

# **Retail Brokerage and Advisory Issues**

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## I. INTRODUCTION<sup>1</sup>

This outline highlights several key areas concerning retail brokerage and advisory issues. Specifically, the outline covers the following topics: (1) the transition of fee-based customer accounts into other types of accounts as a result of the vacation of SEC Rule 202(a)(11)-1; (2) marketing to senior investors; (3) dealing with increased market volatility and rapid regulatory changes; (4) customer complaint statistics and potential causes of complaints in the current environment; and (5) on-line account intrusion.

## II. ISSUES SURROUNDING THE TRANSITION OF FEE-BASED ACCOUNTS

### A. Background

1. In April 1995, the SEC Commission on Compensation Practices published its report (known as the Tully Report after the Commission's Chairman, Daniel Tully). Among other suggestions, the Tully Report recommended "payment for client assets in an account, regardless of transaction activity" as a "best practice." According to the Tully Report, this would alleviate the potential conflict of interest that could lead a broker to recommend trades when, "[i]n many cases the best advice an RR can give a client is to 'do nothing.'"
2. Following the Tully Report, many brokerage firms developed so-called fee-based or fee-in-lieu of commission accounts.
3. In late 2003, NASD issued Notice to Members 03-68 concerning the regulatory issues that may arise in connection with fee-based accounts.
4. In April 2005, the SEC adopted new Rule 202(a)(11)-1 that, among things, carved out from regulation under the Advisers Act of 1940 fee-based brokerage services that adhered to certain conditions.<sup>2</sup>
5. In September 2005, new NYSE Rule 405A regarding fee-based account supervision and disclosure became final.

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<sup>1</sup> This outline was drafted by Ben A. Indek, a partner of Morgan, Lewis & Bockius LLP. The outline represents the views of Mr. Indek and not those of the other panelists and their organizations.

<sup>2</sup> Helpful information on the changes to the investment adviser and broker-dealer landscape resulting from the SEC Rule and the litigation described below can be found in various presentations made in 2007 on this topic. See, e.g., *Investment Adviser Rules – From the Broker-Dealer's Perspective* (SIFMA CL presentation dated March 27, 2007 available at morganlewis.com at biography of Steven W. Stone); *Financial Planning Association v. SEC: Fee Based Brokerage* (SIFMA CL presentation dated May 15, 2007 by Lori Martin of WilmerHale available at sifma.org); and *Transitioning to a Post-Rule 202(a)(11)-1 Environment* (NSCP presentation dated October 22, 2007 available at morganlewis.com at biography of John V. Ayanian). These materials were helpful in creating this section of the outline.

6. Beginning in 2005, the SROs brought cases against a number of firms for, among other things, allegedly failing to reasonably monitor their fee-based brokerage businesses.
7. In March 2007, the DC Circuit Court of Appeals vacated SEC Rule 202(a)(11)-1. The court found that fee-in-lieu of commission brokerage accounts were deemed to have received special compensation and were not excluded from the Advisers Act. The decision became effective October 1, 2007.<sup>3</sup>
8. As a result of the court ruling noted above, firms have transitioned many of their former fee-based brokerage accounts to nondiscretionary advisory accounts that are subject to regulation under the Advisers Act, traditional commission-based brokerage accounts or other types of programs.

**B. SEC OCIE Sweep**

1. It has been reported that in the summer of 2008, the SEC's OCIE began a sweep examination focusing on the transition of accounts out of firms' fee-based brokerage programs. Among other things, OCIE is examining:
  - (1) How the transition process worked;
  - (2) the disclosures provided to clients affected by the transition;
  - (3) the internal communications circulated by firms regarding the transition;
  - (4) the analyses that were undertaken to determine which kinds of accounts were appropriate for clients formerly in fee-based brokerage programs;
  - (5) materials provided to brokers regarding the transition;
  - (6) sample advisory agreements for those choosing an advisory relationship; and
  - (7) information regarding principal trading; and
  - (8) continuing implied obligations for firms to monitor account program appropriateness.

