lists the firm’s potential charges. (Oral Wells notices are also common.) The company will then have the opportunity to respond, in a “Wells submission,” and state why the firm should not be charged with certain violations (or all of the alleged acts) and what kind of sanctions, if any, should be assessed. As noted in a well-used treatise on enforcement:

⁵ These Information Memos continue to be relevant in both NYSE Regulation and FINRA investigations.

This is a key step in the regulatory investigation process. A Wells submission is a firm's opportunity to set forth key facts as well as to make legal and policy arguments. It is a chance to convince the staff that they should either not pursue an action or reduce the charges against the firm.⁶

2. As part of the SEC's Enforcement Management Plan, a firm will not receive a Wells notice until a Deputy Director has been notified and signed off on such a step.

D. Deciding Whether to Settle or Litigate⁷

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

1. Language and Scope of Charges

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

2. Publicity

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

⁶ See The Securities Enforcement Manual, 2d Ed., 165 (ABA 2007).

⁷ "Litigating with the SEC and SROs" by Anne C. Flannery and John Shin presented at the SIFMA Compliance & Legal Division 2007 Annual Seminar.

3. Regulatory Filings

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

4. Reputational Risks

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

5. Collateral Consequences

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

6. Regulatory Relationships

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

7. Sanctions

Generally speaking, there is a perception within the industry that firms or individuals can settle with regulators on terms that may be more advantageous than the sanctions levied at the conclusion of a litigated case. Consideration to the types of charges, fines, undertakings and language available in a settlement must be weighed against those that can be obtained by a regulator in litigation. Consideration also needs to be given to the collateral consequences of an injunction imposed by the SEC.⁸

⁸ Based upon a review of reported decisions, the sanctions imposed in litigation matters may be different from, and at times less than that which may have been procured through settlement. Some commentators have expressed the view that it might be worthwhile to litigate against regulators even if it is likely that the regulator will win on liability. *See, e.g.*, Brian L. Rubin & Christian J. Cannon, *It Sometimes Pays to Litigate Against FINRA*, INSIGHTS: THE CORPORATE & SECURITIES LAW ADVISOR, Vol. 22 No. 5, May 2008.

8. **Distraction**

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

9. **Costs**

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

III. RECENT DEVELOPMENTS AND CASES⁹

A. Recent Trends: Mid-year 2008

SEC

The SEC's current top priorities for broker-dealer enforcement include: (1) auction rate securities (discussed below); (2) valuation of securities; (3) sales of mortgage-related securities, including suitability, disclosures, and extent of due diligence (coordinated with the SEC's Subprime Task Force, which will address aspects other than enforcement); (4) insider trading and controls over material, non-public information; (5) trading, including issues involving best execution and short sales; (6) conflicts of interest; (7) protection of client assets and information, including Regulation S-P; (8) internet fraud (led by the SEC's office of Internet Enforcement); and (9) fraud in the municipal securities markets.

FINRA

FINRA's current top enforcement priorities include: (1) sales practices, particularly involving sales of CDOs and sales to senior citizens; (2) anti-money laundering; (3) supervision; (4) variable annuities; (5) relationships with hedge funds; (6) auction rate securities; (7) Regulation SHO; (8) life settlements; (9) reverse mortgages; and (10) false or misleading rumors.

B. Recent SEC Cases

Auction Rate Securities

In recent months, auction rate securities have received a tremendous amount of attention from the media, regulators and the industry. As of August 29, 2008, several firms have agreed in principle to settle enforcement actions with the SEC and various state

⁹ "U.S. SEC, FINRA and NYSE Regulation: Mid-Year Review – Selected Broker-Dealer Enforcement Cases and Developments" by Ben A. Indek, Anne C. Flannery, Michael S. Kraut, Bonnie L. Altro, Kurt W. Rademacher and Kerry J. Land.

regulators. As part of those agreements, the firms have committed to repurchasing certain auction rate securities from various customers and to the payment of significant fines to regulators. Moreover, the media has reported that FINRA has begun a series of on-site examinations of firms focused on auction rate securities sales practices.

