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U.S. SEC, NASD, and NYSE Regulation: Selected Enforcement Cases and Developments In the First Half of 2007 Regarding Broker-Dealers

Overview

This outline focuses on selected U.S. Securities and Exchange Commission (“SEC”), NASD, and NYSE Regulation enforcement actions and developments in the first half of 2007 regarding broker-dealers.¹

To date this year, the SEC has been busy pursuing alleged insider traders; several of those cases involve alleged improper trading and tipping by Wall Street professionals. The Commission continued to bring cases in the mutual fund market timing, auction rate securities, conflict of interest and best execution areas. Finally, the Commission has also changed the way it negotiates civil penalties and some at the SEC have signaled an interest in “prudential regulation.”

The single most important topic at the SRO level this year is consolidation. It is expected that in early July 2007, the previously announced merger of the NASD and NYSE Regulation will become effective. The new SRO – dubbed the Securities Industry Regulatory Authority, or SIRA – will be responsible for creating a single rulebook, one examination program and a single enforcement arm. As separate entities so far this year, the NASD has brought cases in the anti-money laundering, best execution, and fee-based account areas. At NYSE Regulation, enforcement actions were initiated in, among others, the following areas: NYSE floor trading, supervision, and the sale of private placements. While no official statistics have been released to date, our review indicates that the number of cases brought by these two SROs (and possibly the fines imposed) likely have dropped from prior years.

¹ This outline was prepared by Ben A. Indek, a partner, and Michael S. Kraut, an associate, both resident in the New York office of Morgan, Lewis & Bockius LLP, with substantial assistance from associates Matthew R. Kalinowski and Alice L. McCarthy. Morgan Lewis represented firms in certain actions described in this outline. The outline is current as of June 23, 2007.

Background

In the SEC's fiscal year ("FY") 2006, the SEC initiated 914 investigations and 574 enforcement actions (218 civil proceedings and 356 administrative proceedings).² This was a 9.8% drop in cases from the previous year. The Commission claimed to have obtained more than \$3.3 billion in disgorgement and penalties in these actions. SEC enforcement actions against broker-dealers in FY 2006 fell to 75 from 94 in FY 2005. The Commission seems busy on the enforcement front this year in several areas, but there are no statistics that we are aware of that reflect the number of cases brought so far in FY 2007 or the fines and disgorgement obtained.

The proportion of SEC cases settled at filing is up this year, underscoring a recent trend. As of April 2007, 74% of cases brought in the current year were settled at the time of filing, as compared with 67%, 48%, and 64% in FYs 2004, 2005, and 2006, respectively. Many of the remaining actions will settle before they reach trial.³

The SEC has seen a steady decrease in enforcement referrals from its Office of Compliance Inspections and Examinations (OCIE).

1. In FYs 2004 and 2005, the percentage of broker/dealer examinations resulting in enforcement referrals was 27% and 22%, respectively. In FY 2006, 15-16% resulted in enforcement referrals.
2. OCIE's Chief Counsel believes that greater focus on broker/dealer compliance has led to this decline, occasioned by new compliance

² The SEC's fiscal year begins on October 1st. For example, references to FY 2006 refer to the year that began on October 1, 2005 and ended on September 30, 2006.

³ *Defendants Settle More SEC Actions*, Institutional Investor, April 13, 2007.

rules for broker/dealers and problems revealed by market timing and the research analyst scandals.

3. OCIE's Chief Counsel reiterated that the criteria for deciding whether to make referrals remain unchanged, including:
 - a. "hard core fraud," such as lying, cheating, stealing, or attempts to destroy evidence;
 - b. the involvement of misrepresentations to the examination team; and/or
 - c. whether OCIE trusts the firm to voluntarily fix the problem.⁴

Enforcement Actions

Insider Trading

1. Following a trend from late 2006, the first half of 2007 saw continued enforcement attention being paid to insider trading.
2. The SEC historically brought approximately 45 insider trading cases per year. Through April 20, 2007, the New York Stock Exchange alone already had referred 45 cases to the Commission, compared with 111 for all of 2006, although only some of those referrals will result in actual enforcement actions.⁵
3. So far in 2007, the SEC has prosecuted several insider trading cases against Wall Street professionals. Linda Thomsen, Director of the SEC's Enforcement Division, recently 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."⁶ Some examples of this trend are described below.

