

Morgan Lewis

review



2007 Year in Review: SEC and SRO
Selected Enforcement Cases and
Developments Regarding Broker-Dealers

www.morganlewis.com

TABLE OF CONTENTS

	Page
Executive Summary	1
U.S. Securities and Exchange Commission	4
Statistics	4
Enforcement Actions	6
Insider Trading	6
Market Timing	11
Research Reports/Conflicts of Interest	16
Best Execution	18
On-Line Account Intrusion	19
Suspicious Activity Reports.....	20
Prime Brokerage/Short Selling.....	21
Auction Rate Securities.....	22
Municipal Securities Trading.....	23
Trade Confirmations	25
Sales to Senior Citizens.....	26
SRO Oversight Responsibilities.....	27
Regulation S-P.....	29
Gifts and Gratuities	31
Electronic Communications	31
529 Plans.....	32
Sanctions in SRO Proceedings.....	33
State Actor Cases.....	34
Developments in SEC Enforcement Policy, Procedure and Organization	36
Setting and Negotiating Penalties	36
Elevation of District Offices to Regional Level	37
Enforcement Case Management Procedures	37
Cooperative Arrangements with Foreign Financial Regulatory Counterparts	38
Mutual Recognition	40
Prudential Regulation.....	41

TABLE OF CONTENTS
(continued)

	Page
SEC Broker-Dealer Enforcement Priorities for 2008.....	41
Financial Industry Regulatory Authority	42
Regulatory Consolidation – The Creation of FINRA	42
FINRA Enforcement Statistics	44
Enforcement Actions	44
Sale of Corporate Bonds.....	44
Production of E-mails in Arbitration Proceedings and Regulatory Investigations	45
Market Timing	46
Anti-Money Laundering.....	46
Research Conflicts of Interest/Research Reports	47
Fee-Based Brokerage Accounts	48
Forms U-4/U-5 Filings.....	49
Provision of Accurate Data to Regulators	49
Municipal Securities Business Disclosures	50
FINRA Developments	51
FINRA 2008 Enforcement Priorities	53
NASD	54
Statistics	54
Enforcement Actions	54
Market Timing	54
Best Execution.....	55
Anti-Money Laundering.....	56
Disclosures to Investors.....	57
Non-Cash Compensation.....	59
Cross-Market Trading	60
Fee-Based Brokerage Accounts	61
Mutual Fund Sales Practices	62
Research Reports.....	63
Supervision	64

TABLE OF CONTENTS
(continued)

	Page
NYSE Regulation	67
Statistics	67
Enforcement Actions	67
Market Timing	67
Stock Loan.....	69
Specialist Cases	69
Market-on-Close and Limit-on-Close Orders	71
Trading Error.....	74
Prospectus Delivery	74
Financial Controls	75
Research Reports.....	77
Odd Lot Trading.....	78
Anti-Money Laundering.....	79
Trade Confirmations	80
Proxy Voting	81
Short Interest Reporting.....	82
Supervision	83
Suitability	84
Sale of Unregistered Private Placements	85
Regulation SHO.....	86
Sharing in Customer Losses.....	87
Registration.....	88
Electronic Blue Sheet Reporting	90

This outline highlights selected U.S. Securities and Exchange Commission (“SEC” or the “Commission”), NASD, NYSE Regulation, and Financial Industry Regulatory Authority (“FINRA”) enforcement actions and developments in 2007 regarding broker-dealers.*

In the SEC’s fiscal year 2007 (stretching between October 1, 2006 and September 30, 2007), the Commission initiated 14% more enforcement actions (656) than in the prior year (574). The civil penalties and disgorgement obtained by the SEC in these matters, however, decreased 52% to \$1.6 billion from \$3.3 billion in fiscal year 2006. In fact, an analysis of SEC settlements involving financial institutions over the last four Commission fiscal years reveals a significant increase in the imposition of relatively small fines and a dramatic decline in the number of large sanctions.

Specifically focusing on enforcement actions against broker-dealers, in fiscal year 2007 the Commission brought 89 such cases versus 75 last year. This represents 14% of the SEC’s docket, a slight increase from 13% in fiscal year 2006. These figures are significantly down from fiscal year 2004 when 22% of the SEC’s cases involved broker-dealers.

With respect to broker-dealer enforcement, the SEC made headlines this year in the pursuit of alleged insider trading and tipping by Wall Street professionals; the U.S. Department of Justice also criminally prosecuted a number of these individuals. As in previous years, the Commission brought cases in the mutual fund market timing, auction rate securities and research conflict of interest areas. Actions regarding municipal securities returned again this year, and the SEC opened several new fronts with Regulation S-P, 529 plans, gifts and gratuities, suspicious activity report filing, sales to seniors, and on-line brokerage account intrusion actions. In the policy and process arenas, the Commission changed the way it negotiates civil penalties, reorganized its structure, and developed new enforcement case management procedures. Finally, the Commission entered into new cooperative arrangements with certain key foreign financial regulatory counterparts, and some at the SEC signaled an

* This outline was prepared by Ben A. Indek and Anne C. Flannery, partners, and Michael S. Kraut, associate, resident in the New York office of Morgan, Lewis & Bockius LLP, with substantial assistance from associates Matthew R. Kalinowski, Alice L. McCarthy, Robert Scannell, and Jordan Weinreich. The authors are grateful for the tireless administrative efforts of Mary-Elizabeth Denmark, without whom this project could not have been completed. Morgan Lewis served as counsel in certain actions described in this outline. This outline is current as of January 14, 2008. Copyright 2008 Morgan, Lewis & Bockius LLP.

interest in “prudential regulation” and “mutual recognition” of foreign compliance regimes.

In fiscal year 2008, Commission enforcement efforts regarding broker-dealers are likely to focus on, among other things, mortgage securities valuation, insider trading, frontrunning, sales to senior citizens, and municipal securities.

The single most important topic at the self-regulatory organization (“SRO”) level was consolidation. In July 2007, the previously announced merger between the NASD and NYSE Regulation became effective. FINRA, the new SRO, spent the better part of the year developing its organizational structure, working on creating one examination program and establishing the procedures for its new single enforcement arm. Work towards a consolidated rulebook was also undertaken and will continue in 2008. FINRA also took incremental steps towards principles-based regulation in 2007.

As a separate entity in the first half of 2007, the NASD continued to be active in some of the same areas that occupied its time in prior years, including anti-money laundering, mutual fund sales practices and research conflicts of interest. In addition, two significant actions were brought in connection with marketing materials distributed to investors and one major case involved supervision of gifts and gratuities and NASD registration requirements. Consistent with its long-standing enforcement program, these cases also focus on broker-dealer supervision. While no official statistics have been released as of the date of this publication, our preliminary review of NASD enforcement activity indicates that for calendar year 2007, the number of cases the NASD brought seems to have declined from prior years. The amount of fines imposed on member firms also appears to have decreased from previous years. One possible explanation for these declines is the time and energy devoted to the merger of NASD with NYSE Regulation.

At NYSE Regulation, enforcement actions continued in several areas that had been the subject of disciplinary cases in years past, such as: NYSE floor activities (enforcement of trading rules, specialist matters, and a significant stock loan case), prospectus delivery, anti-money laundering, net capital and other financial operations issues and registration. NYSE Regulation also brought a major action in a new area – the unregistered private placement arena. These matters also typically include a supervisory charge. Again, there has been no official announcement by NYSE Regulation concerning its enforcement activity statistics for 2007. However, based on our preliminary review, in 2007 the number of enforcement actions brought by NYSE Regulation (approximately 161) dropped 44% from 232 cases in 2006, although the fines assessed by NYSE Regulation in 2007 (approximately \$26 million) nearly matched the fines assessed in 2006 (approximately \$29 million). Again, the drop-off may be merger-related.

After its official launch in July 2007, FINRA concluded and publicized several cases that had been begun by the NASD (including actions regarding e-mail retention and production and compliance with the 2003 breakpoint self assessment). Several of the

priority areas for FINRA in 2008 are investment fraud involving seniors, variable annuities, subprime mortgages, anti-money laundering, and Regulation SHO.

Statistics

- A. In the SEC's fiscal year ("FY") 2007, the Commission brought 656 enforcement actions (262 civil proceedings and 394 administrative proceedings).¹ This is a 14% increase in enforcement actions from the previous year. The increase in the number of cases initiated this year may be explained, in part, by a 57% increase in SEC enforcement actions involving financial disclosure.

- B. Turning to investment banks, SEC enforcement actions against broker-dealers in FY 2007 increased slightly from 13% to 14% but are still down from 22% as recently as FY 2004. In raw numbers, the Commission sanctioned broker-dealers in 89 cases in FY 2007 versus 75 in FY 2006.²

- C. While insider trading dominated the headlines, the SEC brought only one more insider trading case (47) in FY 2007 than it brought in FY 2006.³ In fact, because the overall number of enforcement cases increased in FY 2007 from the prior year, the percentage of SEC cases that involved insider trading actually fell from 8% to 7%.

- D. The Commission also reported a 52% drop in the amount of disgorgement and penalties in its actions, from \$3.3 billion in FY 2006 to \$1.6 billion in FY 2007. In FY 2007, the Commission imposed approximately \$507 million in fines and ordered disgorgement of about \$1.1 billion.⁴

¹ The SEC's fiscal year begins on October 1st. For example, references to FY 2007 refer to the year that began on October 1, 2006 and ended on September 30, 2007.

² See Bailey Somers, "SEC Enforcement Actions Up 14% From Last Year," Securities Law 360, Nov. 16, 2007.

³ See *id.*

⁴ See David Scheer and Jesse Westbrook, "SEC Penalties Fall and 'New Ethos' on Company Fines (Updated)," Bloomberg, Nov. 19, 2007.

E. Over the past few years, it has become apparent that the size of SEC penalties against various financial institutions has been trending down, particularly since Christopher Cox became SEC Chairman. A detailed analysis of the past four years reflects the staggering degree to which this is true.⁵

1. The last four SEC fiscal years (October 1, 2003 to September 30, 2007) can be divided into two halves. First, there is the 22-month period from October 1, 2003 to August 2, 2005. Second, Christopher Cox became SEC Chairman on August 3, 2005 and continued in that role through September 30, 2007; this is 26 months.
2. There were 90 settlements involving financial institutions (broker-dealers, investment advisers, banks, investment companies, transfer agents) in the 22 months before Mr. Cox became SEC Chairman and 108 in the 26 months since then. This reflects a steady pace throughout the four years of slightly more than four settlements per month.
3. Turning to penalties, the statistics are as follows:

Penalty Layers	October 1, 2003 to August 2, 2005	August 3, 2005 to September 30, 2007
\$0 to \$1 million	33	74
Over \$1 million to \$10 million	21	28
Over \$10 million	36	6

4. The number of settlements is comparable (90 for 22 months and 108 for 26), and the middle category (over \$1 million up to \$10 million) stayed nearly constant. However, the sharp increase to the small penalty settlement population and the dramatic shrinking in the number of large penalty settlements are stark. While some of the change could be attributable to substantive differences in the cases brought, the numbers suggest there may have been a philosophical

⁵ Please note that the fine amounts do not account for penalty payments made simultaneously to other regulators and do not include disgorged amounts. These exclusions were applied consistently to all of the enforcement matters in the study.

shift by the Cox Commission in what constitutes an appropriate penalty.⁶

- F. Finally, the SEC's Division of Enforcement has seen a steady decrease in enforcement referrals from its Office of Compliance Inspections and Examinations ("OCIE").
1. In FY 2007, the number of referrals to the Division of Enforcement from OCIE was 203, down 9% from FY 2006. However, most notably, this number is down 58% and 49%, respectively, from FY 2004 and FY 2005. Relatedly, the percentage of broker-dealer examinations with significant findings fell from 48% in FY 2005 to 40% in FY 2006 to 37% in FY 2007.

Enforcement Actions

Insider Trading

As discussed above, the number of insider trading cases brought in 2007 remained essentially static from last year.

Notably, however, in 2007, the SEC prosecuted several insider trading cases against Wall Street professionals. In June 2007, Linda Thomsen, Director of the SEC's Enforcement Division, commented that "[o]ne of the things that is particularly disturbing to me is the number of Wall Street professionals that are engaged in insider trading. It is frankly outrageous."⁷ In addition to SEC actions, a number of the individuals in the cases listed below were also the subject of criminal prosecutions by the United States Department of Justice. Some examples of the noted trend are described below.

- A. *SEC v. Mitchel S. Guttenberg, Erik R. Franklin, David M. Tavdy, Mark E. Lenowitz, Robert D. Babcock, Andrew A. Srebnik, Ken Okada, David A. Glass, Marc R. Jurman, Randi E. Collotta, Christopher K. Collotta, Q Capital Investment Partners, LP, DSJ International Resources Ltd. (d/b/a Chelsey Capital), and Jasper Capital LLC* (S.D.N.Y. Mar. 1, 2007)

⁶ Several media articles have noted this apparent philosophical shift. See, e.g., Jesse Westbrook, "Cox Sets Off Alarms on Investor Rights with SEC Moves," Bloomberg, May 24, 2007; Carrie Johnson, "SEC Shift May Lead to Lower Penalties," Washington Post, at D1, Apr. 13, 2007. For a discussion of recent changes in SEC policy concerning penalties, see *infra* at 35-36.

⁷ Bob Drummond, "Insider Trading Makes Comeback in Options 20 Years After Boesky," Bloomberg.com, June 20, 2007.

1. The SEC charged fourteen defendants in connection with two related insider trading schemes, in which Wall Street professionals allegedly traded after receiving a series of tips from insiders at UBS Securities LLC and Morgan Stanley & Co., Inc., in exchange for cash kickbacks.
 - (a) In one scheme, which occurred between 2001 through 2006, an executive director in the UBS equity research department allegedly tipped material non-public information concerning upcoming UBS analyst upgrades and downgrades to at least two Wall Street traders in exchange for a portion of the profits from the inside trading.
 - (b) In the second scheme, several of the participants in the first scheme, and others, allegedly traded ahead of corporate acquisition announcements after receiving inside information stolen by an in-house attorney in Morgan Stanley's global compliance department.
2. The alleged tippees used these tips to trade in their personal accounts, their relatives' personal accounts, and/or in trades made on behalf of their broker-dealer or investment adviser employers. The tippees also passed the tips on to others, who traded on the inside information in exchange for kickbacks.
3. The SEC's press release announcing the charges included a statement by an Associate Director of Enforcement that this action represents one of the largest SEC insider trading cases against Wall Street professionals in twenty years.
4. On November 20, 2007, the SEC settled its case against Andrew Srebnik, one of the fourteen defendants. Srebnik, a former Bear Stearns trading desk employee, consented to findings that between March 2002 and June 2002, he monitored trading by a colleague who he knew was receiving undisclosed analyst upgrades and downgrades from an employee in UBS's equity research department. Srebnik allegedly then traded in his personal account based on the UBS information. Srebnik consented to a cease-and-desist order, disgorgement and a civil penalty of approximately

\$23,000 and a bar from association with any broker-dealer or investment adviser.

5. In a related criminal case, the U.S. Attorney's Office for the Southern District of New York criminally charged thirteen alleged participants in the fraudulent scheme, a number of whom have pled guilty.

B. *SEC v. One or More Unknown Purchasers of Call Options for the Common Stock of TXU Corp.* (N.D. Ill. May 4, 2007)

1. The SEC charged Hafiz Naseem, a Credit Suisse investment banker, with misappropriating material, non-public information involving several business deals in which Credit Suisse served as an investment banker or a financial adviser. Naseem allegedly passed the information onto Ajaz Rahim, a Pakistani banker employed by Faysal Bank, who traded while in possession of the tips and earned millions of dollars in profits.
2. On May 11, 2007, the SEC amended its complaint to charge Rahim with insider trading in connection with his trading after receiving tips from Naseem. In the amended complaint, the SEC also alleged that Naseem granted discretion in one of his brokerage accounts to Rahim to enable Rahim to repay Naseem for the tips.
3. The SEC seeks injunctive relief, disgorgement, and a civil penalty against Naseem and Rahim, but the SEC's case is on hold pending resolution of the criminal case. Federal prosecutors charged Rahim and Naseem with securities fraud and conspiracy; the case has not yet been resolved.
4. In the press release announcing the charges against Rahim, the SEC thanked the NYSE, Chicago Board Options Exchange, the Swiss Federal Banking Commission and the Financial Services Authority of the United Kingdom for their assistance.

C. *SEC v. Jennifer Xujia Wang, Ruben Chen, and Zhiling Feng* (S.D.N.Y. May 10, 2007)

1. The SEC charged Wang, then a Vice President of Morgan Stanley and her husband Chen, a former employee of ING Investment Management Services, LLC, with trading based on material non-public information that she misappropriated from Morgan Stanley. The couple allegedly purchased securities of three companies, each of which had approached Morgan Stanley to provide services in connection with future acquisitions.
2. The SEC seeks permanent injunctions, disgorgement, prejudgment interest, and civil penalties.
3. Wang and Chen were also criminally prosecuted by the Department of Justice. On September 5, 2007, Wang and Chen each pled guilty to one count of conspiracy and three counts of insider trading and were each sentenced to 18 months in prison and to disgorge more than \$600,000 in illegal gains. In addition, Wang and Chen received one year and two years, respectively, of supervised release after their prison sentences.