Rumor Spreading

The following settled administrative proceeding alleging the creation and dissemination of false or misleading rumors to manipulate the price of securities received a significant amount of attention from the media and Wall Street.¹⁰

1. *In the Matter of Paul S. Berliner* (Admin. Proc. File No. 3-13035, May 5, 2008)

The SEC settled an administrative proceeding against Berliner, a trader formerly associated with Schottenfeld Group LLC (“Schottenfeld”), for his dissemination of a false rumor involving The Blackstone Group’s (“Blackstone”) acquisition of Alliance Data Systems (“ADS”). Berliner allegedly started the rumor to cause ADS’s stock price to drop, enabling him to profit from his short sales in its stock.

Berliner allegedly sent instant messages to 31 traders and other securities professionals in which he intentionally and falsely claimed that ADS’s board of directors was meeting to consider a revised proposal from Blackstone to acquire ADS at a significantly lower price of \$70 per share because ADS was “getting pounded.”

The rumor rapidly spread throughout Wall Street and the media, leading to heavy trading in ADS stock and causing its stock price to fall from \$77 per share to \$63.65 in thirty minutes. Minutes earlier, Berliner allegedly sold short thousands of shares of ADS stock, earning approximately \$25,000 in profits.

In announcing this case, Scott Friestad, Associate Director of the SEC’s Division of Enforcement, said, “Conduct like this is particularly insidious because it harms investors by distorting the information they use to make investment decisions.”¹¹

Berliner consented to findings that he violated Section 17(a) of the Securities Act, Sections 9(a)(4) and 10b of the Exchange Act and Rule 10b-5 promulgated thereunder. Berliner consented to a permanent bar, disgorgement of his trading profits, and a civil penalty of \$130,000.

¹⁰ For more information on this topic, we refer you to FINRA News Release, Self-Regulators Warn Against Spreading False Rumors and Other Abusive Market Activity (Mar. 31, 2008); SEC Press Release 2008-140, Securities Regulators to Examine Industry Controls Against Manipulation of Securities Prices Through Intentionally Spreading False Information (Jul. 13, 2008); and NYSE Regulation, NYSE Market Surveillance Sweep Letter on Rumors (Jul. 14, 2008).

¹¹ SEC Press Release 2008-64, SEC Charges Wall Street Short-Seller With Spreading False Rumors (Apr. 24, 2008). We note that in the first half of 2008, Walter Ricciardi and Peter Bresnan, formerly co-Deputy Directors of SEC Enforcement, left the Commission and were replaced by Scott Friestad and George Curtis.

Regulation S-P

Regulation S-P prohibits a firm from disclosing non-public personal information to nonaffiliated third parties without first notifying the subject and offering the subject an opportunity to opt out. Below are two litigated cases involving Regulation S-P from the first half of 2008.¹²

1. *In the Matter of NEXT Financial Group, Inc.* (“NEXT”) (Admin. Proc. File No. 3-12738, June 18, 2008)

The SEC alleged that NEXT violated Regulation S-P by permitting its registered representatives who were leaving the firm to take clients’ personal information with them. The SEC also alleged that NEXT aided and abetted other firms’ violations of Regulation S-P by assisting newly hired registered representatives in taking non-public personal information concerning their clients from their former firm and sending it to NEXT.

An ALJ concluded that NEXT willfully violated Regulation S-P because before representatives ceased to work for NEXT and joined a new firm, they disclosed clients’ social security numbers, dates of birth, and banking information. The ALJ found that NEXT’s privacy notice did not inform customers that the firm permitted departing registered representatives to disclose personal information to third parties and that NEXT did not provide customers with a reasonable opportunity to opt out of this disclosure.

The ALJ further concluded that NEXT knew that registered representatives likely would disclose clients’ personal identifying information to new employers but did not establish policies or procedures until February 2006 for safeguarding this information and was therefore at least negligent.

Notably, the ALJ rejected the SEC staff’s argument that existing regulations required NEXT to encrypt its emails containing customer data.

The ALJ entered a cease-and-desist order and a civil penalty of \$125,000 against NEXT but did not order the more severe penalty of \$325,000 requested by the SEC staff because of mitigating factors, such as no actual harm to customers, no prior violations for the firm and no evidence of unjust enrichment that could be quantified.