⁴ *Enforcement Referrals Decline*, Institutional Investor, April 23, 2007.

⁵ Jenny Anderson, *Suspicious Trading On the Rise*, The New York Times, May 12, 2007.

⁶ Bob Drummond, *Insider Trading Makes Comeback in Options 20 Years After Boesky*, Bloomberg.com, June 20, 2007.

- 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)
- (i) 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.
 - (ii) 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 onto others, who traded on the inside information, in exchange for kickbacks.
 - (iii) The SEC seeks injunctive relief, disgorgement, and civil penalties. In a related criminal case, the U.S. Attorney's Office for the Southern District of New York

has criminally charged thirteen alleged participants in the fraudulent scheme.

- (iv) 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.

b. *SEC v. Hafiz Naseem* (N.D. Ill. May 4, 2007)

- (i) The SEC charged a 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 a Pakistani banker, who traded while in possession of the tips and earned millions of dollars in profits.
- (ii) The SEC seeks injunctive relief, disgorgement, and a civil penalty against Naseem.

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

- (i) The SEC charged Wang, then a Vice President of Morgan Stanley and her husband, 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.
- (ii) The SEC seeks permanent injunctions, disgorgement, prejudgment interest, and civil penalties.

- d. *SEC v. Barclays Bank PLC and Steven J. Landzberg*
(S.D.N.Y. May 30, 2007)
- (i) The SEC filed a civil action against Barclays Bank PLC and Landzberg, a former proprietary trader for Barclays' U.S. Distressed Debt Desk, alleging that between March 2002 and September 2003, they violated federal securities laws by illegally trading bonds on the basis of material, non-public information obtained through membership on bankruptcy creditors committees.
 - (ii) 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.
 - (iii) Neither Barclays nor Landzberg disclosed the material non-public information received from creditors committees to their trading counterparties.
 - (iv) Barclays' Compliance personnel allegedly failed to prevent the illegal insider trading, despite knowledge that the proprietary desk had received non-public information and should have been restricted from trading.
 - (v) 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). To settle the charges against him, Landzberg consented to a permanent injunction and agreed to pay a civil penalty of \$750,000.

- e. *SEC v. Luiz Gonzaga Murat Jr.* (D.D.C. February 22, 2007); *SEC v. Alexandre Ponzio De Azevedo* (D.D.C. February 22, 2007)
 - (i) The SEC filed settled civil actions against two individuals, including 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. The ABN AMRO employee, 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.
 - (ii) The ABN AMRO employee 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

1. “Market timing” refers to (a) frequent buying and selling of shares of the same mutual fund or (b) buying or selling mutual fund shares in order to exploit inefficiencies in mutual fund pricing. While not per se illegal, the SEC views market timing as harmful to other mutual fund shareholders because it can dilute the value of their shares if the market timer is exploiting pricing inefficiencies, disrupt the management of the mutual fund’s investment portfolio or cause the targeted mutual fund to incur costs borne by other shareholders to accommodate frequent buying and selling of shares by the market timer.

2. *In the Matter of A.G. Edwards & Sons, Inc. ("AGE")* (Admin. Proc. File No. 3-12624, May 2, 2007)
 - a. 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.
 - b. 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 by disguising their own identities and the identities of their market timing customers and disguised the fact that multiple short-term trades were attributable to the same customers.
 - c. 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.
 - d. 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 any policies or sufficient procedures to address the market timing activity at the firm until at least September 2003.
 - e. As part of its settlement with the SEC, AGE agreed to pay disgorgement and prejudgment interest of \$2.36 million and civil penalties of \$1.5 million for a total payment of \$3.86 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.

- f. In a related action, the SEC settled an administrative proceeding against 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.

3. *In the Matter of Michael Sassano, Dogan Baruh, Robert Okin, and R. Scott Abry* (Admin. Proc. File No. 3-12554, Jan. 31, 2007)
 - a. The SEC alleged that Sassano and Baruh, former CIBC World Markets Corp. and Fahnestock & Co., Inc. brokers collaborated with many hedge fund customers to deceptively market time mutual funds.

 - b. 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, RR 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.

 - c. In addition, Baruh allegedly accepted mutual fund orders after 4:00 p.m. ET and processed those orders as though they had been placed prior to 4:00 p.m. ET so that they received the same day’s net asset value.