D. *SEC v. Barclays Bank PLC and Steven J. Landzberg* (S.D.N.Y. May 30, 2007)

1. The SEC filed a civil action against Barclays Bank PLC (“Barclays”) and Landzberg, a former proprietary trader for Barclays’ U.S. Distressed Debt Desk, alleging that between March 2002 and September 2003, they violated the federal securities laws by illegally trading bonds on the basis of material non-public information obtained through membership on bankruptcy creditors’ committees.
2. Landzberg served as Barclays’s representative on the creditors’ committees and received material non-public information regarding, among other things, the financial condition and prospects of the issuers, their most recent business plans, detailed management projections, and the timing and terms of proposed plans of reorganization.

3. Neither Barclays nor Landzberg disclosed the material non-public information received from creditors' committees to the firm's trading counterparties.
4. Barclays' Compliance personnel allegedly failed to prevent the illegal insider trading, despite knowledge that the proprietary desk had received material non-public information and should have been restricted from trading.
5. Barclays consented to a court order requiring it to pay over \$10.94 million (disgorgement of \$3,971,736, prejudgment interest of \$971,825, and a civil penalty of \$6,000,000). Landzberg consented to a permanent injunction and agreed to pay a civil penalty of \$750,000.

E. *SEC v. Luiz Gonzaga Murat Jr. and SEC v. Alexandre Ponzio De Azevedo* (D.D.C. Feb. 22, 2007)

1. The SEC filed settled civil actions against two individuals, including Alexandre Ponzio de Azevedo, a former employee of ABN AMRO Real S.A. ("ABN AMRO"). ABN AMRO, an investment banking firm, had been retained by an issuer to provide advice in connection with the issuer's possible tender offer of a target company. Azevedo, who was assigned to work on that representation, purchased American Depositary Shares of the target company after ABN AMRO placed the target company on its watch list and prior to the announcement of the tender offer. He sold most of his shares the day after the tender offer was announced.
2. Azevedo consented to a judgment that required him to pay more than \$68,000 in disgorgement and interest and a civil penalty of more than \$67,000 and barred him from association with a broker or dealer with a right to reapply after three years.

Market Timing

In 2007, the SEC brought matters involving market timing against A.G. Edwards & Sons, Inc., a former Prudential broker, former CIBC World Markets Corp. and Fahnstock & Co., Inc. brokers, Mutuals.com, Inc., Wachovia Securities, and Morgan Stanley & Co. Inc.

A. *In the Matter of A.G. Edwards & Sons, Inc.* (“AGE”) (Admin. Proc. File No. 3-12624, May 2, 2007)

1. The SEC settled an administrative proceeding against AGE for allegedly failing reasonably to supervise some of its registered representatives who used deceptive means to place market timing trades on behalf of their customers.
2. The SEC alleged that certain of AGE’s financial consultants (“FCs”) enabled their market timing customers to continue trading with mutual funds that previously restricted their market timing activities. The FCs allegedly were able to accomplish this by, *inter alia*, using multiple account numbers for the same customer; opening accounts in the names of multiple entities affiliated with the same customer; opening accounts at different branch offices for the same customer; placing trades using multiple FC identification numbers; and transferring assets between related accounts.
3. In April 2003, an internal AGE working group issued a report to members of senior management detailing the extent of the continuing market timing at the firm and recommending that AGE take steps to prevent any further market timing from occurring. Nevertheless, AGE allegedly did not develop or implement sufficient policies or sufficient procedures to address the market timing activity at the firm until at least September 2003.
4. As part of its settlement with the SEC, AGE agreed to pay disgorgement and prejudgment interest of \$2.36 million and a civil penalty of \$1.5 million. AGE also agreed to certain undertakings, including hiring an independent consultant to review whether the changes AGE has made to its policies and procedures are reasonably designed to prevent and detect future market timing activity.

5. In a related action, the SEC settled an administrative proceeding against Charles Sacco, an AGE FC, involving the same conduct. Sacco agreed to pay disgorgement plus prejudgment interest totaling \$272,871.22, an amount that was reduced to \$15,000 based on his inability to pay. Sacco also consented to the issuance of a Commission order that barred him from association with any broker or dealer for two years.

B. *SEC v. Justin Ficken* (“Ficken”) (D. Mass. Sept. 13, 2007)

1. In November 2003, the SEC brought an action against five former Prudential registered representatives and two branch managers for assisting clients in market timing mutual funds. Some of the respondents settled with the SEC, others failed to respond, and charges against others appear to remain outstanding.
2. On September 13, 2007, a Massachusetts federal judge entered a final judgment against Justin Ficken, one of the former Prudential registered representatives, after granting the SEC’s summary judgment motion. The judge issued a cease-and-desist order against Ficken and ordered him to disgorge nearly \$500,000.
3. On December 19, 2007, the United States Attorney’s Office indicted Ficken on multiple counts involving conspiracy, wire fraud and securities fraud in connection with his alleged market timing conduct and one count of obstruction of justice in connection with testimony he gave to the SEC staff during its investigation.

C. *In the Matter of Michael Sassano, Dogan Baruh, Robert Okin, and R. Scott Abry* (Admin. Proc. File No. 3-12554, Jan. 31, 2007)

1. The SEC alleged that Sassano and Baruh, former CIBC World Markets Corp. and Fahnestock & Co., Inc. brokers collaborated with hedge fund customers to deceptively market time mutual funds.

2. Despite complaints by mutual fund families concerning the market timing activities, Sassano and Baruh allegedly employed an array of strategies designed to help their hedge fund customers “stay under the radar” of the mutual funds’ internal timing monitors, including: (1) the use of multiple accounts, registered representative numbers, and branch numbers; (2) trading in smaller dollar amounts; (3) moving accounts to other broker-dealers to continue market timing funds that had blocked their customers trading through CIBC; and (4) market timing variable annuities.
3. In addition, Baruh allegedly accepted mutual fund orders after 4 PM and processed those orders as though they had been placed prior to 4 PM so that they received the same day’s net asset value.
4. Okin and Abry supervised Sassano and Baruh and purportedly knew of, and assisted, Sassano and Baruh’s deceptive market timing practices.
5. The SEC seeks cease-and-desist orders, disgorgement, civil penalties, and prejudgment interest.
6. Notably, the SEC staff investigated this matter, and many other investigations under a single omnibus formal order with separate file numbers. The respondents in this matter moved for discovery of all the staff’s documents (from any of its investigations) that it obtained via subpoena under the omnibus formal order. The staff opposed the discovery motion, arguing that producing all of the requested documents would be extraordinarily burdensome. The administrative law judge determined that while the staff need not produce all documents obtained via the formal order, it had to provide all such non-privileged documents “relating to any of the mutual funds, annuity funds, hedge funds, trading platforms, and individuals” referenced in the Order Instituting Proceedings against the respondents. The staff appealed, but the SEC held that extraordinary circumstances requiring interlocutory review did not exist.

D. *In the Matter of Mutuals.com, Inc.* (“Mutuals.com”), *Connely Dowd Management Inc.* (“Connely”), *MTT Fundcorp, Inc.* (“MTT”), *Richard Sapio, Eric McDonald and Michele Leftwich* (Admin. Proc. File No. 3-12837, Sept. 26, 2007)

1. The SEC alleged that between July 2001 and September 2003, Mutuals.com, two of its wholly owned subsidiaries (Connely and MTT), and the firms’ three principals provided market timing and late trading services to at least 11 institutional clients and customers.
2. In providing these services, these firms and principals used deceptive tactics to evade detection by mutual funds, such as using multiple accounts for the same client, multiple registered representative numbers, and multiple branch codes. The firms continued to engage in these practices even after mutual funds asked them to stop.
3. Each respondent consented to cease-and-desist orders. The SEC barred the individual respondents from association with any broker, dealer or investment adviser. Mutuals.com’s CEO agreed to pay a civil penalty of \$120,000 plus disgorgement and prejudgment interest. Mutuals.com, Connely, and MTT were ordered to pay disgorgement and interest, but the SEC waived these payments based on sworn representations as to their inability to pay.

E. *In the Matter of Evergreen Investment Management Company, LLC, Evergreen Investment Services, Inc., Evergreen Service Company, LLC and Wachovia Securities, LLC* (Admin. Proc. File No. 3-12805, Sept. 19, 2007)

1. The SEC settled an administrative proceeding against Wachovia Securities, LLC and Evergreen Investment Services, Inc. (“EIS”) (both registered broker-dealers), along with their affiliates Evergreen Investment Management Company, LLC, and Evergreen Service Company, LLC.
2. The SEC alleged that the respondents, along with William M. Ennis, a senior vice-president of Evergreen Investment

Company (the holding company), agreed to permit a registered representative whom Wachovia was trying to recruit to market time Evergreen funds.

3. In addition to the market timing charges, the SEC also charged EIS for failing to preserve e-mails related to its business as a broker-dealer.
4. Each respondent consented to censure and a cease-and-desist order. The order also required the respondents to pay a total of \$28.5 million in disgorgement and \$4 million in civil penalties.
5. In a related action, Ennis consented to disgorge \$1 and pay a civil penalty of \$150,000.⁸

F. *In the Matter of Morgan Stanley & Co. Inc.* (Admin. Proc. File No. 3-12907, Dec. 18, 2007)⁹

1. The SEC alleged that, between January 2002 and August 2003, four Morgan Stanley registered representatives employed multiple deceptive tactics to facilitate market timing for their hedge fund clients, such as using multiple accounts and broker codes. Morgan Stanley allegedly failed to implement policies and procedures to prevent and detect the market timing.
2. The SEC also alleged that members of Morgan Stanley's operations department with oversight responsibility for mutual fund trading and financial advisors placed, cancelled and amended orders for hedge fund clients after the 4 PM market close while still providing the same day's NAV.
3. Morgan Stanley consented to charges that it violated Section 17(a)(1) of the Exchange Act and Rule 17a-3 thereunder, and Rule 22c-1(a) of the '40 Act. Morgan Stanley agreed to a censure, a cease-and-desist order, and to pay

⁸ See *In the Matter of William M. Ennis* (Admin. Proc. File No. 3-12805, Sept. 19, 2007)

⁹ Note that this case was resolved after the close of the SEC's FY 2007.

disgorgement of \$4,400,000 and a penalty of \$11,880,000, plus interest.

4. In a related proceeding, Marc Plotkin, a former Morgan Stanley registered representative, consented to charges that he violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder for knowingly and substantially assisting another Morgan Stanley financial advisor engage in deceptive trading practices designed to circumvent mutual funds' restrictions on market timing. Plotkin was barred from association with any broker, dealer or investment advisor for one year and fined \$90,000.¹⁰ The SEC also charged two other former Morgan Stanley registered representatives (Darryl Goldstein and Christopher O'Donnell) for assisting market timing clients. That matter has not yet been resolved.

Research Reports/Conflicts of Interest

Beginning in 2003, the SEC (along with the SROs and a number of state regulators) began bringing cases against a number of large investment banks regarding alleged conflicts of interests in the research and investment banking area. The case described below may be the last in this string.

- A. *In the Matter of Banc of America Securities LLC* ("BAS") (Admin. Proc. File No. 3-12591, Mar. 14, 2007)
 1. The SEC settled an administrative proceeding against BAS for allegedly violating the antifraud and internal controls provisions of the federal securities laws in connection with its issuance of research between January 1999 and December 2001.
 2. BAS allegedly lacked policies and procedures to prevent the misuse by the firm and its employees of material non-public information contained in its research reports.
 3. BAS sales and trading employees learned of forthcoming research changes, including upgrades and downgrades of the issuers, but BAS did not provide clear or effective

¹⁰ See *In the Matter of Marc H. Plotkin* (Admin. Proc. File No. 3-12906, Dec. 18, 2007)

policies and procedures regarding the handling or control of such information.

4. BAS also permitted its Marketing Director for Equity Research to have access to and communications with the firm's research analysts without establishing additional policies and procedures to protect against the potential misuse of material non-public research information and without maintaining or enforcing the policies that were already in place.
5. As a result, in at least two instances, BAS employees who had knowledge of forthcoming upgrades or downgrades traded for the firm's proprietary account before the research reports were publicly issued.
6. The SEC also alleged that BAS failed to address conflicts of interest that resulted in the publication of materially false and misleading research reports concerning three issuers.
7. According to the order, between 1999 and 2001, BAS employed business practices that linked research and investment banking and incentivized research analysts to support the firm's investment banking efforts. In so doing, BAS allegedly fostered an environment in which BAS investment bankers inappropriately influenced analysts.
8. BAS consented to pay \$26 million in disgorgement and penalties, a cease-and-desist order, and retain a consultant to review the firm's internal controls designed to prevent the misuse of material non-public information concerning forthcoming research.
9. This action completed an investigation that led to prior action by the SEC Enforcement Division. In March 2004, BAS paid a \$10 million civil penalty to settle charges that it failed to promptly produce documents requested by the SEC staff, provided misinformation, and engaged in dilatory tactics that delayed the investigation.

Best Execution

For several years, regulators have highlighted best execution as an examination priority. In mid 2007, the SEC brought a significant enforcement action in this area.

A. *In the Matter of Morgan Stanley & Co. Inc.* (“Morgan Stanley”) (Admin. Proc. File No. 3-1263, May 9, 2007)

1. The SEC settled charges against Morgan Stanley for breaching its duty to provide best execution in retail orders placed between 2001 and 2004 for over-the-counter (OTC) securities. More than 1.2 million executions valued at approximately \$8 billion were involved.
2. Morgan Stanley allegedly embedded undisclosed mark-ups and mark-downs on certain “not held” retail orders without the customers’ prior consent.
3. Morgan Stanley used a trading mechanism that at times slowed down trade execution, so that the firm could try to obtain better prices for not held orders. This activity breached Morgan Stanley’s duty of best execution because it delayed the execution of certain held market orders for which the firm was obliged to execute without hesitation.
4. Morgan Stanley also embedded (but did not disclose) mark-ups and mark-downs on certain retail orders for OTC stocks in which it made a market but filled with executions from other market centers. These executions should have received the same execution prices that Morgan Stanley received without any mark-ups, mark-downs, commissions or other fees.
5. Morgan Stanley consented to \$6 million in disgorgement, a \$1.5 million civil penalty, a cease-and-desist order, and retention of an independent distribution consultant and an independent compliance consultant.

On-Line Account Intrusion

In 2007, the SEC brought several matters involving on-line account intrusion.

- A. *SEC v. One or More Unknown Traders in the Common Stock of Certain Issuers, Defendants, and JSC Parex Bank, Relief Defendant* (D.D.C. Mar. 7, 2007)
1. The SEC obtained a freeze of \$3 million worth of assets held in a Latvian-based bank's U.S. trading account, which were allegedly used to conduct a hi-tech market manipulation scheme.
 2. The account allegedly had been used by unknown offshore sub-account holders to launch a "pump-and-dump" scheme involving the stocks of fifteen public companies. The unknown traders allegedly hacked into investors' online brokerage accounts and sold the investors' positions, thereby artificially creating the appearance of trading demand for the thinly-traded stocks. The traders then sold their holdings at a substantial profit.
 3. The action seeks injunctive relief, disgorgement with prejudgment interest, and civil monetary penalties.
- B. *SEC v. Jaisankar Marimuthu, Chockalingam Ramanathan and Thirugnanam Ramanathan* (D. Neb. Mar. 12, 2007)
1. The SEC filed civil charges against three Indian nationals who allegedly participated in a fraudulent scheme to manipulate securities prices through the unauthorized use of other people's online brokerage accounts.
 2. Between July and November 2006, the defendants allegedly acquired positions in their own accounts in at least fourteen securities and "out of the money" put options on shares of Google, Inc. The defendants then hacked into their victims' online brokerage accounts using stolen usernames and passwords, and using the victims' funds, placed unauthorized buy orders at above-market prices. After executing these buy orders, which increased the market

price for the securities, the defendants sold the positions that they held in their own accounts at the artificially inflated prices, realizing profits of over \$121,500. At least 60 individuals and nine brokerage firms were identified as victims.

3. On several occasions, the defendants allegedly opened online brokerage accounts using stolen personal information and then funded these accounts with money from the victims' bank accounts. On other occasions, securities held in the victims' online brokerage accounts were liquidated in order to finance unauthorized trading.
4. The SEC seeks injunctive relief, disgorgement with prejudgment interest, and civil monetary penalties.
5. In a related action, the U.S. Department of Justice filed a twenty-three count indictment against the same three individuals, charging conspiracy, computer fraud, wire fraud, securities fraud, and aggravated identity theft. This matter marked the first time that individuals overseas were arrested in connection with online brokerage account intrusion in the United States.
6. This action marked the fourth account intrusion case brought by the SEC since December 2006.

Suspicious Activity Reports

In 2006, the SEC initiated its first anti-money laundering action under the U.S.A. Patriot Act against a broker-dealer. In 2007, the Commission took its first action against a broker-dealer for failure to file a suspicious activity report ("SAR").

- A. *In the Matter of Park Financial Group, Inc. and Gordon C. Cantley* (Admin. Proc. File No. 3-12614, Dec. 5, 2007)
 1. The SEC instituted an enforcement action alleging that broker-dealer Park Financial Group ("Park") and its principal, Gordon Cantley, aided and abetted a "pump-and-dump" scheme and failed to file the SARs required by the Bank Secrecy Act.