2. *SEC v. Sidney Mondschein* (N.D. Cal. Apr. 14, 2008)

In a case filed in federal court in 2007, the SEC alleged that between December 2002 and August 2005, Sidney Mondschein, a former WFG Investments Inc.

¹² On March 11, 2008, the SEC proposed amendments to Regulation S-P requiring more specific standards under the safeguards rule, amending the scope of the information covered by the safeguards and disposal rules, requiring written records of policies and procedures and compliance with same, and a new exception to the regulation’s notice and opt-out requirements.

(“WFG”) registered representative, illegally profited by selling insurance agents the names and other confidential personal information of over 500 customers. Mondschein sold this confidential information as sales “leads” to enable the insurance agents selling annuities to solicit these customers, many of whom had already purchased fixed or equity-indexed annuity products, to buy additional annuity products. Many of these “leads” were elderly persons.

The SEC alleged that in exchange for selling the “leads,” Mondschein accepted cash as well as kickbacks. Many of the insurance agents who received the “leads” recommended to their clients that they use Mondschein, instead of their existing broker, to sell securities to fund their annuity purchases, enabling Mondschein to collect additional brokerage commissions and fees.

In April, 2008, the case settled. Mondschein consented to a permanent injunction against violating Section 10(b) and Rule 10b-5 of the Exchange Act and aiding and abetting any violations of Rules 4(a) and 5(a) of the Exchange Act and 10(a)(1) of Regulation S-P. Mondschein also consented to disgorgement of \$53,000, a civil penalty of \$45,000 and a five-year bar.

Market Timing/Late Trading

For several years, market timing and late trading had been hot topics in SEC enforcement. It now appears that that pipeline of cases is running dry. Of note, however, is that while most market timing and late trading cases in prior years have been settled, this year saw the issuance of several opinions in litigated cases.

1. *In the Matter of Trautman Wasserman & Company, Inc.* (“TWCO”), Gregory O. Trautman, Samuel M. Wasserman, Mark Barbera, James A. Wilson, Jr., Jerome Snyder and Forde H. Prigot (Admin. Proc. File No. 3-12559, Jan. 14, 2008)

In a contested administrative proceeding, the SEC alleged that TWCO, Trautman (TWCO’s president, CEO, and majority shareholder), and Wasserman (TWCO’s chairman) violated the federal securities laws by engaging in a scheme to defraud mutual funds by market timing and late trading.

Between January 2001 and September 2003, the Commission asserted that TWCO accepted thousands of orders from its hedge fund clients to trade mutual funds after 4 pm EST, but time-stamped the order tickets for those trades as though they had been received prior to 4 pm in order to enable them to occur at the same day’s net asset value price.

When the mutual funds attempted to halt market timing transactions by limiting the number of transactions in a client’s account, the SEC alleged that the TWCO officers deceived the mutual funds by opening new accounts and continuing to trade under the radar for clients after they had received notice prohibiting further trading.

TWCO defaulted in the proceedings by not filing an answer. The ALJ determined that even if TWCO had not been in default, it would be liable for violations of Section 17(a)(1) of the Securities Act, Section 10(b) of the Exchange Act, and Exchange Act Rule 10b-5 because the market timing and late trading conduct of senior personnel was imputed to the company. The ALJ revoked TWCO's registration and ordered the firm to disgorge the amount of its assets up to \$9,040,000 and pay a civil monetary penalty of \$500,000.

The ALJ did not find Trautman's testimony to be credible and found that he violated Section 17(a)(1) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder, and aided and abetted and caused a mutual fund company's violations of Rule 22c-1 in connection with TWCO's late trading. The ALJ issued a cease-and-desist order and a permanent bar against Trautman and ordered him to disgorge more than \$1.3 million and to pay a civil monetary penalty of \$500,000.