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<sup>3</sup> Financial Planning Association v. SEC, 2007 U.S. App. LEXIS 7356 (D.C. Cir. Mar. 30, 2007).

### **III. MARKETING TO SENIOR INVESTORS**

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

#### **A. SEC Seniors Summits**

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

#### **B. Sweep Examinations**

In addition to the above-noted summits, securities regulators have been keenly focused on conducting targeted examination sweeps to identify potential broker-dealer misconduct in connection with sales to seniors. These sweeps include the following:

1. An SEC OCIE, NASAA and FINRA sweep that culminated in a September 2007 joint report titled "Protecting Senior Investors: Report of Examinations of Securities Firms Providing 'Free Lunch' Sales Seminars."<sup>5</sup> The regulators found:
  - (1) "sponsors of "free lunch" sales seminars offer attractive inducements to attend;
  - (2) often, the target attendees are seniors;
  - (3) seminars are designed to sell;
  - (4) some firms had particular compliance and supervisory controls that appear to be effective. And, during a small number of the examinations (5 examinations or 4% of those conducted), regulators found no problems or deficiencies;

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<sup>4</sup> An excellent White Paper on compliance issues surrounding senior investors was prepared by Alston + Bird and Bressler, Amery & Ross for the NSCP in September 2007.

<sup>5</sup> This report is available at [sec.gov](http://sec.gov) and [finra.org](http://finra.org).

- (5) half of the examinations found that firms used advertising and sales materials that may have been misleading or exaggerated or included seemingly unwarranted claims (in 63 of 110 examinations, or 57%). Many broker-dealer firms did not submit their sales materials to NASD (now FINRA) for review, as required by NASD advertising rules;
  - (6) individuals attending the sales seminars may not understand that the seminar is sponsored by an undisclosed company with a financial interest in product sales;
  - (7) many examinations found indications that firms had poorly supervised these sales seminars;
  - (8) some examinations found indications that registered representatives or investment advisers holding the sales seminars had recommended investments that did not appear to be suitable for the customers; and
  - (9) in some instances the sales seminars may have involved fraud.”
2. Two sweeps announced by FINRA in September 2007 at the SEC Seniors Summit. The first was said to examine whether brokers are using various titles or designations to mislead and defraud senior investors. The second examination targeted early retirement seminars designed to entice workers to liquidate their retirement accounts and invest them with a broker or firm. These two new sweeps were in addition to ongoing examinations focusing on sales of CDOs and life settlements to seniors.
  3. Finally, in September 2008, the SEC, NASAA and FINRA released a new report titled “Protecting Senior Investors: Compliance, Supervisory and Other Practices Used by Financial Firms in Serving Senior Investors.”<sup>6</sup> In this report, the regulators provided practical examples of ways in which the industry is attempting to work with senior investors in a sound and principled manner. Specifically, the report includes a summary of certain practices used by firms and individuals in serving senior investors in these areas:
    - (1) “getting started: how firms are thinking of ways to remodel their supervisory and compliance structures to meet the changing needs of senior investors;
    - (2) communicating effectively with senior investors;

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<sup>6</sup> This report is available at [sec.gov](http://sec.gov) and [finra.org](http://finra.org).

- (3) training and educating firm employees on senior-specific issues (such as how to identify signs of diminished capacity and elder abuse);
- (4) establishing an internal process for escalating issues and taking next steps;
- (5) encouraging investors of all ages to prepare for the future;
- (6) advertising and marketing to senior investors;
- (7) obtaining information at account opening;
- (8) ensuring the appropriateness of investments; and
- (9) conducting senior-focused supervision, surveillance and compliance reviews.”

### **C. Rulemaking**

As a complement to their examination and enforcement efforts, regulators have also focused on rulemaking in the senior area. Of particular note is the NASAA Model Rule on the Use of Senior-Specific Certifications and Professional Designations adopted on March 20, 2008.<sup>7</sup> The Model Rule is intended to prohibit the misuse of certifications or designations by industry professionals.