 - d. Okin and Abry supervised Sassano and Baruh and purportedly knew of, and assisted, Sassano and Baruh’s deceptive market timing practices.

 - e. The SEC seeks cease-and-desist orders, disgorgement, civil penalties, and prejudgment interest.

Conflicts of Interest Related to Research Reports

1. *In the Matter of Banc of America Securities LLC* (“BAS”) (Admin. Proc. File No. 3-12591, Mar. 14, 2007)
 - a. 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 from January 1999 through December 2001.
 - b. 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.
 - (i) 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 policies and procedures regarding the handling or control of such information.
 - (ii) 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.
 - (iii) 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.
 - c. 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.
 - (i) According to the order, from 1999 to 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

- d. BAS consented to: (1) pay \$26 million in disgorgement and penalties; (2) a cease-and-desist order; and (3) retain a consultant to review the firm's internal controls designed to prevent the misuse of material non-public information concerning forthcoming research.
- e. This action completed an investigation that led to prior action by the SEC Enforcement Division. In March 2004, Banc of America paid a \$10 million civil penalty to settle charges that it failed to promptly produce documents requested by the Enforcement Division, providing misinformation, and engaging in dilatory tactics that delayed the investigation.

Best Execution

- 1. *In the Matter of Morgan Stanley & Co. Inc.* ("Morgan Stanley") (Admin. Proc. File No. 3-1263, May 9, 2007)
 - a. 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.
 - (i) Morgan Stanley allegedly embedded undisclosed mark-ups and mark-downs on certain "not held" retail orders without the customers' prior consent.
 - (ii) 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.

- (iii) 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.
- b. 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.

Fraudulent Trading Schemes

1. *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)
 - a. 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.
 - b. 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. Then the traders sold their holdings at a substantial profit.
 - c. The action seeks injunctive relief, disgorgement with prejudgment interest, and civil monetary penalties.
2. *SEC v. Jaisankar Marimuthu, Chockalingam Ramanathan and Thirugnanam Ramanathan* (D. Neb. Mar. 12, 2007)
 - a. 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.

- b. 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.
- c. 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.
- d. The SEC seeks injunctive relief, disgorgement with prejudgment interest, and civil monetary penalties.
- e. 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 marks the first time that individuals overseas were arrested in connection with online brokerage account intrusion in the United States.
- f. This action marked the fourth account intrusion case brought by the SEC since December 2006.

3. *In the Matter of Park Financial Group, Inc. and Gordon C. Cantley* (Admin. Proc. File No. 3-12614, Apr. 11, 2007)
 - a. 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 suspicious activity reports (“SARS”) required by the Bank Secrecy Act.
 - b. Between 2002 and 2003, Park and Cantley allegedly executed numerous trades 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 the then-CEO of Spear & Jackson.
 - c. 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.
 - d. Proceedings will be held to determine whether a cease-and-desist order should issue and what remedial action, if any, should be taken, including disgorgement and/or civil penalties.

Order Marking

1. *In the Matter of Goldman Sachs Execution & Clearing L.P.* (“GSEC”) (Admin. Proc. File No. 3-12590, Mar. 14, 2007)
 - a. 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.
 - b. 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 REDI System) and falsely marked the orders “long,” even though the orders were in fact short.

- c. 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.
- d. 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.
- e. GSEC agreed to pay a \$2 million civil penalty (\$1 million each to the SEC and to the NYSE).

Auction Rate Securities

- 1. *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)
 - a. The SEC settled charges involving Legg Mason’s conduct in the auction rate securities market.
 - b. 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.
 - c. 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.

- d. 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.
- e. Citigroup Global Markets, which acquired Legg Mason after the conduct at issue occurred, consented to a censure and a \$200,000 civil penalty.
- f. As noted in last year's outline, Citigroup Global Markets is already subject to a cease-and-desist order from a settlement that it and fourteen other broker-dealers entered into last year with the SEC concerning violative auction rate securities practices.

Failure to Exercise Regulatory Oversight Responsibilities

- 1. *In the Matter of American Stock Exchange LLC ("Amex")* (Admin. Proc. File No. 3-12594, Mar. 22, 2007)
 - a. 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.
 - (i) 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.
 - (ii) 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.