The ALJ found Wasserman's testimony credible; she found that Wasserman was not actively involved in the firm's mutual fund trading and did not act with scienter and therefore was not liable for the same violations as Trautman. However, the ALJ found that Wasserman acted negligently and therefore violated Sections 17(a)(2) and 17(a)(3) of the Securities Act. The ALJ barred Wasserman from serving as a supervisor and ordered him to disgorge \$25,000, but rejected the Enforcement staff's requests for a cease-and-desist order, permanent bar, civil monetary penalty, and a larger disgorgement amount. In fashioning a remedy, the ALJ considered that Wasserman was unaware of TWCO's illegal conduct and "suffered substantial financial losses and damage to his professional reputation as a result of his relationship with TWCO."

On February 14, 2008, the SEC settled matters involving former TWCO employees Mark Barbera (TWCO's CFO) and Forde Prigot (TWCO's compliance officer) in connection with the firm's market timing and late trading activities. Each consented to a cease-and-desist order and a six-month suspension. In addition, Prigot consented to a \$30,000 civil money penalty.

Insider Trading

In 2007, the U.S. Department of Justice and the SEC prosecuted a number of insider trading cases, many of which involved Wall Street employees. In 2008, further developments occurred in those cases, and the SEC filed several new insider trading-related actions.

1. *SEC v. Chanin Capital LLC* (D.C. Apr. 28, 2008) and *In the Matter of A. Carlos Martinez* (Admin. Proc. File No. 3-13032, May 1, 2008)

The SEC filed a civil complaint against Chanin Capital LLC ("Chanin"), a broker dealer, for failing to establish, maintain and enforce written policies and

procedures reasonably designed to prevent the misuse of material nonpublic information, as required under Section 15(f) of the 1934 Act.

The SEC alleged that between 1999 and September 15, 2003, Chanin had no consistent system for collecting signed acknowledgements or ensuring compliance with the firm's insider trading prevention policies. The firm lacked records evidencing that any employee sought or received pre-clearance to place a single securities trade. Although it had more than 35 employees at the time, Chanin did not collect more than four signed insider trading policy acknowledgements in 1999, 2000, or 2001.

The SEC alleged that while Chanin's policies and procedures improved in 2003, they were still insufficient. For example, beginning in 2003, Chanin held mandatory training sessions related to the insider trading policy but did not track which employees attended. As another example, Chanin required employees to disclose their existing personal trading accounts, but it did not compel disclosure of accounts that employees opened subsequently. Finally, Chanin failed to collect signed insider trading policy acknowledgements from all employees, including Chanin's two principals.

Chanin consented to judgment against it and a \$75,000 penalty.

A. Carlos Martinez, who served as Chanin Capital's CFO and its Chief Compliance Officer, was responsible for implementing and enforcing the firm's insider trading prevention policies and procedures. In a companion administrative proceeding against him, the SEC alleged that Martinez willfully aided and abetted Chanin's violations by failing to maintain policies and procedures to prevent the misuse of material non-public information.

Martinez consented to a cease-and-desist order against future violations, a censure, and a civil penalty of \$25,000.

This appears to be the first time that the SEC has brought charges against a Chief Compliance Officer for aiding and abetting violations of 15(f). It also appears to be the first time that the SEC has implied that failing to adopt policies that the SEC staff has said it views as "minimum standards," but not required by the Exchange Act, could result in liability under 15(f).

Conflicts of Interest

In the first half of 2008, the SEC brought cases involving conflicts of interest in a variety of contexts, including gifts and gratuities, the independent selection of recommended mutual funds, research reports, and the awarding of securities business by municipalities.

1. *In the Matter of Fidelity Management & Research Company and FMR Co., Inc.* (collectively, “Fidelity”) (Admin. Proc. File No. 3-12976 Mar. 5, 2008)

The SEC brought a settled action against Fidelity, alleging that certain of its equity traders allowed their receipt of travel, entertainment, gifts and gratuities (“TEGG”) from, or their relationships with, brokerage firm employees to influence the mutual fund firm’s allocation of order flow to brokers.

The SEC alleged that between January 2002 and October 2004, ten Fidelity traders and two senior executives (Scott DeSano and Bart Grenier) received TEGG worth approximately \$1.6 million from brokerage firms that provided, or sought to provide, brokerage services to Fidelity. During the same period, certain Fidelity equity traders placed fund trades with brokers with whom they had personal or familial relationships.