### **D. Enforcement Efforts**

In addition to sweeps and rulemaking, regulators have been busy in the enforcement arena. Below are several cases involving alleged misconduct in connection with senior investors.<sup>8</sup>

#### **1. *Securities America Inc.* (Securities America”) (Sept. 14, 2006)**

The NASD fined Securities America for failing to adequately supervise a broker who had lured long-term employees of Exxon-Mobil to retire early, cash out their company-sponsored 401(K) and pension plans, and reinvest the funds from the retirement plans with Securities America. The broker then placed these customers into variable annuities, Class B or Class C mutual fund shares and exchange-traded funds and promised them that their monthly income from these investments would match what they

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<sup>7</sup> The Model Rule is available at [nasaa.org](http://nasaa.org).

<sup>8</sup> The summaries of the cases below are taken from the “Year in Review” publications issued by Morgan Lewis in 2006, 2007 and 2008 that describe certain SEC and SRO enforcement actions and developments. These reports are available at [morganlewis.com](http://morganlewis.com).

would be earning in salary. Customers who followed the broker's recommendations could not maintain their recommended withdrawal amounts without depleting their retirement account to levels that threatened their incomes.

James S. Shorris, then NASD Executive Vice President and Head of Enforcement, stated "in this case, Securities America's lack of supervision resulted in Exxon employees being fraudulently induced into retiring early, based upon false and misleading projections of future investment returns on their nest eggs."

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

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

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

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

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

The SEC found that the respondents failed to supervise in several respects. First, Bleidt personally owned the independent office in which he worked. The firms permitted Bleidt to hire and personally employ the OSJ manager who supervised him. The SEC concluded that the conflict of interest inherent in such a structure may have compromised supervisory review.

Second, the SEC concluded that the firms lacked adequate policies and procedures to follow up on red flags concerning Bleidt's outside business activities and for review of incoming correspondence.

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

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

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

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

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

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

These charges are still pending.

#### **IV. DEALING WITH INCREASED MARKET VOLATILITY AND RAPID REGULATORY CHANGES**

The markets are increasingly volatile today, with significant point and percentage decreases and increases in the Dow Jones Industrial Average seemingly every day. In addition, there have been substantial changes to the rules governing trading and disclosure (particularly in the short selling area) over the last few months; some of those modifications have been on short notice to the industry.

1. These issues can necessitate rapid changes to firms' systems and the need for fast and accurate communication with brokers, traders, supervisors and clients. Firms facing these challenges should consider the creation of ad hoc task forces or working groups composed of individuals from senior management, information technology, legal, compliance, and operations to handle these issues in an orderly and effective fashion.

## V. CUSTOMER COMPLAINTS

Through September, new case filings with FINRA Dispute Resolution are up significantly over the prior year. Specifically, between January and September 2007, investors had filed 2,382 arbitration cases with FINRA Dispute Resolution. Through September 2008, FINRA Dispute Resolution had received 3,469 arbitration filings. This represents a 46 percent increase.<sup>9</sup>

1. In today's market environment, it is critical for legal and compliance staffs to not only be cognizant of the increase in customer complaints but most importantly to understand and address their root causes. In that regard, firms may see a rise in complaints in the auction rate, margin call, system access, trade cancellation, erroneous trading and account performance areas.

## VI. ON-LINE ACCOUNT INTRUSION

Over the last few years, regulators and firms have been focused on combating on-line account intrusions by computer hackers and securities fraudsters. Intrusions typically occur through customer vulnerability (e.g., computer viruses) or behavior (e.g., using public computers in hotels, libraries or cyber cafes to access their accounts) rather than as the result of any vulnerabilities in firm systems.

- A. In 2007, the SEC brought several matters involving on-line account intrusion. The following are two examples of such matters.<sup>10</sup>

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)

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.

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.

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<sup>9</sup> These statistics are available in the Dispute Resolution section of FINRA's website at [finra.org](http://finra.org).

<sup>10</sup> The cases described below, with the exception of that pertaining to LPL Financial, can be found in the Morgan Lewis reports referred to in footnote 8.