2. Between 2002 and 2003, Park and Cantley allegedly executed more than 200 trades involving one million shares for three companies located in the British Virgin Islands in Spear & Jackson securities, despite red flags that the B.V.I. companies were secretly controlled by Dennis Crowley, the then-CEO of Spear & Jackson. Park and Cantley permitted the trades to occur, despite knowledge that Crowley was not an authorized signatory on the accounts.
3. Park allegedly failed to file SARs with the Financial Crimes Enforcement Network to report suspicious transactions in Spear & Jackson stock, as required by regulations implementing the Bank Secrecy Act (which was amended by the USA Patriot Act). This is the first SEC enforcement action alleging violations due to a broker-dealer's failure to file SARs.
4. After the initiation of proceedings, Cantley and Park settled this matter by consenting to charges of aiding and abetting Crowley's violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. Park also violated, and Cantley aided and abetted, Park's violations of Section 17(a) of the Exchange Act and Rule 17a-8 thereunder. Cantley consented to a cease-and-desist order, a bar from association with any broker or dealer (with a right to reapply after two years), and a fine and disgorgement totaling approximately \$33,000. Park consented to a censure, a cease-and-desist order, disgorgement of approximately \$30,000 and a fine of \$50,000.

Prime Brokerage/Short Selling

Short selling has been a hot regulatory and enforcement topic over the last several years. In 2007, two regulators combined to bring a significant action in this area.

- A. *In the Matter of Goldman Sachs Execution & Clearing L.P.* ("GSEC") (Admin. Proc. File No. 3-12590, Mar. 14, 2007)
 1. The SEC and NYSE Regulation settled enforcement proceedings against GSEC for failing to detect or prevent its clients' unlawful trading that involved transactions of short

sales of securities that were marked long in the clients' prime brokerage accounts.

2. The order alleges that from at least March 2000 to May 2002, certain of GSEC's customers placed orders to sell through the firm's direct market access, automated trading system (called the REDI System) and falsely marked the orders "long," even though the orders were in fact short.
3. GSEC relied solely on the client marking of their orders and executed the transactions as long sales. GSEC's exclusive reliance on its clients' marking was deemed unreasonable because in certain instances, the firm possessed records that demonstrated that the clients did not own the securities that they were selling. Specifically, the firm's records reflected that its clients covered their short positions with securities purchased in follow-on and secondary offerings after executing their sales in violation of Rule 105 of Regulation M.
4. The SEC found that GSEC could have discovered its customers' trading scheme if it had instituted and maintained procedures reasonably designed to detect these trading disparities.
5. GSEC agreed to pay a \$2 million civil penalty (\$1 million each to the SEC and to NYSE Regulation).

Auction Rate Securities

In 2006, 14 broker-dealers were sanctioned by the SEC with respect to auction rate securities practices. In 2007, the Commission brought yet another action.

- A. *In the Matter of Citigroup Global Markets, Inc., successor by merger to Legg Mason Wood Walker Inc.* ("Legg Mason") (Admin. Proc. File No. 3-12629, May 7, 2007)
 1. The SEC settled charges involving Legg Mason's conduct in the auction rate securities market.

2. Auction rate securities are municipal bonds, corporate bonds or preferred stocks with interest rates or dividend yields that are periodically re-set through Dutch auctions.
3. Between January 2003 and June 2004, Legg Mason allegedly intervened in auctions by bidding for its proprietary account to prevent failed auctions without adequate disclosure. When this practice lowered the clearing rate of an auction, investors received a lower rate of return on their investments.
4. Because Legg Mason was under no obligation to guarantee against a failed auction, investors may not have been aware of the liquidity and credit risks associated with certain securities.
5. Citigroup Global Markets, which acquired Legg Mason after the conduct at issue occurred, consented to a censure and a \$200,000 civil penalty.

Municipal Securities Trading

In 2007, the SEC showed renewed interest in municipal securities trading cases, some of which involved broker-dealers.

A. *In the Matter of D.M. Keck & Company, Inc. d/b/a Discount Munibrokers (“D.M. Keck”), Donald Michael Keck and Patricia Ann Seelaus (Admin. Proc. File No. 3-12839, Sept. 27, 2007)*

1. The SEC settled an administrative proceeding against D.M. Keck, its President and CEO Donald Michael Keck, and its SVP and CFO Patricia Ann Seelaus for misrepresentations, adjusted trading and other fraudulent conduct in connection with the “auction-type” sale of municipal securities.
2. During 2003 and 2004, the firm entered fake bids to make certain sales appear more competitive or to satisfy customer requirements. In addition, it reported fictitious prices to the market as part of its adjusted trading scheme.

3. In addition to the trading violations, the SEC alleged that the firm failed to supervise and failed to retain certain correspondence (faxes).
4. The SEC revoked Discount Munibrokers' broker-dealer registration. The individual respondents were barred from association with any broker, dealer or municipal securities dealer in a supervisory capacity for five years. Donald Keck also consented to a cease-and-desist order and a \$15,000 civil penalty.

B. *In the Matter of Regional Brokers, Inc. ("Regional Brokers") and Patrick Lubin* (Admin. Proc. File No. 3-12838, Sept. 27, 2007)

1. The SEC settled an administrative proceeding against Regional Brokers and Patrick Lubin for misrepresentations and other fraudulent conduct in connection with their sale of municipal securities.
2. Between December 2003 and December 2004, the firm entered fake bids to make certain sales appear more competitive. In addition, it accepted bids after the cutoff time set for bids in various auctions.
3. In addition to the trading violations, the SEC also found that the firm failed to supervise and failed to retain required correspondence (faxes and e-mails).
4. Regional Brokers and Patrick Lubin each consented to a censure and a cease-and-desist order. Regional Brokers agreed to pay a \$100,000 civil penalty while Lubin agreed to pay \$50,000. In addition, Lubin was barred from association with any broker, dealer or municipal securities dealer.

Trade Confirmations

Regulators consistently bring enforcement actions relating to broker-dealer operational issues. In late 2007, the SEC initiated such an action regarding trade confirmations.

- A. *In the Matter of Morgan Stanley & Co. Inc.* (Admin Proc. File No. 3-12864 Oct. 10, 2007)¹¹
1. The SEC alleged that over a five-year period beginning in 2000, Morgan Stanley DW, Inc. (“MSDW”) (which merged into its affiliate Morgan Stanley & Co. in 2007) provided confirmations for certain trades involving fixed income securities that contained missing or inaccurate information concerning, for example, the firm’s role as agent, call and put details, and the securities’ yield.
 2. The SEC alleged that MSDW did not address this issue quickly enough. The SEC alleged that MSDW was aware of this issue, based on customer complaints beginning in May 2000, a task force that the firm created to address the issue in August 2003, and notice by the SEC staff in December 2004. In addition, the firm subsequently discovered additional regulatory violations related to confirmations for fixed income securities during an internal review. The settlement release also noted that in 2005, Morgan Stanley & Co. disclosed to the staff that it too had provided customers with noncompliant confirmations for trades involving fixed income securities.
 3. Morgan Stanley consented to violations of Exchange Act Section 15B(c)(1) and Rule 10b-10, as well as MSRB Rule G-15. The firm accepted a censure, a cease-and-desist order, and paid a penalty of \$7.5 million. In addition, the firm agreed to retain an independent compliance consultant.

¹¹ Note that this case was resolved after the close of the SEC’s FY 2007.

Sales to Senior Citizens

In early September 2007, SEC Chairman Cox testified before a United States Senate Special Committee, calling the protection of seniors one of the most important issues of our time and one of his highest priorities. Also, in early September 2007, the SEC held its second annual Senior Summit in which a number of regulators came together to discuss the issue of protecting seniors from investment fraud. At about the same time, the Commission brought two significant enforcement actions in this area.

- A. *In the Matter of Commonwealth Equity Services, LLP d/b/a Commonwealth Financial Network* (“Commonwealth Equity”) (Admin. Proc. File No. 3-12749, Sept. 6, 2007) and *In the Matter of Detwiler, Mitchell, Fenton & Graves, Inc.* (“Detwiler”) (Admin. Proc. File No. 3-12750, Sept. 6, 2007).
1. The SEC brought actions against both Commonwealth Equity and Detwiler in connection with their employment of Bradford Bleidt, a registered representative. Bleidt defrauded approximately 59 customers from these broker-dealers by lying about purchases and sales, misappropriating funds and sending falsified statements related to their accounts. The Commission alleged that at least 40 of Bleidt’s clients were over age 70 at the time of the SEC’s charges. In July 2005, Bleidt pled guilty to mail fraud and money laundering charges and received an 11 year sentence.
 2. The SEC found that the respondents failed to supervise in several respects. First, Bleidt personally owned the independent office in which he worked. The firms permitted Bleidt to hire and personally employ the OSJ manager who supervised him. The SEC concluded that the conflict of interest inherent in such a structure may have compromised supervisory review. Second, the SEC concluded that the firms lacked adequate policies and procedures to follow up on red flags concerning Bleidt’s outside business activities and for review of incoming correspondence.
 3. The SEC censured each of the respondents and ordered them to pay \$250,000 in civil penalties.

SRO Oversight Responsibilities

In 2007, the SEC brought matters against the American Stock Exchange LLC and Boston Stock Exchange, Inc. and former officers of these exchanges.¹²

- A. *In the Matter of American Stock Exchange LLC* (“Amex”) (Admin. Proc. File No. 3-12594, Mar. 22, 2007)
1. The SEC settled an administrative proceeding against Amex, finding that from at least 1999 through June 2004, the exchange allegedly failed adequately to surveil for its members’ violations of order handling rules, and also failed to keep and furnish surveillance and other records.
 2. The SEC found that, notwithstanding a September 2000 SEC order, which sanctioned Amex for its inadequate options regulation, Amex’s programs for surveillance of options order handling remained inadequate to detect violations of rules relating to firm quotes, customer priority, limit order display, and trade reporting.
 3. The SEC also found that, even in those instances in which Amex’s surveillance programs detected rule violations, Amex failed to investigate violations properly, improperly excused violations, and failed to pursue adequately disciplinary actions for rule violations.
 4. In addition to the deficiencies in the Amex's surveillance, investigatory, and enforcement programs, the SEC found that Amex failed to keep and furnish certain records relating to its surveillance, investigatory, and enforcement activities.
 5. Amex agreed to: (1) a cease-and-desist order, (2) file a rule proposal designed to enhance its trading systems so that specialists systemically will be prevented from violating

¹² Despite these actions against SROs, the SEC has been the subject of some criticism regarding its oversight of the SROs. In November 2007, the United States Government Accountability Office (“GAO”) released a report entitled “Opportunities Exist to Improve Oversight of Self-Regulatory Organizations” (GAO-08-33). The report criticizes several aspects of the SEC’s Office of Compliance Inspections and Examinations program for examination of SROs and the Division of Enforcement’s tracking of investigative referrals. The GAO recommended: (i) OCIE should document its processes in an examination manual that would provide formal guidance; (ii) OCIE’s determination of high risk areas appropriate for inspection rely on numerous data but do not incorporate information that surfaces during SRO internal audits; (iii) OCIE should formally track the implementation status of recommendations that it makes during inspections; and (iv) the SEC should update its electronic system used to track referrals from SROs to enable more robust searching.

customer priority rules, (3) enhance its training programs, and (4) retain an auditor to examine its programs related to trading.

6. In a related proceeding, the SEC also alleged that former Amex chairman and CEO Salvatore Sodano abdicated his oversight responsibilities and ignored red flags regarding Amex's regulatory deficiencies, even after issuance of the SEC's September 2000 order. In August 2007, an ALJ granted Sodano's motion for summary disposition on the grounds that the applicable statute only vests the SEC with jurisdiction to bring charges against current officers and directors of an SRO. Sodano had resigned from those positions with Amex by 2005.¹³
7. The SEC staff petitioned the SEC for review of the ALJ's decision. Sodano then moved the SEC for summary affirmance, which the SEC denied, explaining that the submission of briefs would aid the SEC in reaching its decision.¹⁴
8. In another related proceeding, the SEC issued an order against Richard Robinson, a former Amex vice president responsible for overseeing Amex's regulatory surveillance programs for the derivatives and options markets. The order found that Robinson was a cause of the Amex's violations by failing to oversee properly the surveillance program for derivatives and options and by failing to maintain proper investigative files. Robinson consented to a cease-and-desist order.¹⁵

B. *In the Matter of Boston Stock Exchange, Inc. ("BSE") and James B. Crofwell* (Admin. Proc. File No. 3-12744, Sept. 5, 2007)

1. The SEC alleged that BSE failed to adequately enforce its rules to prevent specialists from violating priority trading rules (trading ahead of clients' orders or interpositioning between two client orders). In 1996, BSE implemented an

¹³ See *In the Matter of Salvatore F. Sodano*, Initial Decision Release No. 333 (Admin. Proc. File No. 3-12596, Aug. 20, 2007).

¹⁴ See *In the Matter of Salvatore F. Sodano*, (Admin. Proc. File No. 3-12596, Dec. 13, 2007).

¹⁵ See *In the Matter of Richard Robinson* (Admin. Proc. File No. 3-12595, Mar. 22, 2007).

innovation to its trading system designed to promote price competition and liquidity. The innovation made BSE's surveillance of priority trading rule compliance more difficult.

2. In 1999, SEC staff members allegedly informed BSE that it needed to develop procedures to surveil trading ahead. By 2000, BSE had also learned that its trading system permitted specialists to execute certain trades in violation of BSE's priority trading rules. Although BSE's internal audit documents reflected the need to enhance this type of surveillance, BSE did not take sufficient action to address the issue until mid-2004. In the interim, many priority rule violations went undetected. As a result, the SEC found that BSE placed its interests in developing the 1996 innovation ahead of its responsibilities to regulate its members.
3. BSE consented to a censure, a cease-and-desist order, and undertakings involving training and a third-party audit.
4. The SEC also charged Crofwell, BSE's former president and chief operating officer, because he allegedly knew that BSE's surveillance systems were inadequate and failed to devote resources to meet targets to improve surveillance set forth in timetables that he had presented to the SEC staff. Crofwell consented to a censure, a cease-and-desist order, and a \$75,000 civil penalty.

Regulation S-P

Customer privacy has been on the regulatory agenda for some time now. In the past several months, the SEC filed complaints against a broker-dealer and a registered representative alleging violations of Regulation S-P.

- A. *In the Matter of NEXT Financial Group, Inc.* ("Next") (Admin. Proc. File No. 3-12738, Aug. 24, 2007)

1. The SEC alleged that Next violated Regulation S-P by permitting its registered representatives who were leaving the firm to take customer's personal information with them. 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. 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.

2. This matter has not yet been resolved.

B. *SEC v. Sidney Mondschein*, CV 07-6178 (N.D. Cal. Dec. 6, 2007)¹⁶

1. The SEC alleged that between December 2002 and August 2005, Sidney Mondschein, a former WFG Investments Inc. ("WFG") registered representative, illegally profited by selling to 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.
2. 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.
3. The complaint alleges that Mondschein violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. The complaint also charges Mondschein with aiding and abetting WFG's violations of certain of the customer privacy provisions of Regulation S-P.
4. The SEC seeks a permanent injunction against Mondschein, as well as disgorgement and a civil penalty.

¹⁶ This action was filed in the SEC's FY 2008.

Gifts and Gratuities

Following investigations and media reports into allegedly improper gifts and entertainment, the SEC settled the following action in its FY 2007.

- A. *In the Matter of Jefferies & Co., Inc.* (“Jefferies”) *et al.* (Admin. Proc. File No. 3-12495, Dec. 1, 2006)
1. The SEC settled an administrative proceeding against Jefferies for allegedly giving \$2 million in illegal gifts and gratuities to win mutual fund trading business. From May 2002 to October 2004, a Jefferies employee, Kevin Quinn, in order to obtain business from a family of mutual funds, allegedly provided the fund adviser’s traders with expensive golf trips, flights on private jets, tickets to sporting events and Broadway shows, and helped pay for one trader’s bachelor party. The SEC also alleged that Jefferies and Scott Jones, its Director of Equities, failed to supervise Mr. Quinn.
 2. Jefferies agreed to a cease-and-desist order, to accept censure, to pay \$4.2 million in disgorgement and \$580,316 in prejudgment interest, and to undertake remedial efforts to improve its policies and procedures regarding the provision of gifts, including retaining an independent consultant to review its internal practices. Jefferies also agreed to pay a penalty of \$5.5 million to the NASD in connection with the settlement of a separate NASD proceeding based on the same underlying conduct.

Electronic Communications

The SEC and the SROs have been active in the supervision and retention of electronic communications area over the last several years. In FY 2007, the SEC settled the following case.

- A. *In the Matter of Bear, Stearns & Co., Inc.* (“Bear Stearns”) (Admin. Proc. File No. 3-12484, Nov. 21, 2006)
1. The SEC settled an administrative proceeding against Bear Stearns for e-mails and faxes sent by its sales staff that allegedly contained sales offers not in the form of a prospectus during periods when a registration statement for

the securities had been filed but not yet declared effective by the SEC (the “quiet period”) in 2002 and 2003. The SEC also alleged that Bear Stearns failed to implement policies and procedures regarding the review of such electronic communications, and failed to supervise its employees.

2. The securities laws in place during the relevant time period prohibited issuers and underwriters from making written offers of securities during quiet periods in a form other than the prospectus.
3. Bear Stearns agreed to a cease-and-desist order, and to accept censure. No fine was imposed against the firm.

529 Plans

While the SROs had been active in the 529 plan enforcement arena in prior years, in FY 2007 the SEC made its foray into this area.