Fidelity allegedly violated Section 206(2) of the Advisers Act because: (1) its equity traders allowed TEGG and personal relationships to factor into broker selection in violation of the duty to seek best execution, and (2) Fidelity failed to disclose TEGG and personal relationships among its broker selection factors in its Form ADV and the funds’ SAIs.

The SEC alleged that Fidelity, through DeSano, failed to reasonably supervise the equity traders. DeSano, as head of the equity trading desk, was aware that the equity traders had benefited from lavish TEGG because he attended certain of the trips. DeSano did not monitor their receipt of TEGG “on a systematic basis” for compliance with the firm’s gifts and gratuities policy and to prevent the equity traders from receiving compensation in the form of TEGG in exchange for allocated brokerage. The SEC settlement Order notes that although much of the TEGG violated the firm’s gifts and gratuities policy, none of the twelve individuals sought or received an exception to the policy.

The SEC also alleged that Peter Lynch (vice chairman and director of Fidelity and formerly a Fidelity portfolio manager) periodically requested and obtained tickets to events from two equity traders, who obtained them from brokers. As a result, Lynch allegedly caused the equity traders to accept compensation in exchange for fund order flow in violation of the Investment Company Act.

On the day that the SEC issued the release announcing its settlement with Fidelity, the SEC also released orders: (1) announcing its settlement with Peter Lynch, Bart Grenier, and one equity trader (Marc Beran), and (2) bringing charges against DeSano and the remaining nine equity traders named in Fidelity’s order (Tom Bruderman, Tim Burnieika, Robert Burns, David Donovan, Ed Driscoll, Jeffrey Harris, Christopher Horan, Steve Pascucci, and Kirk Smith). The latter cases are in litigation.

Best Execution

For years, best execution was a priority among regulatory examiners. Over the past two years, it also has been a focus in the enforcement area, as shown in the case discussed below.

1. *SEC v. Kenneth D. Pasternak and John P. Leighton* (D.N.J. June 24, 2008)

In late 2004, the SEC settled an enforcement action against Knight Securities involving best execution for institutional customers. Between January 1999 and November 2000, when Knight's head institutional sales trader received an institutional "not held" buy order from a customer (*i.e.*, the trader was given discretion as to the price and time of execution), he acquired shares of the requested security for the firm's proprietary account before filling the customer's order. He then waited to see how the security performed in the market during the day. If the stock went up in price during the day, he executed the customer's order from the market, locking in a profit in Knight's proprietary account. If the stock price dropped during the day, he would fill the customer's orders from the firm's proprietary position at prices that nevertheless provided a profit to the firm.

In March 2005, NASD Regulation filed a complaint against Knight's former CEO, Kenneth Pasternak, and the former head of its institutional sales desk, John Leighton. In April 2007, an NASD Regulation hearing panel found that Pasternak and John Leighton failed to adequately supervise the lead trader on the trading desk (Joseph Leighton, who is John's brother) to prevent that conduct. The panel found that the two executives failed to respond adequately to numerous red flags.

Notwithstanding NASD Regulation's case, in August 2005, the SEC also filed an injunctive action against Pasternak and John Leighton. In June 2008, almost three years after the complaint was initially filed and eight years after the last alleged wrongful activity, a federal judge held that the SEC failed to prove that Pasternak or John Leighton violated the federal securities laws in connection with the firm's alleged failure to seek best execution as described above and dismissed all charges.

The SEC alleged that John Leighton and Pasternak participated in the alleged securities fraud committed by Knight's institutional desk by failing to disclose to Knight's institutional customers the significant profits generated by Joseph Leighton's strategy. The court rejected the SEC's argument that earning above-average (or "excessive") profits demonstrated that Joseph Leighton engaged in conduct that violated the securities laws. The court also rejected the SEC's claim that Joseph Leighton charged customers an undisclosed excessive mark-up, finding that he did not charge an identifiable mark-up, and even if he did, the SEC failed to prove he had an obligation to disclose those mark-ups to customers.