- (iii) 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.
 - (iv) 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 customer priority rules, (3) enhance its training programs, and (4) retain an auditor to examine its programs related to trading.
- b. 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. Sodano has not settled these charges and is entitled to a hearing to determine whether Sodano failed to enforce compliance with the federal securities laws, rules, and regulations, and Amex rules by members of Amex and persons associated with those members.
- c. 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.

Other Significant Events at the SEC

Negotiation of Penalties

1. The Enforcement Staff will 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 will then offer the Enforcement Staff attorneys an applicable range

of penalty amounts. This is a marked change from prior practice, in which the enforcement staff would negotiate the sanction with the putative defendant and then submit the agreed-upon penalty to the Commission for review.

2. 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.
3. 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.
4. 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." (*Speech by SEC Chairman: Address to the Mutual Fund Directors Forum, Seventh Annual Policy Conference, by Chairman Christopher Cox (Apr. 13, 2007)*)

Prudential Regulation

1. In a speech at the annual SIFMA Compliance and Legal Division's 38th Annual Seminar in March 2007, 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."
2. 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. (*Remarks Before the SIFMA Compliance and Legal Conference, by Commissioner Annette L. Nazareth (Mar. 26, 2007)*)

3. Comments concerning prudential or principles-based regulation were also made at the SIFMA Conference in March 2007 by Rick Ketchum, then-CEO of NYSE Regulation, and Mary Schapiro, then-Chairman and CEO of NASD.

Cooperative arrangements with foreign financial regulatory counterparts

1. 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.
2. *SEC, UK FSA, and UK FRC Sign Protocol for Sharing Information on Application of IFRS (April 25, 2007)*
 - a. 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).
 - b. 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.
 - c. 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.
 - d. 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.

- e. The SEC plans to sign similar protocols in the remaining CESR member jurisdictions in the coming months.

3. *SEC, Euronext Regulators Sign Regulatory Cooperation Arrangement (Jan. 25, 2007)*

- a. 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.
- b. 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.
- c. The regulatory authorities from the Netherlands, France, Belgium, Portugal, and the United Kingdom comprise the College of Euronext Regulators.
- d. The MOU will become effective after Euronext Paris S.A. publishes a declaration that the thresholds for acceptance of the NYSE Euronext offer have been reached.

4. *SEC, German BaFin Sign Regulatory Cooperation Arrangement (April 26, 2007)*

- a. 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.
- b. 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

1. 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.
2. 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."
3. The Commission recently convened a roundtable discussion to explore this framework and other mutual recognition issues.

SEC Reorganization

1. *SEC Elevates District Offices to Regional Level (March 30, 2007)*
 - a. The SEC eliminated the two-tier hierarchy and nomenclature distinction between the 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.

Background

The number of cases and the size of fines brought in 2006 were dramatically lower than in 2005. In 2006:

1. The NASD resolved 1,147 formal actions, nearly 200 fewer than in 2005. As a result of those actions, 15 firms were expelled, 394 individuals were barred, and 4 firms and 352 individuals were suspended;
2. NASD fines plummeted nearly 50% from approximately \$148.5 million in 2005 to \$75 million in 2006.
3. An NASD spokesperson opined that the disparity can be explained by the unusually high number of enforcement actions in 2005 resulting from industry-wide sweeps. For example, in 2005, 26 firms were fined a total of \$55 million for directed brokerage and revenue sharing violations, and six firms were fined \$40 million for unsuitable sale of B-share mutual funds.

The NASD does not release statistics regarding total fines or disciplinary actions until the end of the calendar year. As such, it is difficult to determine the number of cases and total fines imposed so far in 2007. Nevertheless, anecdotal evidence suggests that the number of cases and fine levels will be down in 2007 compared with prior years.

SRO Consolidation

1. In late 2006, NASD and NYSE Regulation announced that they would consolidate their member regulation operations into a single entity. In June 2007, they announced that the combined entity would be named Securities Industry Regulatory Authority (SIRA).

2. In January 2007, By-Law amendments regarding governance changes for the consolidation were approved by the securities industry. In March, the amended By-Laws were filed with the SEC, and the SEC comment period closed on April 16. Clearances to complete the consolidation have been received from the Justice Department and the IRS. SIRA is expected to begin operations during the week of July 2, 2007.