A. *In the Matter of 1st Global Capital Corp.* (“1st Global”) (Admin. Proc. File No. 3-12479, Nov. 15, 2006)

1. This was the SEC’s first case in this area and notably involves alleged violations of Municipal Securities Rulemaking Board (“MSRB”) rules. The SEC settled administrative proceedings against 1st Global for allegedly violating MSRB rules by recommending and selling investments in classes of 529 plans without having a reasonable basis to believe that such recommendations were suitable based on customer needs, and by failing to deal fairly with its customers in connection with such sales, for the period from January 2001 through January 2004.
2. 1st Global agreed to a cease-and-desist order, to accept censure, to pay a \$100,000 civil penalty, and to undertake remedial efforts to improve its policies and procedures regarding making investment recommendations in 529 plans, including retaining an independent consultant to review its internal practices.

Sanctions in SRO Proceedings

The case below is a litigated matter concerning a company's response to an NASD request for information. The matter was fought by the firm up to the D.C. Circuit Court of Appeals and is notable for the court's discussion of sanctions imposed by regulators.

A. *PAZ Securities et al v. SEC* (D.C. Cir. July 20, 2007)¹⁷

1. The NASD alleged that in 2003, it began an examination of PAZ Securities, Inc. The NASD allegedly sent three letters seeking information from PAZ and subsequently filed a complaint against PAZ and its president Joseph Mizrachi, which the respondents did not answer. After the NASD mailed the complaint a second time, the respondents retained an attorney who obtained additional time to respond but never filed an answer. On December 31, 2003, a NASD Hearing Officer entered a default decision, expelling PAZ from NASD membership and barring Mizrachi from association with a member firm.
2. PAZ and Mizrachi unsuccessfully sought to vacate the decision and appealed to the NASD's National Adjudicatory Counsel ("NAC") and the SEC. Both the NAC and the SEC affirmed the hearing officer's decision, with the SEC emphasizing that the NASD had the right to the information it had sought and that member firms and associated persons "cannot second-guess NASD's requests."
3. PAZ and Mizrachi appealed to the D.C. Circuit, arguing that the Commission had abused its discretion by affirming sanctions that were grossly disproportionate to their conduct without considering mitigating factors and without articulating a remedial purpose for the sanctions. The D.C. Circuit agreed with petitioners that the Commission had not addressed all of the mitigating factors.
4. The D.C. Circuit held that federal law authorizes the Commission to order "expulsion not as a penalty but as

¹⁷ See "The D.C. Circuit's Remand of the SEC's Order Sustaining an NASD Disciplinary Proceeding Puts Focus on the Standard for SEC Review of Sanctions Imposed by SROs," Morgan Lewis Securities LawFlash, Adrienne M. Ward Ivan P. Harris and (Aug. 1, 2007) at http://www.morganlewis.com/pubs/Securities_SECReviewSanctionsSROs_LF_01aug07.pdf

means of protecting investors.” Therefore, if the Commission orders expulsion, “it must explain why; furthermore, as the circumstances in a case suggesting that a sanction is excessive and inappropriately punitive become more evident, the Commission must provide a detailed explanation linking the penalty imposed to those circumstances if it wishes to uphold the sanction.” Specifically, the Commission “must explain why imposing the most severe, and therefore apparently punitive sanction is, in fact, remedial, particularly in light of the mitigating factors brought to its attention.”

State Actor Cases

Since the landmark 2006 matter in which the SEC set aside the NASD’s bar of Frank Quattrone, after he had asserted the Fifth Amendment and refused to testify, several individuals who asserted the Fifth Amendment have asked the Commission to review their expulsions from the industry. In the underlying proceedings, the individuals were not allowed to provide evidence that the SRO was a state actor, which they argued would have mitigated the failure to testify. In 2007, the Commission heard at least two such matters, involving respondents Warren Turk and Gregg Heinze.

A. *In the Matter of the Application of Warren E. Turk* (Admin. Proc. File No. 3-12404, June 22, 2007)¹⁸

1. In 2004, NYSE Regulation requested that Turk, then an employee of Van Der Moolen, appear for testimony. Turk agreed to testify but first testified before the SEC Staff. After his SEC testimony, Van Der Moolen informed him that it was terminating him at the request of the United States Attorney’s Office. Turk then informed NYSE Regulation that he would not appear for testimony. In 2005, NYSE Regulation and the SEC brought charges against Turk and other NYSE specialists. In addition, NYSE Regulation censured and permanently barred Turk for failing to appear for testimony. In December 2006, Turk informed NYSE Regulation that because it appeared that he would not be charged with any crimes, he would appear for testimony. NYSE Regulation did not accept the offer because its investigation had been completed.

¹⁸ See *Id.*

2. Turk acknowledged that he did not appear for NYSE testimony. However, he argued that because NYSE Regulation was acting in concert with the SEC and United States Attorney's Office to investigate Turk and others, NYSE Regulation was engaged in state action, which permitted him to assert his Fifth Amendment right against self-incrimination and not testify.
3. The Commission's opinion stated that SROs generally are not state actors but could in limited circumstances engage in state action. The opinion noted that proving such state action is a high bar and that the burden of proof rests on the party asserting state action. The Commission remanded the proceedings to NYSE Regulation for an evidentiary hearing on the issue of state action.
4. The Commission's opinion also stated that in the future, it expects parties will introduce evidence related to state action during an initial evidentiary hearing, so that the record can be fully developed when the case is before the SRO, instead of requiring the Commission to remand for further hearings.

B. *In the Matter of the Application of Gregg Heinze* (Admin. Proc. File No. 3-12461, July 19, 2007)

1. In late 2004, the SEC staff issued a subpoena for testimony and documents to Heinze, then a specialist with Bear Wagner Specialists, LLC. NYSE Regulation then sent a request for documents to Heinze, to which he responded that he had no responsive documents. In January 2005, Heinze informed the staff that he was asserting his Fifth Amendment rights against self-incrimination as to all of the staff's requests. That same day, NYSE Regulation requested that Heinze appear for testimony, but he refused. NYSE Regulation censured and permanently barred Heinze for failing to appear for testimony.
2. On appeal, the Commission remanded the proceedings to NYSE Regulation for an evidentiary hearing on the issue of state action.

Developments in SEC Enforcement Policy, Procedure and Organization

Setting and Negotiating Penalties

- A. In 2007, the SEC modified the way it will negotiate penalties. By way of background, in a January 4, 2006 statement, the SEC provided guidance on the standards used in assessing civil penalties against issuers. The SEC explained that the appropriateness of a corporate penalty turns “principally on two considerations”: the presence or absence of a direct benefit to the corporation; and the degree to which the penalty will benefit or further harm injured shareholders. Additional factors that are “properly considered” in determining whether to impose a corporate penalty include: the need to deter a given offense; the extent of injury to innocent parties; the company’s complicity in the violation; the intent of the perpetrators; the degree of difficulty in detecting the offense; the company’s steps to take remedial action; and the company’s cooperation with the SEC or other agencies.¹⁹
- B. in 2007, Chairman Cox reported that SEC Enforcement staff would not discuss a potential civil penalty with a company until the staff has first sought the input of the Commissioners on the appropriate penalty size. Commissioners would then offer the staff attorneys an applicable range of penalty amounts. This is a marked change from prior practice, in which the staff would negotiate the sanction with the putative defendant and then submit the agreed-upon penalty to the Commission for review.
- C. If the penalty that the Enforcement staff negotiates with the respondent is within the range of the Commission’s guidance, then the settlement will receive faster, or “seriatim,” approval by the Commissioners. If the negotiations lead to a proposed settlement that is not within the range recommended by the Commissioners, then the case moves to a slower track.
- D. The purpose behind soliciting Commissioner guidance before settlement discussions commence is to achieve “a guarantee of fairness and of horizontal equity in a nationwide program” and grant the staff a stronger negotiating position.

¹⁹ See speech by Christopher Cox, “SEC Chairman: Statement of Chairman Cox Concerning Objective Standards for Corporate Penalties,” (Jan. 4, 2006). While the above standards explicitly relate to penalties assessed to issuers, an argument could be made that such standards are also relevant when assessing penalties against regulated entities.

- E. Chairman Cox opined that “if anything, the penalties you will see imposed in future cases will be stiffer – because the staff lawyers negotiating them won't have to hedge their bets, wondering whether the Commission will later on back them up, or rather cut them off at the knees.”²⁰

Elevation of District Offices to Regional Level

- A. On March 30, 2007, the SEC announced that it was eliminating the two-tier hierarchy and nomenclature distinction between its District and Regional offices. The six former District offices (Atlanta, Boston, Fort Worth, Philadelphia, Salt Lake City and San Francisco) are now on par with the five Regional ones (Chicago, Denver, Los Angeles, Miami and New York City).
- B. The SEC made this change to provide all eleven offices with the authority necessary to carry out their enforcement duties and to eliminate the potential for redundancy in inspection and enforcement procedures.

Enforcement Case Management Procedures

In a luncheon speech to the SIFMA Compliance and Legal Division in July 2007, Walter Ricciardi, Deputy Director of Enforcement, provided an overview of new procedures the Enforcement Division implemented for case management.²¹ The highlights, some of which have been followed in regional offices but now will be followed across the Division, were as follows:

- A. A deputy director of enforcement will sign off on any new enforcement matters and determine staffing and which office will handle the matter.
- B. After a matter has been open for six months, the staff will submit a short memorandum to a deputy on the investigation's status. Based on the progress, the matter may be closed, continued as is, or expanded.

²⁰ See speech by Christopher Cox, “SEC Chairman: Address to the Mutual Fund Directors Forum, Seventh Annual Policy Conference,” (Apr. 13, 2007).

²¹ The issues noted in the text, and others, were described in an August 2007 GAO report entitled “Additional Actions Needed to Ensure Planned Improvements Address Limitations in Enforcement Division Operations.”

- C. A deputy director of enforcement must sign off before any Wells notices are given. If the staff determines that it will recommend charges, the respondent will be afforded an opportunity to respond to the recommendation.
- D. A deputy director of enforcement must sign off before the staff begins settlement negotiations. Sign off will include a settlement range.
- E. The staff is obliged to give notice when it will not make a final recommendation for an enforcement action. This notification can be made before a case is "officially" closed.

In August 2007, the U.S. Senate Committee on Finance and Committee on the Judiciary issued a joint report entitled "The Firing of an SEC Attorney and the Investigation of Pequot Capital Management," which reported the findings of "an extensive joint investigation into allegations of lax enforcement, improper political influence, whistleblower retaliation, and related matters involving the SEC." The report included recommendations that the SEC should:

- A. draft and maintain standardized investigative procedures;
- B. direct resources to significant and complex cases;
- C. require supervisors to maintain complete and reliable records of external communications;
- D. develop greater independence for the Office of Inspector General;
- E. review guidance to employees concerning recusals to ensure that they are done timely and in all appropriate matters; and
- F. establish standardized procedures to evaluate employees.

Cooperative Arrangements with Foreign Financial Regulatory Counterparts

A number of recent agreements between the SEC and the regulatory bodies of foreign nations reflect the continuing globalization of the world's capital markets. Though none of the arrangements impose much in the way of legally binding

obligations, collectively they evidence the intent of regulators around the world to cooperate and share information.

- A. SEC, UK FSA, and UK FRC Sign Protocol for Sharing Information on Application of IFRS (Apr. 25, 2007)
1. The SEC, the United Kingdom Financial Services Authority (FSA), and the United Kingdom Financial Reporting Council (FRC) signed a protocol to implement the Work Plan between the SEC and the Committee of European Securities Regulators (SEC-CESR Work Plan) as a step towards achieving the goal of consistent application of the International Financial Reporting Standards (IFRS).
 2. The IFRS aims to generate widespread acceptance and use of global accounting standards. The SEC-CESR Work Plan is designed to facilitate information sharing in the application of IFRS in the financial statements of issuers listed in the UK and registered with the SEC.
 3. The recently signed protocol is intended to provide the framework for the confidential exchange of information between the SEC staff and the staff of the FRC, which is charged with reviewing issuers' published financial statements in the UK.
 4. For example, under the protocol, the SEC must consult with the FRC's staff on novel or unprecedented IFRS matters, or when the SEC's views on an IFRS matter conflict with those of the FRC. These intra-agency consultations are intended to facilitate the SEC's full consideration of the FRC's view on the application of IFRS.
 5. The SEC plans to sign similar protocols in the remaining CESR member jurisdictions in the coming months.
- B. SEC, Euronext Regulators Sign Regulatory Cooperation Arrangement (Jan. 25, 2007)
1. The SEC and the College of Euronext Regulators signed a comprehensive Memorandum of Understanding (MOU) to

facilitate cooperation in market oversight in view of the then-pending combination between the NYSE Group, Inc. and Euronext N.V. into NYSE Euronext, Inc.

2. The MOU expresses the regulators' commitment to close cooperation and collaboration to promote investor protection, foster market integrity, and maintain investor confidence and systemic stability in the regulation of the combined group.
3. The regulatory authorities from the Netherlands, France, Belgium, Portugal, and the United Kingdom comprise the College of Euronext Regulators.

C. SEC, German BaFin Sign Regulatory Cooperation Arrangement (Apr. 26, 2007)

1. The SEC and the German Federal Financial Supervisory Authority (BaFin) signed a comprehensive arrangement to facilitate their supervision of internationally active firms and their oversight of markets.
2. The MOU provides mechanisms for consultation and exchanges of information between their agencies. The MOU sets forth the terms and conditions for the sharing of information about regulated entities and financial groups that operate in the United States and Germany, and outlines a framework for cooperation in the oversight of markets in both countries.

Mutual Recognition

In the Winter 2007 edition of the Harvard International Law Journal, the Director and a Senior Counsel in the SEC's Office of International Affairs co-authored an article advocating a new "substituted compliance" framework for providing access to U.S. capital markets for foreign financial service providers without requiring them to register with the SEC.

Under the proposed framework, foreign stock exchanges and foreign broker-dealers would be eligible for an exemption from SEC registration requirements "based on their compliance with substantively comparable foreign securities regulation and laws and supervision by a foreign securities regulator with oversight and a regulatory and enforcement philosophy similar to the SEC's."

On June 12, 2007 the Commission convened a roundtable discussion to explore this framework and other mutual recognition issues.

Prudential Regulation

In a speech at the SIFMA Compliance and Legal Division's 38th Annual Seminar in March 2007, SEC Commissioner Nazareth advocated a movement by the Commission toward a more prudential approach to regulation, which she defined as "having a clear set of standards with a more flexible implementation approach for meeting those standards. It means permitting regulated entities to meet their obligations in a more customized, as opposed to 'one-size-fits-all,' manner."

Commissioner Nazareth was careful to limit the extent of potential applications of the prudential approach, mentioning that a rules-based approach may be more suitable for areas such as sales practices and regulation of smaller firms.²²

Comments concerning prudential or principles-based regulation were also made at the SIFMA seminar by Richard Ketchum, then-CEO of NYSE Regulation, and Mary Schapiro, then-Chairman and CEO of NASD. These remarks are described below in the FINRA section of this outline.

SEC Broker-Dealer Enforcement Priorities for 2008

A review of press reports, speeches and other materials reveals that in FY 2008, the SEC's Division of Enforcement may be active in the following broker-dealer areas:

- A. mortgage securities pricing and the disclosure by investment banks of the value of such securities and the risks posed to their balance sheets;
- B. municipal securities;
- C. frontrunning;
- D. insider trading by Wall Street professionals; and
- E. sales to senior citizens and the supervision of such activities.

²² See Commissioner Annette L. Nazareth, Remarks before the SIFMA Compliance and Legal Conference, (Mar. 26, 2007).

Regulatory Consolidation – The Creation of FINRA

In late 2006, NASD and NYSE Regulation announced that they would consolidate their member regulation, enforcement and arbitration operations into a single entity.

In January 2007, By-Law amendments regarding governance changes for the consolidation were approved by the securities industry. In March 2007, the amended By-Laws were filed with the SEC.

On July 26, 2007 the SEC approved the consolidated SRO.²³

On July 30, 2007, FINRA issued its first press release announcing the commencement of its operations. The press release contained a quote from Mary Schapiro, CEO of the new organization, describing the formation of FINRA as “the most significant modernization of the self-regulatory regime in decades.” Ms. Schapiro also stated that FINRA will be “an investor-focused and more streamlined regulator that is suited to the complexity and competitiveness of today’s global markets.” FINRA employs approximately 3,000 individuals and operates from Washington, DC, New York City and 15 District Offices throughout the United States.

- A. FINRA’s organizational structure and key personnel are as follows:
1. Mary Schapiro is the Chief Executive Officer of FINRA. Richard Ketchum is the Chairman of FINRA’s Board of Governors.
 2. Senior Executive Vice President Steven Luparello oversees Member Regulation, Enforcement, and Market Regulation.

²³ It is important to note that potential trading violations that occur on or through the systems and facilities of the NYSE Group continue to be investigated and enforced by NYSE Regulation; this function did not move into FINRA.

3. Vice Chairman Doug Shulman oversees Strategy and Planning, Market Transparency Services, Testing and Continuing Education, Registration and Disclosure, Technology Operations and Member Relations.²⁴
 4. Senior Executive Vice President Elisse Walter oversees Investment Company Regulation, Investor Education, Corporate Finance, Emerging Issues, Advertising Regulation and Member Education
- B. *Member Regulation:* The consolidated SRO's Member Regulation function is split into two departments: (1) the Department of Risk Oversight and Operational Regulation headed by Executive Vice President Grace Vogel, who formerly led Member Firm Regulation at NYSE Regulation, and (2) the Department of Sales Practice Regulation headed by Executive Vice President Robert Errico, who formerly ran Member Regulation at NASD.
- C. *Enforcement:* The consolidated SRO has a single Enforcement Department, which integrates the former enforcement departments of the NASD and NYSE. Executive Vice President Susan Merrill, formerly in charge of Enforcement at NYSE Regulation, is Chief of the combined Enforcement Department. James Shorris, formerly Head of Enforcement at NASD, is the Executive Director.
- D. *Dispute Resolution:* NYSE Regulation's arbitration program and NASD's arbitration and mediation programs combined to form FINRA's Office of Dispute Resolution. Linda Feinberg, who formerly ran NASD Dispute Resolution, serves as President of Dispute Resolution and Chief Hearing Officer.