The SEC also claimed that Pasternak made false and misleading statements by signing the company's 10-K forms in 1999 and 2000, which stated that Knight

provided its customers with best execution. The court held that the SEC did not establish that Pasternak knew or should have known that Joseph Leighton did anything improper and noted that Pasternak took the appropriate steps to investigate whether Joseph Leighton was engaging in front-running when the possibility of it was brought to his attention. The court ruled that the SEC failed to establish that Knight did not provide its customers with best execution or, if it did not, that Pasternak knew that the statements in the 10-Ks were false.

Finally, the SEC alleged that institutional sales traders at Knight, including Joseph Leighton, misused ACT modifiers causing inaccurate and untimely reporting of trades to NASDAQ in order to obscure the quality of the execution prices, and that the defendants were aware of the issue. The court held that the SEC failed to prove that any trader misused ACT modifiers, or that such misuse was part of any fraudulent manipulation or a violation of statutory reporting requirements.

The court noted that John Leighton regularly reviewed Joseph Leighton's trade runs, that the industry standard in 1999 and 2000 was not to disclose profits earned on a trade, and that John Leighton's knowledge of Joseph Leighton's profits did not trigger any obligation to further investigate his trades.

In April 2005, when the SEC first filed a complaint against him, Joseph Leighton consented to a permanent bar from association and to pay over \$1.9 million in disgorgement, \$660,282 in interest, and a penalty of \$750,000 to settle the SEC matter. Joseph Leighton also consented to pay a \$750,000 fine to settle the NASD Regulation action.

As noted above, on June 24, 2008, the court ruled for Pasternak and John Leighton, finding that the SEC failed to prove that the defendants had violated any securities laws.

C. Recent FINRA Cases

Variable Annuity Sales

Sales of variable annuities continue to be a priority for FINRA. FINRA's Executive Vice President and Chief of Enforcement Susan Merrill commented in early 2008 that, "[w]hen firms are recommending annuities or annuity exchanges to elderly customers, they must act in the customers' best interests, taking into account all relevant factors - including the customers' ages and liquidity needs, surrender charges, product expenses and investment features."¹³ The case that spurred this comment is described below.

¹³ FINRA News Release, FINRA Fines Banc One for Unsuitable Variable Annuity Sales, Inadequate Supervision of Fixed-to-Variable Annuity Exchanges (Jan. 29, 2008).

1. *Banc One Securities Corp.* (“Banc One”) (Jan. 29, 2008)

FINRA alleged that, between January 1, 2004 and June 30, 2005, Banc One recommended unsuitable exchanges of deferred variable annuities to clients and had inadequate systems and procedures governing annuity exchanges.

FINRA alleged that Banc One representatives made unsuitable recommendations to 23 clients, 21 of whom were over 70 years old, and nine of whom were over 80 years old, to exchange their variable annuities. The clients exchanged out of annuities that were earning a minimum of 3 percent to annuities that earned a maximum of 3 percent. In addition, as a result of the exchanges, the clients ceased to hold annuities that had expired surrender periods and acquired annuities that had new three or six year surrender periods during which they would incur penalties for withdrawals.

In this matter, FINRA alleged that, considering the customers’ ages, investment objectives, financial situations, income needs and the surrender periods of the variable annuities, the recommendations were unsuitable and in violation of NASD Rules 2310 and 2110.

Finally, FINRA asserted that the firm violated Conduct Rule 3010(a) because the firm’s principals were aware of the customers’ circumstances but did not adequately consider the various factors before approving the unsuitable transactions.

FINRA also alleged that the firm failed to supervise the exchange transactions in that the firm’s supervisory systems and procedures did not require firm supervisors to obtain or consider certain information, such as the costs and benefits of the products being exchanged – information which is critical to conducting the required suitability review of a variable annuity exchange.

Banc One consented to a fine of \$225,000, and agreed to pay restitution of \$6,500 to two customers who incurred surrender charges when exchanging annuities. In addition to the fine, Banc One agreed to allow the 23 customers to sell their variable annuities without penalty.

Senior Investors

Over the past several years, the SEC, FINRA, and state regulators have focused on senior investors as the baby boomer generation moves toward retirement age. Key issues involve adequate disclosures to clients (particularly with respect to registered representatives’ titles and so-called “free lunch” seminars) and suitability.