3. On March 16, 2007, NASD Chairman and CEO Mary Schapiro announced a number of leadership and structural moves for the consolidated SRO, and on May 17, 2007, Ms. Schapiro testified before the United States Senate Securities, Insurance and Investment Subcommittee, regarding the consolidated SRO. She announced the following anticipated changes and guidance:
 - a. There will be a single rulebook for the consolidated SRO. Currently, work is being done to harmonize NASD and NYSE rules. The new rulebook will take a tiered approach to accommodate firms of different sizes and business models. The NASD and NYSE rules regarding arbitration and mediation will be harmonized.

 - b. Organizational Structure:
 - (i) *Member Regulation*: The consolidated SRO's Member Regulation function will be split into two departments. (1) the Department of Risk Oversight and Operational Regulation will be headed by Grace Vogel, who currently heads Member Firm Regulations at NYSE, and (2) the Department of Sales Practice Regulation will be headed by Robert Errico, who currently heads Member Regulation at NASD. The consolidated SRO will have a single examination program.

 - (ii) *Enforcement*: The consolidated SRO will have a single Enforcement Department, which will fully integrate the enforcement departments of the NASD and NYSE. Susan Merrill, currently in charge of Enforcement at NYSE Regulation, will be Chief of the combined Enforcement Department. James Shorris, currently chief of NASD Enforcement, will serve as Executive Director.

- (a) During a panel session of enforcement regulators at the annual SIFMA Compliance and Legal Division's 38th Annual Seminar in March 2007, the Panel noted that the consolidated SRO would be coordinating cases right away, and that enforcement staffs would shortly begin to go through their dockets to harmonize their case loads and develop priorities for the remainder of 2007. The Panel also noted that cases in litigation that were filed prior to the merger will use the rules of the SRO initiating the complaint.

- (iii) *Emerging Issues*: NYSE Regulation's Office of Risk Assessment and the NASD Office of Emerging Issues will be combined into a single group. This group will report to Elisse Walter, who currently oversees NASD regulatory policy and programs.

- (iv) *Dispute Resolution*: NYSE Regulation's arbitration program and NASD's arbitration and mediation programs will be combined to form the new SRO's Office of Dispute Resolution. Linda Feinberg, who currently runs NASD Dispute Resolution, will head the new office.

- (v) *Technology*: The integration of the two organizations' technology portfolios will be led by NASD's Chief Technology Officer, Marty Colburn, and will be supported by NYSE's Angela Posillico.

Enforcement Actions

Market Timing

1. 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).
 - 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 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.
- e. 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.

Best Execution

- 1. The NASD settled an enforcement action involving failure to supervise government securities transactions to ensure best execution against *HSBC Brokerage Inc.* ("HBI") (May 29, 2007).
 - a. 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 ("HSI"), its affiliate.

- b. 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.
- c. 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.
- d. HBI consented to a fine of \$250,000.

Anti-Money Laundering

- 1. The NASD settled an enforcement action involving failure to comply with laws and firm policies concerning anti-money laundering against *Banc of America Investment Securities, Inc.* (“BAI”) (Jan. 29, 2007).
 - a. 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.
 - b. 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.

- c. 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.
- d. BAI consented to a fine of \$3 million.

Misleading Documents and Inadequate Disclosures

- 1. The NASD settled two enforcement actions involving the use of misleading materials and/or inadequate disclosures against broker/dealers affiliated with Citigroup and Fidelity Investments.
- 2. *Citigroup Global Markets, Inc.* ("CGMI") (June 6, 2007).
 - a. 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.
 - b. 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.
 - c. 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.

- d. 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.
 - e. 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 up to 18 months.
3. *Fidelity Investments Institutional Services Company, Inc. ("FIISC") and Fidelity Distributors Corp. ("FDC") (together, "Fidelity") (May 8, 2007)*
- a. 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.
 - b. 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.
 - c. The NASD found that Fidelity's marketing materials were misleading. For example, certain materials depicted certain the plan's outperforming the S&P 500 over the prior 30 year period without disclosing that it 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.
 - d. The NASD also found that Fidelity failed to adequately supervise the review of its Destiny-related sales literature.
 - e. 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.

- f. Fidelity also agreed to publish specified additional disclosures on its Destiny sales literature, website, and account statements sent to Destiny plan holders.