Much of 2007 was spent by NASD and NYSE Regulation personnel in efforts to merge the two organizations, begin the development of a single examination program and combine the enforcement arms. Work was also started on the creation of a single FINRA rulebook; additional efforts on this large scale project will continue in 2008.

²⁴ On November 21, 2007 President Bush nominated Mr. Shulman to be the new Internal Revenue Service Commissioner.

FINRA Enforcement Statistics

As noted, FINRA began operations on July 30, 2007. No official statistics regarding the number of enforcement actions or penalty amounts had been released as of the date of this publication.

Enforcement Actions

Between July and December 2007, FINRA publicized the settlement of nine enforcement actions. Other FINRA actions were reported in Regulatory Notices. The nine significant cases are described below.

Sale of Corporate Bonds

On August 2, 2007, FINRA announced its first settled enforcement action, which involved the sale of corporate bonds, against Morgan Stanley & Co. and a corporate bond trader.

1. FINRA alleged that during a five month period in 2001, MSDW charged customers excessive mark-ups on the sale of corporate bonds. While securities industry guidelines provide for brokerage firms to set markups generally at 5% or less, FINRA found that MSDW's mark-ups on more than 2,800 sales of Kember Lumbermens Mutual Casualty Surplus Notes ranged from 5.88% to 17.86%.
2. FINRA also alleged that MSDW's supervisory system for monitoring its pricing of corporate fixed income securities was inadequate. The firm's procedures did not provide for a review of mark-ups using the prevailing market price at the time of the sale.
3. In the press release announcing the settlement, Susan Merrill reminded firms to "carefully monitor the methods used by traders in setting prices to ensure that the prices paid by customers are not excessive."
4. Morgan Stanley consented to a fine of \$1.5 million and restitution of \$4.6 million. The firm's corporate bond trader who set the bond prices was fined \$40,000 and suspended for 15 business days.

Production of E-mails in Arbitration Proceedings and Regulatory Investigations

Late in 2006, the NASD filed a complaint against Morgan Stanley for allegedly failing to provide e-mails to arbitration claimants and regulators. FINRA settled this matter in 2007.

A. *Morgan Stanley & Co. Incorporated* (Sept. 24, 2007)

1. FINRA alleged that between October 2001 and March 2005, MSDW failed to provide to claimants in arbitration proceedings e-mails that pre-dated September 11, 2001, claiming that such e-mails were destroyed during the terrorist attacks. While the firm's e-mail servers were destroyed, the firm had restored millions of such messages using back-up tapes and had access to many other e-mails that were stored by employees on network and local drives. MSDW also allegedly deleted certain e-mails that had been restored by recycling the back-up tapes.
2. FINRA also alleged that the firm failed to provide to arbitration claimants certain supervisory materials.
3. Besides arbitration proceedings, MSDW failed to provide pre-September 11, 2001 e-mails in response to requests from the NASD, NYSE, and Massachusetts Securities Division.
4. Morgan Stanley consented to a censure, a fine of \$3 million and a payment of \$9.5 million into a fund established for arbitration claimants. This matter marked the first time that a pool was established to compensate customers who had brought claims in arbitration proceedings. Eligible customers have the option to: (1) accept a standard payment from the pool, or (2) waive the standard amount, request the e-mails that were not produced, and have the fund administrator determine the amount that the claimant should receive, up to \$20,000.
5. Morgan Stanley also agreed to retain an independent consultant to review its policies and procedures for complying with discovery obligations in arbitration proceedings.

Market Timing

Since the states, the SEC and SROs began investigating market timing and late trading in 2003, numerous actions have been brought in these areas. 2007 was no exception.

A. *Rafferty Capital Markets* (“Rafferty”) (Nov. 29, 2007)

1. FINRA alleged that between January 2001 and August 2003, two Rafferty brokers aided six hedge funds evade mutual fund companies’ market timing restrictions. The Rafferty brokers took several steps to circumvent mutual fund companies’ attempts to block trading through the use of multiple account numbers and branch codes. FINRA found that the firm did not adequately respond to red flags about market timing and lacked procedures for escalating and responding to mutual fund block notices.
2. FINRA also found additional deficiencies, including that Rafferty failed to: (1) establish supervisory systems and written procedures to prevent and detect late trading; (2) retain all required electronic communications; and (3) create and preserve records reflecting the receipt time of mutual fund orders.
3. Rafferty consented to pay a fine of \$350,000 and disgorgement of approximately \$60,000. In addition, FINRA ordered the firm to refrain from opening new mutual fund accounts (for new or existing customers) for 90 days and to review its procedures and certify that it had established new policies and procedures.

Anti-Money Laundering

Anti-money laundering has long been an examination and enforcement priority at the SROs. In 2007, FINRA expelled a member firm for numerous anti-money laundering rule violations.

A. *Franklin Ross, Inc.* (“Franklin Ross”) (Nov. 5, 2007)

1. FINRA alleged that between February 2004 and September 2006, Franklin Ross repeatedly violated numerous anti-

money laundering rules. Franklin Ross allegedly failed to: (1) investigate and report suspicious transactions; (2) procure background information with respect to new accounts; (3) independently test its anti-money laundering program; and (3) train its employees concerning anti-money laundering requirements.

2. FINRA found that Franklin Ross's conduct was compounded by the fact that some of its clients were linked to fraudulent trades and had been barred by FINRA or disciplined in SEC enforcement proceedings. In addition, FINRA found that many trades placed through Franklin Ross were suspicious and should have raised red flags.
3. FINRA expelled Franklin Ross, suspended its former president Mark Ross, Jr. from serving as a principal for 2 years and 90 days in all capacities, and fined him \$35,000. FINRA suspended Franklin Ross's current president Kevin Herridge for 6 months from serving in a principal capacity and 30 days in all capacities and fined him \$25,000.

Research Conflicts of Interest/Research Reports

Continuing to pursue actions in the research conflicts of interest/research report arena, FINRA brought a significant action against one firm in late 2007 for violations in this area.

A. *Wachovia Capital Markets* ("Wachovia") (Nov. 28, 2007)

1. FINRA alleged that Wachovia failed to include required disclosures in its research reports. Between June 2004 and May 2006, Wachovia allegedly did not disclose Wachovia's financial relationships with the companies that were the subject of the research reports. Wachovia allegedly did not disclose that with respect to certain research reports: (1) it managed or co-managed a public offering involving securities of the subject company, (2) Wachovia provided investment banking services to the subject company for compensation, or (3) that Wachovia owned stock, or made a market, in the subject company.

2. FINRA also alleged that with respect to 15,000 research reports, Wachovia's general disclaimer that it "may" own stock in the subject company was inadequate under FINRA rules because Wachovia owned more than one percent of the subject company's common stock.
3. Wachovia consented to a censure and a fine of \$300,000.

Fee-Based Brokerage Accounts

Picking up where the NASD and NYSE Regulation left off, FINRA brought a fee-based brokerage account matter in 2007. This action, which settled in September 2007, was brought against AXA Advisors, LLC.

1. *AXA Advisors, LLC* ("AXA") (Sept. 5, 2007)
 - (a) FINRA alleged that between 2001 and 2005, AXA failed to adequately supervise its fee-based brokerage business and maintain related policies and procedures.
 - (b) AXA allegedly failed to institute systems and procedures designed to determine whether fee-based accounts were beneficial for clients opening new accounts and/or continued to be beneficial for existing clients.
 - (c) In certain instances, clients who engaged in no trading or whose accounts held insufficient assets to qualify were enrolled in fee-based accounts. In other instances, clients were charged asset-based fees before their accounts reached the requisite threshold for accrual of such fees contrary to representations by registered representatives and in the firm's sales literature.
 - (d) AXA consented to a censure, a fine of \$1.2 million, and restitution of approximately \$1.4 million.

Forms U-4/U-5 Filings

In 2004, the NASD concluded a sweep by sanctioning a number of broker-dealers for late forms U-4/U-5 filings. Since that time, the NASD brought several additional actions. In 2007, FINRA concluded the following such case.

- A. *UBS Financial Services, Inc.* (“UBS”) (Oct. 25, 2007)
1. FINRA alleged that between 2002 and 2004, UBS failed to make timely and/or accurate disclosures to the NASD’s Central Registration Depository (CRD).
 2. FINRA alleged that eighteen percent of the time between January 2002 and December 2004, UBS failed to timely report required disclosures on Forms U4 and U5 concerning topics including customer complaints, regulatory actions and criminal disclosures. UBS also allegedly failed to disclose certain customer complaints and to report certain retired brokers’ separation from the firm in a timely and accurate manner.
 3. UBS consented to a censure, a \$370,000 fine and an undertaking to review its procedures.

Provision of Accurate Data to Regulators

As reported in last year’s outline, NASD charged Oppenheimer and the firm’s CEO, Albert Lowenthal, with knowingly submitting inaccurate and incomplete data in connection with the NASD’s request regarding the firm’s self-assessment of mutual fund breakpoint discount practices. That action was settled by FINRA in 2007.

- A. *Oppenheimer & Co. Inc.* (“Oppenheimer”) and *CEO Albert Lowenthal* (“Lowenthal”) (Oct. 30, 2007)
1. In early 2003, the NASD required each of approximately 2,000 broker-dealers that sold front-end load mutual funds during 2001 and 2002 to conduct a self-assessment of its compliance and report the results to the NASD. The self-assessment only requested a self-assessment of Class A share sales because breakpoint pricing typically applies only to Class A shares in order to reduce sales loads at certain

investment levels. Class B and C shares do not charge a front-end load and therefore are not eligible for breakpoint pricing.

2. NASD alleged that three days before submitting its response, Oppenheimer learned that the firm's sample included Class A, B, and C shares, not just Class A as required, which diluted the sample. The firm nevertheless submitted the flawed data and did not notify the NASD about it. The NASD noticed the deficiency and ordered a new self-assessment. Oppenheimer submitted its second self-assessment five months later containing many of the same errors as the first time. By January 2006, Oppenheimer still had not submitted an accurate self-assessment; the NASD charged the firm and Lowenthal.
3. Oppenheimer consented to a censure, a fine of \$1 million (\$750,000 for violating NASD rules 8210 and 2110 and \$250,000 for violating NASD rules 3010(a) and 2110), and undertook to perform internal audits and retain an independent consultant to review the firm's policies and procedures with respect to delegation of authority.
4. In settling this matter, FINRA dismissed the charges against Lowenthal.

Municipal Securities Business Disclosures

In late 2007, FINRA settled an action regarding municipal securities business disclosures.

A. *JP Morgan Securities, Inc.* ("JP Morgan") (Dec. 13, 2007)

1. MSRB G-38 requires brokers, dealers and municipal securities dealers to disclose on a quarterly basis information concerning consultants engaged to obtain municipal securities business. FINRA alleged that between April 2000 and June 2003, JP Morgan failed to disclose that it had obtained municipal securities business through the use of consultants and made payments to those consultants.

2. FINRA also alleged that JP Morgan violated MSRB Rule G-38 by filing outdated versions (for three years) of form G-37/G-38 that should have disclosed its use of, and payments to, consultants.
3. FINRA also alleged that JP Morgan violated MSRB Rule G-27 by failing to adopt, maintain and enforce procedures designed to ensure compliance with the reporting requirements of Rule G-38.
4. JP Morgan consented to a censure and payment of a \$500,000 fine.

FINRA Developments

In 2007, Mary Schapiro, previously NASD Chair and CEO and currently FINRA CEO, outlined five ways in which regulators must change to keep pace with today's changing capital markets.²⁵

- A. First, regulators must ensure that investors may choose among various types of firms that offer an array of products and services. In order to accommodate different business models without compromising investor protection, Ms. Schapiro suggested that regulators may have to operate under more of a principles-based approach in certain circumstances.
- B. Second, regulators must not be solely be reactive, but rather proactively look for emerging trends in the industry and address them early.
- C. Third, regulators must find ways to assist the industry in fulfilling its compliance and regulatory responsibilities, particularly through member education to ensure that the rules and regulators' expectations are clear.
- D. Fourth, regulators must understand the complexities of the world in which they operate, working hard to accommodate the regulation of

²⁵ See Mary L. Schapiro, Remarks at the SIFMA Compliance & Legal Division's 38th Annual Seminar and FINRA 2007 Fall Securities Conference.

business that crosses borders in cooperation with regulators around the world.

- E. Fifth, regulators need to engage investors through education, rather than simply responding to investor complaints or problems.

Similar themes were sounded by Richard G. Ketchum, then CEO of NYSE Regulation and current Chair of FINRA's Board of Governors. He described five fundamental underpinnings of effective regulation in a March 27, 2007 speech during SIFMA's Compliance and Legal Division's 38th Annual Seminar:

- A. First, there should be increased emphasis on prudential regulation. Regular and candid dialogues between regulators and firms enable regulators to better understand firms' businesses and efforts to maintain achieve regulatory compliance and inform firms about regulators' concerns.
- B. Second, when fashioning rules, regulators should always consider whether a more general approach that involves "more industry-empowered, risk-based discretion" would be more successful than a strict uniform rule.
- C. Third, regulators must provide greater levels of interpretive guidance, especially if more flexible risk-based rulemaking is embraced.
- D. Fourth, regulators must effectively interact with stakeholders in formulating and applying the rules. Perspective can be gained through more informative interactions with the industry.
- E. Fifth, there must be a conscious focus on improving investor education.

As noted, both Ms. Schapiro and Mr. Ketchum talked about principles-based regulation in 2007. There were two additional developments in this area worth noting. First, in December 2007 FINRA published Regulatory Notice 07-59 regarding the supervision of electronic communications. Rather than resort to new rule making, FINRA issued what it called "principles-based guidance" in this area, which permits firms flexibility to design supervisory procedures for electronic communications that are appropriate to each organization's business model and organizational structure. Second, senior FINRA officials recently

publicly discussed the creation of a list of 11 principles that would govern member organizations' general conduct. This work is in its formative stages.²⁶

FINRA 2008 Enforcement Priorities

FINRA's enforcement priorities in 2008 include:

1. Fraud perpetrated against senior citizens
2. Subprime mortgages, including disclosure, valuation issues and manipulation schemes
3. Collateralized mortgage obligations, including suitability and supervision
4. Anti-money laundering, including penny stock manipulation and monitoring of suspicious activity
5. Variable annuities, including supervision of registered representatives located in bank facilities
6. Excess mark-ups
7. Regulation SHO
8. Mutual funds, including NAV transfer programs

²⁶ It is interesting to note that in November 2007, the New York Insurance Department issued a draft regulation that would make it the first insurance regulator in the country to establish principles-based regulation. The draft regulation included 10 principles for the industry. These principles are strikingly similar to the 11 U.K. Financial Services Authority principles. The draft regulation is available on the internet at the New York Insurance Department's website via the following URL: www.ins.state.ny.us/press/2007/rp071105pbrd.pdf.

Statistics

At the time of publication, neither the NASD nor FINRA had published an official summary of enforcement statistics for the NASD's actions through July 2007 (when it merged with NYSE Regulation to form FINRA). Nevertheless, we believe that the number of cases and fine levels will be down compared with prior years.

Enforcement Actions

Market Timing

In 2007, the NASD brought an enforcement action involving market timing against two brokers who formerly worked for Prudential Securities, Inc. ("PSI") (Feb. 15, 2007).²⁷

- A. The NASD alleged that the two former PSI brokers facilitated a hedge fund manager's deceptive practices to market time through variable annuities offered by three different life insurance companies. The hedge fund manager was the Chairman, CEO, and majority owner of James River Capital Corporation, and paid the largest sanction ever by an individual to the NASD for deceptive market timing (\$2.25 million).

- B. The brokers allegedly assisted the hedge fund manager in executing approximately 900 variable annuity sub-account exchanges between October 2001 and September 2003, which earned approximately \$5.2 million in profits (and \$45,000 in commissions for the brokers). The hedge fund manager and the brokers attempted to evade market timing restrictions imposed by insurance companies by deceptively opening many accounts using

²⁷ In August 2006, the NASD, along with federal and state regulators and the U.S. Department of Justice settled charges against PSI for conduct including market timing, resulting in sanctions against the firm totaling \$600 million.

several broker identification numbers, different limited partnerships to purchase the contracts, and different annuitants.

- C. The NASD also charged the brokers' branch manager with failure to supervise the brokers' activities.
- D. This case has yet to be resolved.

Best Execution

SRO examiners have consistently reviewed firms' best execution policies, procedures and practices. In mid 2007, the NASD brought a case in this area.