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

FINRA filed a complaint alleging that John Mullins, a registered representative, misappropriated nearly \$400,000 from an elderly customer and her charitable organization and attempted to steal funds from his employer in the form of

improper expense submissions. Mullins' wife, a broker, was also charged by FINRA.

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

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

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

These charges are still pending.

Forms U-4/U-5 Filings

In 2004, NASD Regulation concluded a sweep by sanctioning a number of broker-dealers for late form U-4/U-5 filings. Since that time, NASD Regulation, and now FINRA, have brought several additional actions. To date in 2008, FINRA settled several actions in this area including the case described below; note the relatively high fines FINRA continues to impose in these actions.

1. *Hunter Scott Financial LLC and Peter Alex Gouzos* (Jan. 2008)

FINRA alleged that the firm, through the actions of one of its principals (Gouzos), failed to timely file amendments to Forms U-4 and Forms U-5 disclosing the receipt of customer complaints or arbitrations.

The firm, acting through Gouzos, also allegedly failed to enforce its procedures prohibiting the use of external email accounts, which caused the firm to fail to preserve certain electronic communications as required by Rule 17a-4 under the Exchange Act.

The firm, again acting through Gouzos, also allegedly failed to implement written supervisory procedures to achieve compliance with the rules regarding a number of additional issues including the Firm Element of the Continuing Education requirements, internal inspection of its OSJ's activities, and requirements of Section 220.8(c) under Regulation T.

The firm and Gouzos consented to a censure and a joint and several fine of \$125,000.

Continuing Education Training

In March, FINRA brought actions against sixteen State Farm representatives concerning misconduct in connection with continuing education training.¹⁴

1. Sixteen State Farm registered representatives settled FINRA charges in connection with testing misconduct by either taking tests for superiors or directing subordinates to take tests for registered State Farm employees.
2. FINRA requires a mandatory two-part training program consisting of regulatory and firm elements. The “firm” element is administered by firms to registered representatives who have direct customer contact and their immediate supervisors. State Farm designed a computerized system of testing for the firm element, and in this case, computer IDs of superiors were used by subordinates to take the test.
3. In one instance, a supervisor, Rebecca Sappington, directed a subordinate, Karen Curtis, to obtain user IDs and passwords of four other State Farm registered representatives who worked on Sappington’s team. Sappington directed Curtis to access the computerized testing system and complete the tests for the four individuals. When Curtis failed to complete the task, Sappington directed her to delegate the task to another employee. That individual, an unregistered new hire to the firm, then completed the tests.
4. Nine of the State Farm employees who were sanctioned were supervisors who either ordered or allowed subordinates to complete the test for them. Two of these supervisors were Series 26 registered principals. These two individuals consented to a \$10,000 penalty, a six month suspension as a principal and a 90-day suspension in all other capacities. The other seven supervisors, all Series 6 registered, each consented to \$5,000 penalties and 60-day suspensions.
5. For her actions ordering subordinates to complete the tests of other employees, Ms. Sappington, also Series 26 registered, consented to a \$10,000 penalty, a bar as a principal and a six month suspension in all other capacities.
6. Six additional employees, all Series 6 registered, were subordinates who completed the test for superiors. Each of these employees consented to a \$5,000 penalty and a 30-day suspension.
7. State Farm discovered this conduct in one region initially through an employee tip and self-reported the information to FINRA. After expanding its internal review nationwide, State Farm provided its findings to FINRA.
8. Notably, FINRA did not bring a case against the firm.

¹⁴ See *Sixteen From State Farm Entity Agree to Sanctions Over Test-Taking*, Broker/Dealer Compliance Report, Vol. 10 No. 10, Mar. 12, 2008.

Overstatement of Trading Volume

In January 2008, FINRA brought actions against a number of broker-dealers for overstating their trade volume in advertisements with service providers. This case is another example of the SRO's sweep actions.