Improper Non-Cash Compensation

- 1. 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)
 - a. 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.
 - b. The NASD also found that the firms failed to implement adequate systems and procedures to ensure compliance with the non-cash compensation rules.
 - c. Scudder, Putnam, and AllianceBernstein consented to fines of \$425,000, \$175,000, and \$100,000, respectively.

Cross-Market Manipulation

- 1. 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.
 - a. The NASD and CHX alleged that the traders 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.

- b. 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.
- c. In this case, a trader employed by NASD-registered First Analysis, which 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 a Dougall trader to purchase shares before the open the next day at the greater price. That transaction artificially inflated the price, enabling the First Analysis trader to conduct the cross trade at the higher price.
- d. The NASD found that the issuer, First Analysis, and Dougall were all unaware of the fraudulent scheme.
- e. NASD imposed a \$25,000 fine and a three-month suspension on the First Analysis trader, and CHX imposed a \$20,000 fine and a two-month suspension on the Dougall trader.

Fee-Based Brokerage

- 1. The NASD settled an enforcement action involving fee-based brokerage against *Wachovia Securities, LLC* ("Wachovia") (June 21, 2007).⁷
 - a. Between 2001 and 2004, Wachovia allegedly failed to adequately supervise its fee-based brokerage business.

⁷ On March 30, 2007, the U.S. Court of Appeals for the D.C. Circuit struck down an SEC rule 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 because Congress did not intend for such an exemption from investment adviser registration. The SEC requested a 120-day stay of the court's ruling so that investors and their brokers could respond. The Commission estimates that one million fee-based brokerage accounts are affected by the ruling. The SEC will consider whether further rulemaking or interpretations are necessary regarding the application of the Advisers Act to these accounts and the issues resulting from the court's decision.

- b. 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.
- c. The firm also allegedly exempted certain high-producing brokers from the firm's review and approval process.
- d. 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.
- e. 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."
- f. Wachovia consented to a censure and a \$2 million fine, in addition to certain undertakings, including the payment of restitution to certain customers.
- g. This action represents the latest 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.

Supervisory Violations

1. 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.

2. *Raymond James Financial Services, Inc. ("RJFS") (Feb. 21, 2007)*

- a. The NASD settled an action against RJFS for an alleged failure to maintain an adequate supervisory system and to maintain adequate books and records.
- b. 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.
- c. 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").
- d. The firm was 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.
- e. RJFS consented to a \$2.75 million fine. The NASD permanently barred the branch manager whose conduct was at issue.

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

- a. 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.

- b. 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.
- c. 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.
- d. 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.

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

- a. 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.
- b. 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.

- c. At least nine traders who were registered through one of the four broker-dealers but worked for its 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.
- d. 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.
- e. 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.

The Evolution of Regulation

NASD Chair and CEO, Mary Schapiro, recently outlined five ways that regulators must evolve in order keep pace with today's changing capital markets. Her remarks were made in a speech at the annual SIFMA Compliance and Legal Division's 38th Annual Seminar on March 26, 2007.

- 1. First, regulators must ensure that investors have choices in the types of firms they seek to do business with and the array of products and services those firms offer. 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.

2. Second, regulators must ensure that they are proactive, and not just reactive, by looking for emerging trends in the industry and addressing them early.
3. Third, regulators must find ways to assist the industry in meeting its compliance and regulatory obligations, particularly through member education to ensure that the rules and regulators' expectations are clear.
4. Fourth, regulators must understand the complex world in which we operate, working hard to accommodate the regulation of business that crosses borders in cooperation with regulators around the world.
5. Fifth, regulators need to engage investors through education, rather than simply responding to investor complaints or problems that have already come to light.

In a speech on June 20, 2007, Ms. Schapiro recognized that the formation of the consolidated SRO represents an opportunity to redefine the role of the regulator, and she reiterated the five principles that she raised during her March 27, 2007 speech as guidance. Specifically, she believes that for SIRA to be a “true modern regulator, [would mean] engaging investors and ensuring they have choices; being proactive – not reactive; assisting the industry in complying with rules; and understanding the world in which we operate.”

NYSE Regulation

Background

In 2006, NYSE Regulation prosecuted 232 cases (82 against firms and 150 against individuals), imposed approximately \$29 million in fines, and barred or suspended 134 individuals.