- A. *HSBC Brokerage Inc. ("HBI") (May 29, 2007).*
 - 1. The NASD alleged that HBI's best execution policies required its fixed-income traders to contact multiple broker-dealers to shop for the best price for orders received from customers. Beginning in May 2004, HBI's fixed income trading desk was instructed to route all government securities orders to HSBC Securities Inc. ("HSI"), its affiliate.
 - 2. Although HBI still required its traders to shop a government securities order before placing it with an affiliate (to ensure that HSI matched the best available price), the NASD found that HBI failed to implement reasonable policies and procedures to ensure that clients received best execution for these orders, particularly in light of the potential conflict of interest created by routing all trades through an affiliate.
 - 3. The firm was unable to provide documentary evidence of supervisory review or other reasonable diligence for a sampling of government securities transactions requested by the NASD. The firm also did not have a system for recording competitive bids, which inhibited the NASD's ability to review transactions for best execution.
 - 4. HBI consented to a fine of \$250,000.

Anti-Money Laundering

For the last several years, NASD examination and enforcement staffs have been focused on compliance with its anti-money laundering rules.

A. *Banc of America Investment Securities, Inc.* (“BAI”) (Jan. 29, 2007).

1. The NASD alleged that BAI failed to obtain customer information for certain high-risk accounts that the firm had reason to believe involved possible securities fraud. At the time that certain accounts were opened in August 2003, BAI had AML procedures that required the firm to request from accountholders the names of the beneficial owners of the account before substantial account activity could be conducted.
2. Between August 2003 and October 2004, BAI did not request the names of the beneficial owners of 34 accounts, despite repeated requests from its clearing firm. The accounts involved trust and private investment corporations domiciled in the Isle of Man, and during the relevant period, held assets between \$79 million and \$93 million, and engaged in multi-million dollar international wire transfers.
3. The NASD also alleged that BAI failed to ensure that its SARs filing obligations were met. BAI relied on its parent bank to determine whether a SAR should be filed, despite the fact that the bank was subject to different reporting obligations. The NASD found that BAI did not have adequate procedures and communications with its parent bank concerning when SARs should have been filed and whether they in fact were filed.
4. BAI consented to a fine of \$3 million.

Disclosures to Investors

The NASD settled three enforcement actions involving the use of misleading materials and/or inadequate disclosures against broker-dealers affiliated with Citigroup Global Markets, Inc., Fidelity Investments, and Securities America.

A. *Citigroup Global Markets, Inc.* (“CGMI”) (June 6, 2007).

1. The NASD alleged that CGMI failed to adequately supervise brokers who used misleading sales materials during retirement seminars for BellSouth employees in North and South Carolina between 1994 and 2002. The misleading documents exaggerated projections of future earnings without fully explaining the risks involved.
2. The brokers’ sales presentations led the BellSouth employees to expect that for 30 years they could earn 12% annually on their investments and withdraw 9% annually. The brokers’ presentations did not adequately disclose that the recommended investments could decline in value and exposed the investors to greater market risk than retaining their current investments. Citigroup failed to follow up on various red flags arising from the brokers’ conduct.
3. Relying on these presentations, more than 400 BellSouth employees, the majority of whom were unsophisticated investors of modest means, cashed out their BellSouth pensions and 401(k) accounts and invested the proceeds with the CGMI brokers. Over time, the principal in the BellSouth employees’ accounts declined by a total of approximately \$12.2 million.
4. The NASD ordered CGMI to pay \$12.2 million in restitution to more than 200 former BellSouth employees. In addition, CGMI was fined \$3 million.
5. The NASD also disciplined three brokers and two managers of CGMI’s Charlotte branch office, with fines ranging between \$30,000 and \$125,000 and suspensions of up to 18 months.

B. *Fidelity Investments Institutional Services Company, Inc. ("FIISC") and Fidelity Distributors Corp. ("FDC")* (together, "Fidelity") (May 8, 2007)

1. The NASD alleged that Fidelity prepared and distributed misleading sales literature relating to Fidelity's Destiny I and II Systematic Investment Plans, which involved investors making a fixed number of monthly payments over a 10 or 15 year period that were invested in mutual funds.
2. The plans were marketed by non-Fidelity broker-dealers primarily to military service members, but Fidelity distributed various marketing materials to members of the general public.
3. The NASD found that Fidelity's marketing materials were misleading. For example, the materials reflected that certain of the plans outperformed the S&P 500 over the prior 30 year period without disclosing that they had substantially underperformed the S&P 500 during the prior 10 year and 15 year periods. In other materials, the published portfolio returns were higher than investors actually realized because the published figures did not deduct sales charges.
4. The NASD also found that Fidelity failed to adequately supervise the review of its Destiny-related sales literature.
5. Fidelity consented to a fine of \$400,000. The NASD agreed that the fine amount could be paid to the NASD Investor Education Foundation to support educational programs aimed at providing U.S. military personnel and their families with the tools to make informed investment decisions.
6. Fidelity also agreed to publish specified additional disclosures on its Destiny sales literature, website, and account statements sent to Destiny plan holders.

C. *Securities America Inc. ("Securities America")* (July 11, 2007)

1. The NASD alleged that pursuant to a negotiated agreement, a mutual fund company provided more than \$400,000 to

Securities America in brokerage commissions, more than \$260,000 of which Securities America improperly provided to one of its brokers. At the same time that the broker received these payments, he advised his retirement plan clients to invest in that mutual fund company's securities without disclosing the fact that the mutual fund company was compensating him.

2. While the NASD previously brought enforcement actions against brokerage firms for accepting directed brokerage in exchange for shelf space, this settlement marked the first action involving the payment of directed brokerage to an individual broker.
3. The NASD also found that Securities America did not sufficiently supervise the broker's communications with clients to ensure that he disclosed his receipt of the directed brokerage payments.
4. Securities America consented to a fine of \$375,000. The NASD has also brought charges against the broker, but that action has not yet been resolved.

Non-Cash Compensation

Over the last several years, NASD has brought numerous enforcement actions relating to non-cash compensation.

- A. The NASD settled enforcement actions involving non-cash compensation rules against *Scudder Distributors, Inc.* ("Scudder"), *Putnam Retail Management Limited Partnership* ("Putnam"), and *AllianceBernstein Investments, Inc.* ("AllianceBernstein") (Feb. 12, 2007).
 1. The NASD alleged that the three distributors violated the NASD's non-cash compensation rules by: paying for spouses to attend education events and related expensive meals; providing entertainment; and paying for additional nights of lodging without ensuring that extended stays were justified by a cost savings.

2. The NASD also found that the firms failed to implement adequate systems and procedures to ensure compliance with the non-cash compensation rules.
3. Scudder, Putnam, and AllianceBernstein consented to fines of \$425,000, \$175,000, and \$100,000, respectively.

Cross-Market Trading

In 2007 the NASD and the Chicago Stock Exchange cooperated to investigate and prosecute allegedly improper cross-market activities.

- A. The NASD and Chicago Stock Exchange (“CHX”) settled actions against a First Analysis Securities Corporation (“First Analysis”) trader and a Dougall & Associates (“Dougall”) trader (Apr. 30, 2007), respectively.
 1. The NASD and CHX alleged that Klaus Offenbacher (a First Analysis trader) and Bruce Kaminski (a Dougall floor broker) intentionally increased the market price of a company’s stock artificially in order to make it appear that the purchases fell within the SEC’s safe harbor provision for issuer repurchases.
 2. An issuer seeking to repurchase shares of its security on the open market may not participate in the opening transaction of the day and may not repurchase shares at a price greater than the highest independent bid or the last independent trading price.
 3. In this case, Offenbacher, whose employer First Analysis was responsible for repurchasing shares of stock by an issuer, located a customer who was willing to sell the shares at a higher price than the price at which the repurchase could lawfully occur. As a result, he directed Kaminski to purchase shares before the open the next day at the greater price. That transaction artificially inflated the price, enabling Offenbacher to conduct the cross trade at the higher price.
 4. The NASD found that the issuer, First Analysis, and Dougall were all unaware of the fraudulent scheme.

5. NASD imposed a \$25,000 fine and a three-month suspension on Offenbacher, and CHX imposed a \$20,000 fine and a two-month suspension on Kaminski.

Fee-Based Brokerage Accounts

The action below represents another action in a line of fee-based brokerage matters brought by regulators, including actions brought by the NASD against Raymond James and Morgan Stanley in 2005, and by NYSE Regulation against A.G. Edwards in 2006.²⁸

- A. The NASD settled and enforcement action involving fee-based brokerage against *Wachovia Securities, LLC* (“Wachovia”) (June 21, 2007).
 1. Between 2001 and 2004, Wachovia allegedly failed to adequately supervise its fee-based brokerage business.
 2. Wachovia instructed its brokers that the fee-based brokerage arrangement was not suitable for customers who made relatively few trades, buy-and-hold customers, and customers with small accounts, but the firm’s systems and procedures allegedly were not designed in a way that determined whether the fee-based brokerage arrangements were suitable for its customers.

²⁸ Other regulators have brought fee-based brokerage matters as well. For example, on July 16, 2007, the New York Attorney General issued a press release announcing a settlement with UBS Financial Services in which the firm agreed to pay a \$2.3 million penalty and \$21.3 million in disgorgement for “inappropriately steering customers” into fee-based accounts. UBS Financial Services issued its own press release, stating that the Attorney General’s press release mischaracterized the firm’s fee-based brokerage program and its operation. UBS Financial Services noted that the vast majority of its clients who selected the fee-based program realized cost savings over the life of their accounts.

See *infra* at p.48, see *supra* at p. 51 for a discussion of a matter involving fee-based brokerage accounts brought by FINRA against AXA Advisors, LLC on September 5, 2007.

On March 30, 2007, the U.S. Court of Appeals for the D.C. Circuit struck down an SEC rule (Rule 202(a)(11)-1) that exempted broker-dealers from registering as investment advisers if they offered fee-based brokerage accounts. The D.C. Circuit held that the SEC had exceeded its authority under the Investment Advisers Act of 1940 (“Advisers Act”) because Congress did not intend for such an exemption from investment adviser registration. The SEC requested and reviewed a 120-day stay of the court’s ruling so that investors and their brokers could respond until October 1, 2007. On September 19, 2007, the SEC adopted a temporary rule, which provided limited relief from principal trading restrictions of Section 206(3) of the Advisers Act. During the same meeting, the SEC proposed a new Rule 202(a)(11)-1, which reinstates guidance from the prior rule that: (i) advisory status should be determined on an account-by-account basis; (ii) a broker-dealer does not receive “special compensation” simply because it charges different commissions for different brokerage services; and (iii) a broker-dealer exercising investment discretion, other than limited or temporary discretion, is subject to the Adviser Act.

3. The firm also allegedly exempted certain high-producing brokers from the firm's review and approval process.
4. As a result of this alleged supervisory failure, 1,200 customers continued in fee-based brokerage arrangements, despite the fact that they placed no trades for at least two consecutive years and/or had relatively small accounts.
5. The NASD also alleged that Wachovia failed to ensure that customers did not pay fees twice for class A mutual fund shares (by paying the sales load and then a fee-based account charge) and provided customers with misleading literature about its fee-based brokerage program by referring to the program as providing an "advisory service."
6. Wachovia consented to a censure and a \$2 million fine, in addition to certain undertakings, including the payment of restitution to certain customers.

Mutual Fund Sales Practices

The NASD settled enforcement actions involving the sale of mutual funds against *MML Investors Services Inc.* ("MML"), *NYLIFE Securities LLC* ("NYLIFE"), *Securities America, Inc.* ("Securities America"), and *Northwestern Mutual Investment Services, LLC* ("NMIS") (June 28, 2007).

A. Mutual Fund Class B and C Shares

1. The NASD alleged that between January 2003 and July 2004, Securities America brokers sold Classes B and C mutual fund shares, and MML and NYLIFE sold Class B mutual fund shares to clients without properly considering factors determining whether the class was appropriate for the particular client. The NASD found that the firms lacked adequate supervisory and compliance policies and procedures related to mutual fund sales.
2. Securities America, MML, and NYLIFE consented to fines in the amounts of \$322,000, \$473,000, and \$354,000, respectively and to offer remediation plans to affected clients.

3. These actions represent the latest in a line of matters brought by regulators involving the sale of unsuitable mutual fund class shares, including actions brought in 2005 by the SEC against Citigroup Global Markets Inc. (joint settlement with the NASD) and IFG Network Securities and by the NASD against American Express Financial Advisers (now Ameriprise), Chase Investment Services Corp. Inc., Merrill Lynch, Pierce, Fenner & Smith, Wells Fargo Investments, and Linsco/Private Ledger Corp.

B. NAV Transfer Programs

1. The NASD also alleged that MML and NMIS failed to have adequate supervisory systems procedures related to NAV transfer programs. Under NAV transfer programs, clients who redeemed shares for which they paid a sales charge were permitted to apply the proceeds of the redemption toward Class A shares of a different mutual fund without incurring another sales charge. As a result, certain MML and NMIS clients were charged undue fees.
2. Notably, the NASD imposed a “reduced” fine of \$100,000 against NMIS and no fine at all against MML due to their proactive remediation. NMIS took steps to assess client harm and provide remediation to eligible clients by returning \$242,000 in fees and converting approximately \$2 million in Class B shares to Class A shares. MML took proactive remedial steps before the NASD discovered MML’s violation by conducting a self-review, enhancing its procedures, and paying more than \$1.8 million in restitution to affected clients.

Research Reports

The NASD settled enforcement actions involving conflicts of interest concerning published research reports against Wells Fargo Securities, LLC (“Wells Fargo”) and Douglas van Dorsten, the firm’s director of research. (June 27, 2007).

- A. The NASD alleged that in April 2005, Wells Fargo published a research report, which was authored by an analyst who had already accepted an offer of employment from the issuer that was the subject of the report. Although the research analyst informed van Dorsten that she had accepted the offer of employment, he

permitted her to continue to cover the issuer on behalf of Wells Fargo, and the firm published her research report without disclosing the conflict of interest.

- B. Wells Fargo consented to a censure and a fine of \$250,000. Van Dorsten consented to a fine of \$40,000, a 60-day suspension in a principal capacity, and an undertaking to cooperate with NASD Department of Enforcement in any further investigation of this matter without requiring an 8210 request.

Supervision

In the first half of 2007, the NASD brought or concluded enforcement actions involving failure to supervise against Raymond James Financial Services, Inc., two former Knight Securities, L.P. executives, and four broker-dealers affiliated with Fidelity Investments.

- A. *Raymond James Financial Services, Inc.* (“RJFS”) (Feb. 21, 2007)
 - 1. The NASD settled an action against RJFS for an alleged failure to maintain an adequate supervisory system and to maintain adequate books and records.
 - 2. Between 2000 and 2004, RJFS allegedly permitted approximately 1,100 branch managers to serve as the primary supervisors of their own business activities. Among other steps, the branch managers approved their own transactions, opened and accepted new accounts, and reviewed their own correspondence.
 - 3. As a result, the firm did not detect one branch manager’s recommendation of unsuitable mutual fund and variable annuity purchases to, and misleading correspondence with, at least five elderly customers. The firm did not detect that more than ninety percent of her accounts listed the same primary investment objective (“growth”) and the same risk tolerance (“medium”).
 - 4. The NASD also found failures with the firm’s supervisory system and written procedures with respect to variable

annuities, with the firm's branch audit program, and with the firm's retention of books and records.

5. RJFS consented to a \$2.75 million fine. The NASD permanently barred the branch manager whose conduct was at issue.

B. *Kenneth Pasternak and John Leighton, Former Knight Securities, L.P. ("Knight") Executives (Apr. 11, 2007)*

1. In late 2004, the SEC settled an enforcement action against Knight involving best execution for institutional customers. Between January 1999 and November 2000, when Knight received an institutional "not held" (*i.e.*, brokers were given discretion as to price and time of execution) buy order from a customer, Knight's traders acquired shares of the requested security for the firm's proprietary account before filling the customer's order. Knight then waited to see how the security performed in the market during the day. If the stock went up in price during the day, Knight 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, Knight would fill the customer's orders from the firm's proprietary position at prices that nevertheless provided a profit to Knight.
2. In April 2007, an NASD hearing panel found that Knight's former CEO and the former head of its institutional sales desk failed to adequately supervise the lead trader on the trading desk (the head of the desk's brother) to prevent that conduct. The panel found that the two executives failed to respond adequately to numerous red flags.
3. The hearing panel issued a \$100,000 fine and a suspension for all supervisory capacities for two years against Knight's former CEO and a \$100,000 fine and a permanent bar from supervisory capacities against the former head of Knight's institutional sales desk.
4. In May 2007, each of the two respondents filed a Notice of Appeal from the panel's decision to the NASD's National Adjudicatory Council.

C. *Fidelity Distributors Corporation, Fidelity Brokerage Services LLC, Fidelity Investments Institutional Services Company, Inc., and National Financial Services LLC (Feb. 5, 2007)*

1. The NASD settled an action against four Fidelity broker-dealers for an alleged failure to properly maintain NASD registrations, failure to supervise compliance with gifts and gratuities rules and firm policies, and failure to retain email in accordance with NASD rules and federal securities laws.
2. The NASD alleged that the firms improperly “parked” NASD registrations for 1,100 individuals who did not perform jobs for which a license was required. As a result, the individuals would have been able to rejoin a broker-dealer without the retesting procedures that are required for individuals who have not been registered for two or more years. The NASD also found that the broker-dealers failed to assign registered supervisors to 1,000 individuals and lacked policies and procedures for ensuring that these 1,000 registered individuals complied with NASD rules.
3. At least nine traders who were registered through one of the four broker-dealers but worked for their investment adviser affiliate, FMR Co., received improper gifts and entertainment valued at hundreds of thousands of dollars from other broker-dealers in violation of NASD Rule 3060 and the firms’ policies.
4. NASD also alleged that the Fidelity broker-dealers failed to retain e-mail related to their business as such, as required by federal securities laws and NASD rules. Of note, the NASD found the Fidelity firms’ failure to preserve all instant messages and Bloomberg e-mail to be a violation of the relevant recordkeeping requirements.
5. The four Fidelity broker-dealers consented to an aggregate fine of \$3.75 million. The NASD also ordered to broker-dealers to undertake audits of the firms’ systems, policies and procedures relating to registration and electronic recordkeeping.