On January 8, 2008, FINRA fined 19 broker-dealers for "substantially overstating their advertised trade volume to three private service providers."¹⁵ The private service providers then passed on this false information to market participants in the form of reports and rankings of the firms' volumes in certain securities. FINRA concluded that inaccurate reporting to third-party providers was inconsistent with members' obligations to report true trades to FINRA.

FINRA determined that the firms had overstated their trading volume for one or more securities by comparing their advertised trading volume with their executed trade volume in certain securities. FINRA found that the broker-dealers lacked adequate supervisory systems and procedures for communicating trade volumes.

Eight firms were fined \$200,000 each (Broadpoint Capital, Inc.; CIBC World Markets Corp.; Lehman Brothers, Inc.; Merrill Lynch, Pierce, Fenner & Smith, Inc.; Needham & Company, LLC; Robert W. Baird & Co.; Thomas Weisel Partners, LLC; and UBS Securities, LLC).

Six firms were fined \$150,000 each (Bear, Stearns & Co., Inc.; BMO Capital Markets Corp.; Cowen and Company, LLC; Deutsche Bank Securities, Inc.; Leerink Swann & Company, Inc.; and RBC Capital Markets Corp.).

Piper Jaffray was fined \$100,000. This amount was reduced from a higher amount because of the firm's cooperation. The firm conducted its own extensive internal investigation and then voluntarily provided the results to FINRA.

Four firms were fined \$50,000 each (Friedman, Billings, Ramsey & Co., Inc.; Jefferies & Company, Inc.; JMP Securities, LLP; and Pacific Crest Securities, Inc.).

The amounts of the fines varied between the firms because of "the number of misstatements and the magnitude of the misstatements."¹⁶

¹⁵ FINRA News Release, *FINRA Fines 19 Firms a Total of \$2.8 Million for Inaccurate Advertised Trade Volume Information* (Jan. 8, 2008).

¹⁶ Paul Gores, *One of 19 Firms Fined, Baird to Pay \$200,000 to Financial Regulator*, Milwaukee Journal Sentinel, Jan. 9, 2008 (quoting from interview of Richard Wallace, Vice President of Market Regulation for FINRA).

Order Audit Trail Systems (“OATS”) Reporting

So far in 2008, FINRA has picked up where NASD Regulation left off with respect to bringing cases against broker-dealers for inaccurate OATS reporting. The actions below came with hefty fines.

1. *TradeStation Securities, Inc.* (“TradeStation”), *E*Trade Securities, LLC* (“E*Trade”) and *CIBC World Markets Corp.* (“CIBC”) (May 15, 2008)

FINRA fined TradeStation, E*Trade and CIBC a total of \$1.6 million for violations of the OATS rules, which require firms to report to FINRA order handling and execution information related to customer orders and proprietary trading for Nasdaq and OTC Equity securities. The 3 firms all consented to FINRA’s actions.

FINRA fined TradeStation \$200,000 for failing to report approximately 23.5 million Reportable Order Events (“ROEs”) relating to orders received during 2000 through 2004 and \$550,000 for failing to have adequate written supervisory procedures. The firm’s procedures did not identify a person responsible for supervising the firm’s compliance with the OATS rules and did not identify steps for that person to comply with the rules. FINRA also found that TradeStation failed to conduct supervisory reviews for OATS compliance even though the ROEs significantly increased during the relevant period.

FINRA fined CIBC \$150,000 for failure to report approximately 28 million ROEs that were generated between 2003 and 2006 by its affiliate, Canadian Imperial Holdings, Inc. (“CIHI”), to which CIBC provided sponsored market access. It also fined CIBC \$200,000 for failing to supervise the reporting of trades. FINRA noted in the case that it had found that CIBC falsely represented to FINRA’s Market Regulation staff that all of its businesses were properly reporting OATS information. In determining these fines, FINRA took into consideration the fact that CIBC, upon discovery of the failures, self-reported and immediately took actions to correct the issues.

FINRA fined E*Trade \$200,000 for failing to accurately report the order receipt time of customer orders received after the market close and for not accurately reporting that the orders were routed through its affiliate. It also fined E*Trade \$300,000 for failing to have written supervisory procedures that identified a person responsible for supervising the firm’s compliance with OATS rules and that identify steps for that person to take to comply with the rules.