As of June 15, 2007, the enforcement statistics at NYSE Regulation looked like this:

1. 88 hearing board decisions have been issued (as compared with 128 during the same period in the prior year).
2. 20 cases have been brought against firms, and 68 cases have been brought against individuals.
3. The total amount of fines imposed by NYSE Regulation equals \$5,055,000. An additional \$1 million in fines was imposed jointly by NYSE Regulation and other regulators.

Enforcement Actions⁸

Specialist Cases

1. 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,

⁸ 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.

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

2. 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).

3. The settlements involved essentially the same findings, namely that the firms:
 - (i) 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,
 - (ii) mishandled ITS commitments in that eligible limit orders were not displayed immediately (i.e., as soon as practicable),
 - (iii) executed short sales on minus or zero minus tickets, and
 - (iv) failed to have written supervisory procedures specifically relating to the Firm Quote Rule, in its supervision of specialist firm quote activities.

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

1. NYSE Rule 123C requires that all MOC or LOC orders, unless entered to offset a published imbalance, be placed before 3:40 PM and only permits such orders to be canceled or reduced in size between 3:30 PM and 3:50 PM to correct a legitimate error. No MOC or LOC orders can be canceled or reduced in size after 3:50 PM.

2. Under NYSE rules, specialists are required to publish information about share imbalances in MOC or LOC orders of at least 50,000

shares as soon as practicable after 3:40 PM. MOC or LOC orders may be placed after 3:40 PM only on the contraside of the last published imbalance.

3. 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:

a. *Calyon Securities (USA) Inc.* (January 12, 2007)

(i) 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 the testing the connectivity of its order routing systems and in connection with its entry and cancellation of MOC and LOC orders.

(ii) Calyon consented to a censure and a \$90,000 fine.

- b. *UBS Securities, LLC* (January 18, 2007)
 - (i) 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.
 - (ii) UBS consented to a censure and \$95,000 fine.

- c. *Deutsche Bank Securities Inc.* (December 20, 2006)
 - (i) 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 termination floor employees.
 - (ii) Deutsche Bank consented to a censure and \$325,000 fine.

Gifts and Gratuities

- 1. NYSE Regulation brought an action for non-compliance with NYSE Rule 350(a)(3) concerning gifts and gratuities.
 - a. *Farina & Associates, Inc.* ("Farina") (December 12, 2006)

- (i) NYSE Regulation alleged that between January 2004 and June 2005, Farina provided at least \$80,000 worth of sporting event tickets to clients, specialists, and other broker-dealers without the written consent of the recipient's employer. These gifts far exceeded the \$100 maximum value permitted by the applicable NYSE rule.
- (ii) Farina consented to a censure and \$35,000 fine.

Floor Violations

1. NYSE Regulation brought actions involving floor violations against Morgan Stanley & Co., Inc. and *Van Der Moolen Specialists USA, LLC*.
2. *Morgan Stanley & Co., Inc.* ("Morgan Stanley") (December 18, 2006)
 - a. NYSE Regulation alleged that:
 - (i) 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.
 - (ii) The error led to extremely high order volume in numerous securities on the NYSE floor for at least fifteen minutes, causing significant market disruption.
 - (iii) The firm did not have adequate features in place to validate order accuracy and prevent orders exceeding preset parameters from being executed.

- (iv) 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.
- 3. *Van Der Moolen Specialists USA, LLC* (“VDM”) (December 18, 2006)
 - (i) NYSE Regulation alleged that between September 2002 and December 2004, VDM:
 - (a) submitted to the NYSE 131 floor slips that inaccurately stated that they had been approved by an NYSE floor official. In some instances, the Floor Official whose approval appeared on the slip was not working that day;
 - (b) failed to document (and maintain records) whether it had obtained Floor Official approval for the election of certain stop orders; and
 - (c) failed to supervise and implement adequate supervisory procedures reasonably designed to achieve compliance with NYSE rules pertaining to Floor Official approvals.
 - (ii) VDM consented to a censure and a \$50,000 fine.

Published Research Reports

1. Since amendments enacted in July 2002, NYSE Rule 472 requires member firms to include additional conflicts of interest disclosures in research reports themselves and in disclosures about companies analyzed in research reports.
2. NYSE Regulation brought an action for failing to failing to include required disclosures and conflict of interest disclosures on published research reports in *Deutsche Bank Securities, Inc.* (December 20, 2006)

- a. NYSE Regulation alleged that:
 - (i) 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.
 - (ii) 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.
 - (iii) 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.
- b. DBSI consented to a censure and a \$950,000 fine.