Statistics

In 2007, NYSE Regulation prosecuted approximately 161 cases.²⁹ The 161 figure is down 44% from 2006 when NYSE Regulation brought approximately 232 cases. One possible explanation for this drop-off is the merger of NYSE Regulation and NASD effective July 30, 2007.

Although the number of published NYSE Regulation cases fell in 2007, the approximately \$26 million in total fines assessed by NYSE Regulation in those cases nearly matched the approximately \$29 million in fines assessed in 2006.³⁰

Enforcement Actions³¹

Market Timing

Continuing to bring mutual fund market timing cases, NYSE Regulation sanctioned a major investment bank this year.

A. *Citigroup Global Markets, Inc.* (“CGMI”), Hearing Board Decision 07-105 (July 13, 2007).

1. NYSE Regulation alleged that:

(a) 150 of CGMI’s FCs placed approximately 250,000 market timing transactions in proprietary and non-proprietary mutual funds using various means of

²⁹ Because of NYSE Regulation’s review and approval process, not all of these 161 cases had been publicly released as of the date of publication of this outline. We determined the number of cases brought by NYSE Regulation in 2006 and 2007 by identifying the case number with the highest 2006 and 2007 hearing board decision number, respectively reflected on the NYSE website (www.nyse.com/DiscAxn/discAxnIndex.html).

³⁰ To calculate this total, we excluded restitution and disgorgement and also limited the fines imposed to the amount paid to NYSE Regulation in cases in which multiple regulators brought actions.

³¹ Although some of the NYSE Hearing Board Decisions that appear in this outline bear 2006 dates, NYSE Regulation did not release them publicly until 2007.

deception to avoid detection by the mutual fund companies. The firm took largely successful steps to eliminate market timing in proprietary funds. However, NYSE Regulation found that the firm's registered representatives continued to market time non-proprietary mutual funds, despite receiving hundreds of letters and e-mails alerting the firm to the market timing trading.

- (b) When certain registered representatives or their customers were blocked by mutual fund companies from trading in their funds, the registered representatives began market timing variable annuity mutual fund sub-accounts. At the time, CGMI had no system or procedures for monitoring for market timing trading in variable annuities.
- (c) Certain CGMI registered representatives entered into sticky asset agreements with mutual fund distributors, whereby the firm's clients agreed to invest a certain amount of money in a certain mutual fund in return for permission to market time another of the mutual fund company's funds.
- (d) CGMI's registered representatives entered into market timing fee agreements with the approval of in-house counsel that permitted the firm to receive revenue from market timing exchanges that it otherwise would not have received.
- (e) CGMI's electronic mutual fund trading system did not reflect the time that the Firm received orders and therefore could not determine whether trades submitted to mutual fund companies after 4 PM were received prior to 4 PM as required by law and NYSE rules.
- (f) CGMI consented to a censure, disgorgement of \$35 million into a distribution fund, a fine of \$10 million (\$5 million to NYSE Regulation and \$5 million to the distribution fund), in addition to a \$5 million fine paid to the State of New Jersey.

Stock Loan

The action described below represented the most recent in a line of stock loan matters brought by NYSE Regulation, including 2006 matters against Van der Moolen Specialists USA, LLC, CIBC World Markets Corp., and Nandra Group, Inc.³²

- A. *Janney Montgomery Scott LLC* (“Janney”), Hearing Board Decision 07-107 (July 16, 2007).
1. NYSE Regulation alleged that Janney made payments to finders (in some cases, friends or relatives of Janney employees) for stock loan transactions in which the finders provided no services. NYSE Regulation also alleged that Janney participated in stock loan transactions known as “daisy chain” or “swing” trades that had no legitimate purpose and deprived counterparties of proceeds to which they were entitled.
 2. NYSE Regulation found that Janney’s supervision was inadequate in terms of the firm’s review of individual stock loan rates and payments to finders. In addition, NYSE Regulation found that the firm’s books and records were inaccurate in that they reflected that finders had provided services in stock loan transactions when, in fact, they had not.
 3. Janney consented to a censure, a \$2.5 million fine, and an undertaking to record telephone conversations of its stock loan department and retain the recordings for at least one year.

Specialist Cases

On December 21, 2006, NYSE Regulation announced settlements with seven firms for failure to comply with applicable securities laws and regulations relating to specialists’ order handling obligations, and NYSE rules concerning firm

³² On September 20 and 24, 2007, the SEC charged 39 former employees of several firms (including Morgan Stanley, Van der Moolen, Janney Montgomery, A.G. Edwards, Oppenheimer and Nomura Securities) for their conduct in fraudulent schemes involving phony finder fees and illegal kickbacks in the stock loan area. The SEC alleged that these employees skimmed profits from loan transactions pocketing over \$12 million over the course of a decade. The U.S. Department of Justice also criminally prosecuted 16 of these individuals. Thus far, 10 of the 16 individuals have pleaded guilty to criminal charges in connection to this matter, and three have agreed to settlements with the SEC.

quotes, Intermarket Trading System (“ITS”) commitments, limit order display, and short sales.

- A. The firms involved, and their respective fines, were as follows: SIG Specialists, Inc. (\$75,000), Spear, Leeds & Kellogg Specialists LLC (\$600,000), LaBranche & Co. LLC (\$600,000), Kellogg Specialist Group, LLC (\$75,000), Van Der Moolen Specialists USA, LLC (\$400,000), Banc of America Specialist, Inc. (\$500,000), and Bear Wagner Specialists LLC (\$550,000).

- B. The settlements involved essentially the same findings, namely that the firms:
 - 1. violated the Firm Quote Rule by failing to give marketable orders the price of the published quotation that was in effect at the time the order became viewable on the display book;
 - 2. mishandled ITS commitments in that eligible limit orders were not displayed immediately (*i.e.*, as soon as practicable);
 - 3. executed short sales on minus or zero minus tickets; and
 - 4. failed to have written supervisory procedures specifically relating to the Firm Quote Rule, in its supervision of specialist firm quote activities.

- C. On November 27, 2007, the SEC settled matters with three individuals related to their conduct in the specialist’s cases. In a federal criminal matter, a jury previously found two of them guilty of securities fraud, and they were sentenced to six months imprisonment, two years of supervised release, and were assessed a \$250,000 fine. That conviction is currently on appeal. To settle the SEC charges against them, they each consented to a cease-and-desist order, a bar from association with any broker or dealer, and to pay disgorgement of profits that they received through their conduct (although offset against the fines ordered to be paid in the criminal case is permissible if the verdicts are upheld). The third individual who settled with the SEC on November 27, 2007 consented to a cease-and-desist order, a bar from association with any broker or dealer, and to pay a fine of \$300,000.

Market-on-Close and Limit-on-Close Orders

NYSE Regulation initiated and settled cases involving allegations of failing to comply with requirements governing Market-on-Close (“MOC”) and Limit-on-Close (“LOC”) orders, including against Calyon Securities (USA) Inc., UBS Securities, LLC, Deutsche Bank Securities Inc., and Merrill Lynch.

A. *Calyon Securities (USA) Inc.* (“Calyon”), Hearing Board Decision 07-7 (Jan. 12, 2007)

1. NYSE Regulation alleged that Calyon:
 - (a) improperly entered 47 MOC and/or LOC orders. In most instances, the firm entered the trades five or more minutes after the cutoff time via the NYSE SuperDOT system;
 - (b) improperly cancelled three MOC and/or LOC orders after the cutoff time via the NYSE SuperDOT system;
 - (c) failed to properly test its electronic order routing systems’ connectivity to the NYSE’s systems (using orders and cancellations in the guise of actual orders, instead of messages designated as test messages); and
 - (d) failed to reasonably supervise in connection with testing the connectivity of its order routing systems and in connection with its entry and cancellation of MOC and LOC orders.
2. Calyon consented to a censure and a \$90,000 fine.

B. *UBS Securities, LLC* (“UBS”), Hearing Board Decision 07-10 (Jan. 18, 2007)

1. NYSE Regulation alleged that UBS:

- (a) entered more than 1,000 MOC or LOC orders after 3:40 PM on four trade dates that were not entered on the contraside of an imbalance. Nearly all of the trades were part of program trades entered on a date when the Russell 3000 Index rebalanced or a date when the S&P 500 Index was recomposed. The orders were received by UBS before 3:40 PM, but due to an order backlog in UBS's system, the orders did not reach the NYSE until after 3:40 PM.
- (b) failed to implement policies and procedures, including supervisory reviews, specifically addressing odd-lot orders.
- (c) submitted inaccurate (or no) account type indicators for trades effected on the NYSE on multiple occasions;
- (d) failed to retain and produce order tickets for certain trades requested by NYSE Regulation; and
- (e) failed to record order details in an electronic system on the NYSE floor known as FESC before executing the trade on the NYSE floor on thirteen trade dates.

2. UBS consented to a censure and \$95,000 fine.

C. *Deutsche Bank Securities Inc.* ("Deutsche Bank"), Hearing Board Decision 06-218 (Dec. 20, 2006)

1. NYSE Regulation alleged that Deutsche Bank:

- (a) entered more than 3,900, and cancelled more than 115, MOC/LOC orders after the permissible cutoff times;
- (b) failed to adequately supervise an employee, which enabled the employee to access, use, and share with Deutsche Bank colleagues proprietary information

stored on his former member firm employer's password-protected website;

- (c) submitted inaccurate (or no) account type indicators for trades effected on the NYSE on multiple occasions;
- (d) failed to identify for executing brokers the beneficial owners of prime broker customer accounts and to ensure that its prime broker customers maintained the required minimum net equity in prime broker accounts; and
- (e) failed to timely notify the NYSE of the termination of certain floor employees.

2. Deutsche Bank consented to a censure and \$325,000 fine.

D. *Merrill Lynch*, Hearing Board Decision 07-123 (Aug. 21, 2007)

- 1. NYSE Regulation alleged that Merrill Lynch entered and/or cancelled more than 480 MOC/LOC orders after the permissible cutoff times.
- 2. NYSE Regulation found that Merrill Lynch lacked adequate supervisory systems to prevent this conduct because it did not adapt its order management system to account for differences among its different business units that placed the allegedly violative orders to prevent such trades. The Hearing Panel decision acknowledged that to do so, each such business unit would have been required to "develop unique filters, request blocks and adopt policies and procedures to prevent errors and correct orders."
- 3. The hearing panel decision noted that Merrill Lynch was aware of this issue in 2003 because it received a summary fine and letter of admonition for the same conduct.
- 4. Merrill Lynch consented to a censure and a \$100,000 fine.

Trading Error

In today's fast moving and volatile markets, firms and regulators are wary of potentially expensive trading errors. In 2007, NYSE Regulation announced that it had sanctioned a firm in a so-called "fat finger" case.

- A. *Morgan Stanley & Co., Inc.* ("Morgan Stanley"), Hearing Board Decision 06-220 (Dec. 18, 2006)
 1. NYSE Regulation alleged that:
 - (a) a Morgan Stanley trader did not realize that the order entry system entered a basket of trades in units of 1,000 instead of single units and inadvertently entered a 100,000 unit trade instead of 100 units. As a result, he entered a buy order for a basket of trades with a notional value of \$10.8 billion, instead of \$10.8 million. A supervisor who walked the trader through the trade had access to verify the accuracy of the order before it was submitted but failed to do so.
 - (b) The error led to extremely high order volume in numerous securities on the NYSE floor for at least fifteen minutes, causing significant market disruption.
 - (c) The firm did not have adequate features in place to validate order accuracy and prevent orders exceeding preset parameters from being executed.
 2. Morgan Stanley consented to a censure and a fine of \$300,000. NYSE Regulation considered that that the firm realized a loss of approximately \$24 million as a result of the erroneous trade.

Prospectus Delivery

In 2004 and 2005 NYSE Regulation sanctioned two firms for failure to comply with SEC prospectus delivery requirements. NYSE Regulation also began an enforcement sweep to investigate this issue at other firms.

On September 7, 2007, NYSE Regulation alleged that between at least July 2003 and October 2004, 15 member firms failed to ensure the delivery of

prospectuses and/or product descriptions to customers to customers who purchased securities, mutual funds and ETFs. The respondents also failed to establish and maintain appropriate procedures for the supervision and control of these activities. The respondents consented to censures and fines totaling \$10.425 million as follows:

Member Firm	Fine
1. Citigroup Global Markets Inc.	\$2,250,000
2. Deutsche Bank Securities Inc.	\$1,250,000
3. Lehman Brothers Inc.	\$1,250,000
4. UBS Securities LLC	\$800,000
5. Bear, Stearns & Co., Inc.	\$500,000
6. Credit Suisse Securities (USA) LLC	\$500,000
7. Legg Mason Wood Walker, Inc.	\$500,000
8. McDonald Investments Inc.	\$500,000
9. RBC Dain Rauscher, Inc.	\$500,000
10. UBS Financial Services, Inc.	\$500,000
11. Banc of America Securities LLC	\$375,000
12. Goldman, Sachs & Co.	\$375,000
13. JP Morgan Securities Inc.	\$375,000
14. Keefe, Bruyette & Woods, Inc.	\$375,000
15. Wachovia Capital Markets LLC	\$375,000

- A. The fines for Citigroup Global Markets Inc. and Lehman Brothers reflect additional violations of Rule 10b-10 of the Exchange Act for allegedly failing to deliver trade confirmations to customers.
- B. Keefe, Bruyette & Woods, Inc.'s settlement included additional charges that the firm violated Section 17(a) of the Exchange Act and Rules 17a-3 and 17a-4 for allegedly failing to preserve books and records regarding the firm's delivery of prospectuses, although the firm nevertheless paid a penalty at the lowest end of the range.

Financial Controls

NYSE Regulation typically brings a number of financial control cases each year. Two examples from 2007 are outlined below.

A. *Interactive Brokers LLC*, Hearing Board Decision 07-145 (Sept. 10, 2007)

1. NYSE Regulation alleged, in part, that Interactive Brokers:
 - (a) impermissibly allowed ten pattern day traders to place three day trades despite the fact that their accounts lacked the requisite \$25,000 in minimum equity;
 - (b) twice had intra-day deficiencies in its customer reserve account;
 - (c) did not document its physical examination of securities held within the firm's control and direction but not its possession or the names of the participating individuals or supervisors;
 - (d) underpaid a fee to the NYSE by \$55,000 due to a programming error that undercounted the firm's retail commissions;
 - (e) miscoded the beneficial owner type in its audit trail data with respect to sixteen trades on one day;
 - (f) routed thousands of odd-lot trades to the NYSE that should have been aggregated into round lots; and
 - (g) failed to supervise in connection with the above alleged violations.
2. Interactive Brokers consented to a censure and a \$250,000 fine.

B. *Wachovia Securities, LLC* ("Wachovia"), Hearing Board Decision 07-34 (Mar. 12, 2007)

1. NYSE Regulation alleged that Wachovia:

- (a) inaccurately computed its net capital, resulting in an overstatement of net capital by more than \$32 million. For example, Wachovia included in its calculation nearly \$7 million of assets that were not readily convertible to cash and netted inter-company receivables and payables with affiliates;
 - (b) overstated the Excess Customer Debits in its Customer Reserve Formula Computation by \$12 million; and
 - (c) failed to supervise computations leading to these violations.
2. The firm consented to a censure and a \$100,000 fine.

Research Reports

Research report disclosures continue to attract enforcement interest.

A. *Deutsche Bank Securities, Inc.*, Hearing Board Decision 06-217 (Dec. 20, 2006)

1. NYSE Regulation alleged that:
 - (a) In 2001, DBSI began a process to consolidate and automate its publication of research reports. In the interim, the firm relied on a manual process for inputting conflicts of interest disclosures into databases.
 - (b) Additional disclosures were necessary to comply with the 2002 amendments to Rule 472. This increase in disclosures, coupled with the sheer volume of companies involved for which disclosures were necessary, caused difficulty in maintaining current conflicts of interest disclosures in its database. As a result, DBSI published many research reports with outdated disclosures. In addition, the firm's website reflected outdated disclosures.

- (c) Based on information provided by research analysts and employees tasked with maintaining the databases, management was aware of, but did not address, the fact that conflicts of interest disclosures were backlogged.
 - 2. DBSI consented to a censure and a \$950,000 fine.
- B. *UBS Securities LLC*, Hearing Board Decision 07-125 (Aug. 22, 2007)
 - 1. NYSE Regulation alleged that:
 - (a) Between 2004 and 2006, certain of UBS's research reports failed to disclose that the subject company was a client of UBS (or had been during the prior 12 months) and that UBS had provided either non-investment banking securities-related services to the subject company or non-securities services. Other research reports failed to disclose that within the prior 12 months, the subject company had compensated UBS for products and non-investment banking services. In all, more than 10% of UBS's research reports between 2004 and 2006 had allegedly inadequate disclosures.
 - (b) The firm failed to maintain systems and procedures adequate to identify necessary disclosures concerning its subject company relationships.
 - 2. UBS consented to censure and \$150,000 fine.

Odd Lot Trading

NYSE Regulation continued to be active in enforcing the odd lot trading rules in 2007.