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)

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.

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.

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.

The SEC seeks injunctive relief, disgorgement with prejudgment interest, and civil monetary penalties.

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. On September 9, 2008, Thirugnanam Ramanathan was sentenced to two years in prison, followed by three years of supervised release. Ramanathan was also ordered to pay restitution in the amount of \$362,247.

**B.** To date this year, the SEC has brought at least four cases on this topic.

1. *SEC v. Anatoly Russ* (S.D.N.Y. Jan. 16, 2008)

The SEC filed a civil action against Russ, a Russian citizen, alleging that he placed unauthorized orders in online brokerage accounts as part of a fraudulent scheme to control the prices at which he purchased and sold options in ETFs.

Russ obtained brokerage firm clients' usernames and passwords and used them to gain unauthorized access to the clients' online brokerage accounts. He then executed purchase and sell orders in those accounts that were opposite from orders he had placed in his own accounts. Because the options were so thinly traded, Russ was able to control the prices for his own purchase and sell orders, earning guaranteed profits in his own accounts.

Russ realized illegal profits of at least \$88,465 and caused losses of at least \$339,929 in the accounts to which he gained unauthorized access.

The SEC sought a permanent injunction, disgorgement, prejudgment interest, and civil penalties. On July 24, 2008, the District Court issued a default judgment against Russ which: (i) permanently restrained and enjoined Russ from violating Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, promulgated thereunder; (ii) ordered that Russ is liable for disgorgement of \$88,465, plus prejudgment interest of \$12,407.52, for a total of \$100,872.52; and (iii) ordered Russ to pay a civil penalty of \$130,000.

As with instances involving similar fraudulent conduct in the past two years, the online brokers housing the accounts made the intruded accountholders whole for their losses.

2. *SEC v. One or More Unknown Traders in the Common Stock of Certain Issuers a/k/a AWE Trading, Inc. and Andrew Andersen* (E.D.N.Y. Apr. 7, 2008)

The SEC filed a complaint alleging unknown traders fraudulently opened brokerage accounts in the names of unsuspecting individuals, gained unauthorized access to trading accounts of other clients of retail brokerage firms and profited by executing unauthorized securities transactions in those accounts.

The unknown traders posted fake job postings on Craigslist. The traders allegedly opened online securities trading accounts in the names of individuals who responded to the job postings without their knowledge, using personal identifying information that the applicants provided. The traders also gained unauthorized access to retail client accounts at various brokerage firms. Simultaneously, the traders executed transactions in the same securities in both sets of accounts on opposite sides of the market, causing the accounts that they opened to profit and causing losses in the accounts that they accessed without authorization. By taking advantage of the price and volume movements in the stocks, the traders gained approximately \$66,000.

The SEC seeks an injunction and an order requiring defendants to repatriate any assets that they hold outside the United States, disgorge their gains, and pay civil money penalties.

3. *In the matter of LPL Financial Corporation, formerly known as LINSICO/Private Ledger Corp.*, (SEC Release 58515, Sept. 11, 2008)

In this recently settled action, the SEC alleged that despite being on notice of certain problems with its security controls over customer information, LPL failed to put in place adequate controls, including various security measures, which resulted in such customer information being vulnerable to unauthorized access. Specifically, between July 2007 and February 2008, LPL's computer system was breached by an unauthorized individual or individuals who accessed and traded, or tried to trade, in the customer accounts of several of LPL's brokers. As of the date of these intrusions, the firm had failed to implement enhanced security measures and adopt written policies and procedures reasonably designed to guard customer information as required by SEC Regulation S-P. According the SEC, LPL identified the breaches in its system and absorbed the losses in its customer accounts.

The SEC censured LPL and ordered it to cease and desist from committing or causing any violations and any future violations of certain provisions of Regulation S-P. In addition, the firm was fined \$275,000. The firm also undertook to retain an independent consultant to review its policies and procedures relating to Regulation S-P and make recommendations concerning any improvements to those protocols.