Anti-Money Laundering

- 1. In the first half of 2007, NYSE Regulation settled an action for failing to comply with NYSE Rules regarding anti-money laundering compliance program against *RBC Dain Rauscher, Inc.* ("RBC Dain") (March 23, 2007).
 - a. NYSE Regulation alleged that RBC Dain failed to establish an adequate AML compliance program. Specifically, NYSE Regulation found that RBC Dain:
 - (i) did not have written procedures explaining its AML processes or the time in which SARs must be filed;

- (ii) 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
 - (iii) lacked an adequate system for reviewing exceptions raised during its AML review processes. Failed to promptly report to the NYSE the settlement of customer complaints.
- b. 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.
- c. RBC Dain consented to a censure and a \$90,000 fine.

Trade Confirmations

1. In the first half of 2007, NYSE Regulation settled an action against *Pershing, LLC* (“Pershing”) (March 12, 2007) for failing to provide certain customers with required trade confirmations.
 - a. 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).
 - b. 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.
 - c. The firm consented to a censure and \$150,000 fine.

Net Capital and Customer Reserve

1. NYSE regulation settled an action against *Wachovia Securities, LLC* (“*Wachovia*”) (March 12, 2007) for failing to comply with NYSE rules regarding financial and operational requirements.
 - a. NYSE Regulation alleged that Wachovia:
 - (i) 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;
 - (ii) overstated the Excess Customer Debits in its Customer Reserve Formula Computation by \$12 million;
 - (iii) failed to supervise computations leading to these violations; and
 - (iv) the firm consented to a censure and a \$100,000 fine.

Proxy Voting

1. NYSE Regulation settled an action against *First Clearing, LLC* (“*First Clearing*”) (March 8, 2007) involving proxy voting.
 - a. NYSE Regulation alleged that:
 - (i) 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;

- (ii) First Clearing failed to implement adequate operational or supervisory procedures relating to proxy activities that addressed reconciling stock records and supervising its agent.
- b. 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, similar to its findings with respect to First Clearing's affiliate, Wachovia Securities (discussed above). In addition, NYSE Regulation found that eight trades that had been miscoded as agency transactions when submitted to the NYSE.
- c. The firm consented to a censure and a \$350,000 fine.
- d. This action 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.

Failure to Supervise

- 1. NYSE Regulation settled an action against *Morgan Stanley & Co.* ("Morgan Stanley") (May 9, 2007) involving failure to supervise.
 - a. NYSE Regulation alleged various failures to supervise, including that Morgan Stanley:
 - (i) failed to detect unsuitable trading activity in guardian and other accounts;
 - (ii) failed to have adequate procedures for entering and allocating block trades placed through the firm's trading desk;
 - (iii) failed to ensure that order tickets were written for orders that comprised a block trade;

- (iv) failed to produce evidence that it had adequately reviewed and maintained e-mails of registered representatives' and supervisors' e-mail;
 - (v) failed to accurately report statistical information concerning customer complaints; and
 - (vi) failed to have written supervisory procedures that could have prevented the above violations.
- b. Morgan Stanley consented to a censure and a \$500,000 fine.

Sale of Unregistered Private Placements

1. NYSE Regulation recently brought a case against *J.J.B. Hilliard, W.L. Lyons, Inc.* (May 16, 2007) regarding the sale of unregistered securities through private placements.
 - a. NYSE Regulation alleged that:
 - (i) 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.
 - (ii) 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.
 - (iii) 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.

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

Principles of Effective Regulation

Richard G. Ketchum, CEO of NYSE Regulation, outlined five fundamental underpinnings of effective regulation in a March 27, 2007 speech during the SIFMA Compliance and Legal Division's 38th Annual Seminar:

1. 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.
2. 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.
3. Third, regulators must provide greater levels of interpretive guidance, especially if more flexible risk-based rulemaking is embraced.
4. Fourth, regulators must effectively interact with stakeholders in formulating and applying the rules. Perspective can be gained through more informative interactions with the industry.
5. Fifth, there must be a conscious focus on improving investor education.