- A. *NASDAQ Execution Services, LLC f/k/a Brut, LLC* ("NES"), Hearing Board Decision 07-124 (Aug. 22, 2007)

1. NYSE Regulation alleged that NES, a wholly-owned broker-dealer subsidiary of the Nasdaq Stock Market, LLC, violated Exchange rules on multiple occasions by introducing for execution on the NYSE odd-lot orders that aggregated 100 shares or more without consolidating them into round-lots on multiple occasions.
2. NYSE Regulation found that NES failed to adequately supervise in connection with odd-lot trading. Prior to October 2005, NES allegedly lacked specific procedures for entering or routing odd-lot orders and did not have tools to monitor entry and execution of such orders. Subsequently, NES implemented a system that flagged when more than 30 odd-lot orders were entered for the same symbol and side within one minute, which NYSE Regulation determined was inadequate because the threshold of 30 orders was too high to be effective.
3. In addition, NYSE Regulation found that NES violated the NYSE's "Know Your Customer" rule by, among other reasons, failing to adequately obtain information about the odd-lot activity of its subscribers.
4. NES consented to a censure and a \$190,000 fine.

Anti-Money Laundering

In addition to investigating potential money laundering, regulators also focus on whether firms are developing adequate policies and procedures.

- A. *RBC Dain Rauscher, Inc.* ("RBC Dain"), Hearing Board Decision 07-44 (Mar. 23, 2007).
 1. NYSE Regulation alleged that RBC Dain failed to establish an adequate AML compliance program. Specifically, NYSE Regulation found that RBC Dain:
 - (a) did not have written procedures explaining its AML processes or the time in which SARs must be filed;

- (b) did not adequately review for structuring (*i.e.*, transactions broken into multiple transactions, currencies, or financial institutions in order to evade currency transaction reporting requirements) because it failed to review for cash equivalent deposits; and
 - (c) lacked an adequate system for reviewing exceptions raised during its AML review processes.
2. In addition, NYSE Regulation found that RBC Dain failed timely to report to the NYSE two settlements involving customer complaints. Under NYSE rules, member organizations must report within 30 days of the reportable event a settlement of a customer complaint against the member organization in an amount greater than \$25,000.
 3. RBC Dain consented to a censure and a \$90,000 fine.

Trade Confirmations

Over the last several years, NYSE Regulation has brought a number of enforcement actions revolving around operational issues. It has done so even in those instances when a firm has self-identified, corrected and reported the matter.

- A. *Pershing, LLC* (“Pershing”), Hearing Board Decision 07-31 (Mar. 12, 2007)
 1. NYSE Regulation alleged that due to a technological glitch, Pershing failed to deliver trade confirmations for more than 500,000 transactions in violation of Exchange Act Rule 10b-10(a).
 2. Pershing’s data entry system required introducing broker-dealers to input certain information, including whether the client preferred to receive trade confirmations electronically or in hard copy. If the introducing broker-dealers did not indicate either option, the system created a confirmation but did not send it to the client.

3. NYSE Regulation noted in this case that Pershing:
(1) immediately brought this issue to NYSE Regulation's attention; (2) promptly contacted all potentially affected clients; (3) fixed the system error and hired a consultant to confirm that the issue had been corrected; and (4) fully cooperated with the staff's investigation by responding "candidly, promptly, and completely" to all requests.
4. The firm consented to a censure and \$150,000 fine.

Proxy Voting

The action described below represents the most recent in a line of proxy voting matters brought by NYSE Regulation, including 2006 matters against Deutsche Bank Securities, Inc., UBS Securities LLC, Goldman Sachs Execution & Clearing, L.P., Credit Suisse Securities, LLC, and RBC Capital Markets Corporation.

- A. *First Clearing, LLC* ("First Clearing"), Hearing Board Decision 07-28 (Mar. 8, 2007)
 1. NYSE Regulation alleged that:
 - (a) First Clearing violated proxy voting rules by submitting proxies for more shares than it was entitled to submit for proxy matters in seven of fifteen samples reviewed by NYSE Regulation. The agent hired by First Clearing to handle its proxy voting failed to exclude long shares that had been loaned outside the firm;
 - (b) First Clearing failed to implement adequate operational or supervisory procedures relating to proxy activities that addressed reconciling stock records and supervising its agent.
 2. NYSE Regulation also found violations of financial and operational requirements (involving calculations incorporated into the firm's FOCUS reports and computations of its net capital) and supervisory failures leading to these violations. In addition, NYSE Regulation found that eight trades that

had been miscoded as agency transactions when submitted to the NYSE.

3. The firm consented to a censure and a \$350,000 fine.

Short Interest Reporting

NYSE Regulation, NASD and the American Stock Exchange have all brought cases in the short interest reporting area. Indeed, a number of these cases involve simultaneous settlements with all three regulators.

A. *RBC Capital Markets Corporation* (“RBC”), Hearing Board Decision 07-151 (Sept. 14, 2007)

1. NYSE Regulation alleged that between June 2003 and January 2006, RBC failed to submit accurate short interest reporting data to the NYSE (and to the NASD and AMEX).
2. RBC allegedly failed to notify its vendor that shares held by one of its affiliates and pledged as collateral to finance securities positions should have been excluded from RBC’s short interest reporting. As a result, RBC over-reported its short interest positions in NYSE-listed securities by 69%.
3. NYSE Regulation found that RBC failed to supervise in connection with its short interest reporting by failing to establish controls and a system of follow-up and review that would have detected errors.
4. RBC consented to a censure and fines of \$75,000 each to the NYSE, NASD and AMEX.

B. *Citigroup Global Markets, Inc.*, Hearing Board Decision 07-121 (Aug. 23, 2007)

1. In response to a questionnaire from the NYSE Regulation Risk Assessment Unit, CGMI discovered that between 1995 and 2005, the firm had inaccurately reported short positions to the NYSE (and to the NASD).

2. CGMI relied on automated systems to determine which accounts and securities were relevant for short interest reporting. Due to errors in the firm's systems, CGMI had been excluding certain accounts from its short interest reporting and also had been coding certain securities to be reported to the incorrect SRO.
3. NYSE Regulation found that CGMI failed to supervise because its procedures were unable to "detect all potential short interest reporting errors" and because CGMI did not sufficiently audit its short interest reporting process concerning compliance with its regulatory obligations.
4. CGMI consented to a censure and to pay a \$150,000 fine to the NYSE and a \$150,000 fine to the NASD.

Supervision

Supervision is always a hot enforcement topic. In the case below, NYSE Regulation alleged several failures to supervise in various areas at the firm.

- A. *Morgan Stanley & Co.*, Hearing Board Decision 07-66 (May 9, 2007)
 1. NYSE Regulation alleged various failures to supervise, including that Morgan Stanley:
 - (a) failed to detect unsuitable trading activity in guardian and other accounts;
 - (b) failed to have adequate procedures for entering and allocating block trades placed through the firm's trading desk;
 - (c) failed to ensure that order tickets were written for orders that comprised a block trade;
 - (d) failed to produce evidence that it had adequately reviewed and maintained e-mails of registered representatives' and supervisors' e-mail;

- (e) failed to accurately report statistical information concerning customer complaints; and
 - (f) failed to have written supervisory procedures that could have prevented the above violations.
2. Morgan Stanley consented to a censure and a \$500,000 fine.

Suitability

Suitability cases are a standard part of NYSE Regulation's enforcement docket.

- A. *HSBC Securities (USA) Inc., as a successor in interest to HSBC Brokerage Inc.* ("HSBC"), Hearing Board Decision 07-150 (Sept. 13, 2007)
 1. NYSE Regulation alleged that between 2002 and 2005, HSBC sold approximately 2,900 LIBOR CDs to approximately 1,900 (primarily retail) clients, despite the fact that the LIBOR CDs were unsuitable for certain of the clients.
 2. HSBC provided disclosures about LIBOR CDs to its clients. However, some of the firm's clients claimed to be unaware that their LIBOR CDs required them to commit their principal for as long as 10 to 12 years, and that during that period, there may be periods in which no interest at all would be paid. NYSE Regulation also alleged that it was inappropriate for HSBC to provide lengthy disclosures to its clients at the time of purchase of the LIBOR CDs instead of in advance of the purchase.
 3. NYSE Regulation alleged that some of HSBC's registered representatives may have provided misleading information concerning the LIBOR CDs, perhaps because some of the firm's registered representatives did not completely understand the product.
 4. NYSE Regulation also alleged that HSBC failed to supervise its registered representatives by failing to ensure that the

sales of LIBOR CDs were suitable and to adequately supervise representatives' communications with their clients concerning the risks of investing in LIBOR CDs.

5. HSBC consented to a censure, a \$500,000 fine, and an undertaking that the firm submit a remediation plan to repurchase the LIBOR CDs from its clients.

Sale of Unregistered Private Placements

In mid-2007, NYSE Regulation imposed a substantial sanction on a regional firm regarding its sale of unregistered private placements.

- A. *J.J.B. Hilliard, W.L. Lyons, Inc.*, Hearing Board Decision 07-68 (May 16, 2007)

1. NYSE Regulation alleged that:
 - (a) Between July 2000 and March 2001, the firm sold unregistered securities through private placements using offering memoranda that were materially misleading and/or failed to disclose material risks.
 - (b) In one private placement, the firm: sold securities to individuals for whom the securities were not suitable; incorrectly identified the security as common stock when it was a bridge loan; and without disclosure or consent, pooled several individuals' investments in order to meet the minimum investment requirement. Ultimately, the issuer liquidated, and all invested assets were lost.
 - (c) With respect to a second private placement, the firm failed to provide notice to investors that they had a right to a refund after the terms of an offering had been altered.
 - (d) The firm failed to comply with its conflict of interest procedures, deliver trade confirmations, maintain adequate books and records, report settled customer

complaints, and adequately supervise in connection with the private placements.

- (e) The firm consented to a censure, a \$1 million fine, and an undertaking to provide up to \$3.5 million in restitution to customers.

Regulation SHO

Regulation SHO continues to be the subject of enforcement actions. These cases began in 2006 and continued in 2007.

A. *Piper Jaffray & Co.* (“Piper Jaffray”), Hearing Board Decision 07-82 (May 31, 2007)

1. NYSE Regulation alleged that Piper Jaffray violated Regulation SHO in three separate ways:
 - (a) Piper Jaffray’s institutional sales desk allegedly effected a short sale on behalf of a client without confirming that the client had confirmed the availability of shares to borrow.
 - (b) Piper Jaffray failed to timely close out “fail-to-deliver” positions in threshold securities after 13 consecutive settlement days by buying in (*i.e.*, purchasing securities of like kind and quality) and closing the short position.
 - (c) Piper Jaffray failed to mark certain sell orders as long, short, or short sale exempt.
2. NYSE Regulation also alleged that Piper Jaffray failed to comply with the NSCC’s Anticipated Delivery Program by recording (for more than 14 calendar days) non-settled, non-delivered securities as though they were in the firm’s possession and control.
3. In addition, NYSE Regulation alleged that Piper Jaffray failed to supervise because the firm lacked adequate policies and

procedures and supervisory systems to comply with Regulation SHO and the NSCC's Anticipated Delivery Program.

4. Piper Jaffray consented to a censure and a fine of \$150,000.

Sharing in Customer Losses

The litigated case described below contains an interesting discussion of liability and sanctions.

- A. *Bishop Rosen & Co., Inc.* ("Bishop Rosen"), Hearing Board Decision 06-95 (July 11, 2007)
 1. NYSE Regulation's enforcement staff alleged that Bishop Rosen violated NYSE Rule 352(c), which prohibits a broker-dealer from sharing in losses in customer accounts by permitting one of its registered representatives to return a portion of his commissions to clients who had lost money on solicited trades. The Hearing Board concluded that although the firm acted in good faith, its conduct constituted impermissible sharing in its client's losses.
 2. A majority of the Hearing Board found that Bishop Rosen failed to adequately supervise its employees' trading in outside accounts because the firm did not regularly scrutinize accounts of its non-registered employees.
 3. The Hearing Board rejected the enforcement staff's allegations that Bishop Rosen's e-mail retention, prospectus delivery, and instant messaging retention procedures and systems were inadequate.
 - (a) *E-mail*: only the firm's chief compliance officer, vice president of compliance, and a compliance assistant had e-mail access prior to 2002, and the firm's practice was to print and file hard copy e-mails as needed;
 - (b) *Prospectuses*: when the firm received an indication of interest from a client, an employee sent a prospectus

to the client and filed the indication of interest form to document the prospectus delivery;

- (c) The Hearing Board determined that while Bishop Rosen's procedures in these areas were not best practices, they did not constitute violations.
- 4. The Hearing Board similarly concluded that there was insufficient evidence that the firm violated any rules with regard to retention of instant messaging in light of the fact that the instant messaging software on the computers had not been installed and/or activated.
- 5. Although the enforcement staff sought a \$100,000 fine, the Hearing Board imposed a censure and a \$7,500 fine based on the small size of the firm, the good faith efforts of the firm to comply with its regulatory obligations, lack of customer harm, and the fact that each violation was a first-time offense.
- 6. The Hearing Board rebuked the enforcement staff for seeking a more severe penalty, in part, on the basis that the firm did not acknowledge its wrongdoing, explaining that "[t]o the extent that this argument implies that anything less than a confession is grounds for an increased penalty, it is strange and troubling. A respondent should not be punished more harshly for defending against the charges, especially in a case where Enforcement prevailed on only one and a half of the five charges."

Registration

NYSE Regulation brought enforcement actions against Wachovia Securities LLC, H&R Block Financial Advisors, Inc. and Merrill Lynch in the registration area.

- A. *Wachovia Securities LLC* ("Wachovia"), Hearing Board Decision 07-90 (June 18, 2007)
 - 1. NYSE Regulation alleged that 36 Wachovia registered representatives did not complete a portion of their continuing education requirements (the computer-based training

program provided by the NYSE), which caused their registrations to become inactive. While their registrations were inactive, the representatives continued to perform the duties of registered representatives in violation of Rule 345A. NYSE Regulation also found that Wachovia's supervision to ensure compliance with continuing education requirements was inadequate.

2. NYSE Regulation brought an enforcement action against the firm (*In re First Union*) in 2004 for a similar violation.
3. Wachovia consented to a censure and a fine of \$90,000.

B. *H&R Block Financial Advisors, Inc.* ("H&R Block"), Hearing Board Decision 07-96 (June 22, 2007)

1. NYSE Regulation alleged that H&R Block employed seven independent contractors who performed the duties of registered representatives without first receiving NYSE approval. H&R Block also allegedly employed an individual as a branch office manager despite the fact that the individual had not completed the requisite three-year training requirement.
2. NYSE also alleged that H&R Block failed to adequately supervise correspondence, including e-mail. First, the firm's policies and procedures required branch office managers to review a defined amount of registered representatives' e-mails and required area managers to review a defined amount of branch office managers' e-mails. In certain instances, such reviews did not occur. Second, in certain branch offices, the branch office manager reviewed his own incoming and/or outgoing correspondence, which reflected an inadequate supervisory system.
3. H&R Block consented to a censure and a fine of \$45,000.

C. *Merrill Lynch, Pierce Fenner & Smith, Incorporated*, Hearing Board Decision 07-93 (June 20, 2007)

1. NYSE Regulation alleged that prior to September 2005, Merrill Lynch failed to register as branch offices certain alternative locations from which registered representatives conducted limited business.
2. NYSE revised the definition of branch office in September 2005 to exclude certain alternative work locations from the definition of a branch office. Merrill Lynch discovered its violation when it began to develop new policies and procedures to comply with the new rule.
3. NYSE Regulation also alleged that in 45 instances, Merrill Lynch had an office sharing arrangement with an affiliate, Merrill Lynch Investment Managers, that had not been approved by the NYSE.
4. Merrill Lynch consented to a censure and a fine of \$400,000. The Hearing Board Decision noted that Merrill Lynch saved approximately \$350,000 in registration fees by failing to register the alternative locations as branch offices.

Electronic Blue Sheet Reporting

In 2006, NYSE Regulation settled investigations of 20 firms relating to electronic blue sheet reporting. Two firms did not initially resolve their investigations. One litigated case is described below.

A. *In the Matter of Schon-Ex, LLC*, Hearing Board Decision 06-167 (June 6, 2007)

1. NYSE Regulation alleged that between June 2002 and October 2004, Schon-Ex submitted 84 inaccurate electronic blue sheets to the NYSE (through a vendor).
2. In a summary disposition, the hearing officer found that Schon-Ex violated its reporting requirements (and failed to adequately supervise) and that the firm's defenses were, in

effect, mitigating factors that are relevant to penalty determinations. In a matter of first impression, a Hearing Board concluded that NYSE Rule 476(c), as amended in April 2006, authorized a hearing officer to grant a motion for summary judgment.

3. The enforcement staff argued before the hearing panel that a \$300,000 penalty against Schon-Ex would be consistent with the range of penalties against firms that settled similar charges but that a penalty of \$400,000 was appropriate because Schon-Ex contested the matter. Schon-Ex argued that settled cases have no precedential value and therefore should not factor into determining the appropriate penalty for a litigated matter. Instead, the sanction should be guided by the NYSE's published penalty factors in Information Memorandum 05-77. The Hearing Board considered the range of penalties in the settled matters among other factors, including some of the factors in IM 05-77, and assessed a censure and a \$300,000 fine against the firm.
4. The NYSE Board of Directors affirmed the Hearing Board's decision.