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review

2010 Year in Review: SEC and SRO Selected Enforcement Cases and Developments Regarding Broker-Dealers

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Executive Summary

This Outline highlights selected U.S. Securities and Exchange Commission (the "SEC" or the "Commission"), Financial Industry Regulatory Authority ("FINRA") and NYSE Euronext enforcement actions and developments regarding broker-dealers during 2010.[*]

The SEC

In 2009, the SEC's Division of Enforcement began a comprehensive review and reorganization. Over the last year, Enforcement worked on implementing many of the changes to its program that resulted from that review.

One of the most far-reaching changes was the creation of five national specialized units within the Enforcement Division. The leaders of those units were announced in January 2010, and the groups have been staffed with attorneys and other experienced personnel throughout the country. The specialized units have identified a number of initiatives and brought significant enforcement actions in their area of expertise. Examples include several insider trading cases involving rings of tippers and traders initiated by the Market Abuse Unit, and the Structured and New Products Unit's focus on collateralized debt obligations and other complex financial products.

Enforcement's restructuring also included the creation and staffing of two new offices: the Office of the Managing Executive and the Office of Market Intelligence. The Office of Market Intelligence is working on an important Commission initiative – the handling, tracking and distributing for investigation tips, complaints and referrals received at the SEC. In 2010, an FBI agent was embedded into the Office to continue the Commission's coordination with criminal prosecutors to combat financial fraud.

[*] This Outline was prepared by Ben A. Indek, Michael S. Kraut, Kevin T. Rover and Anne C. Flannery, partners, and of counsel Mary M. Dunbar, with substantial assistance from associates Catherine Courtney, Clare M. Cusack, Alex B. Kaplan, Kerry J. Land, Alice McCarthy, Julia N. Miller, Melissa J. Mitchell, Sarah S. Nilson, E. Andrew Southerling and David A. Snider. As noted below, certain sections of the Outline were drawn from Law Flashes published by the Firm. The authors are grateful for the outstanding administrative assistance provided by legal secretary Mary-Elizabeth Denmark. Morgan Lewis served as counsel in certain actions described herein. This Outline is current as of January 21, 2011. Copyright 2011, Morgan, Lewis & Bockius LLP.

Last year, Commission officials expressed an intention to evaluate the Enforcement Division's performance based on qualitative, instead of solely quantitative, metrics. Indeed, SEC Chairman Mary Schapiro and the Director of Enforcement, Robert Khuzami, have emphasized that metrics reflect the number of cases brought, but not the effect and impact of those actions. Consistent with that philosophy, the SEC has developed a list of "National Priority" or "High Impact" actions, which the Commission hopes will be widely covered by the media and affect the future conduct of market participants. At the end of FY 2010, National Priority or High Impact cases comprised 3.26% of the Division of Enforcement's active docket. In FY 2010, 33 such actions were filed.

Several of the metrics traditionally used to measure enforcement activity demonstrate that, in FY 2010, the SEC's Division of Enforcement actively and aggressively pursued misconduct affecting the U.S. markets.[1] Some of the key statistics from FY 2010 are described below:

- The Division opened 531 formal investigations, compared to 496 new inquiries in FY 2009.
- In FY 2010, the SEC brought 681 cases, up slightly from the 664 initiated in the prior year. The number of actions last year is the highest since at least FY 2001.
- The SEC's cases involving broker-dealers declined significantly to 70 actions in FY 2010 from 109 in FY 2009. However, when combined with cases against other regulated entities, including investment advisers and mutual funds, it is clear that the SEC continues to closely regulate financial institutions.
- The Commission brought 53 insider trading cases (up from 37) against 138 defendants (versus 85).
- Last year there were 139 criminal cases relating to Commission actions, down slightly from FY 2009's 154 cases.
- In FY 2010, the SEC reported that it had obtained a "favorable" outcome (including through litigation, settlement or a default judgment) in 92% of its cases. Interestingly, this is exactly the same percentage the Commission achieved in the prior three fiscal years.
- For FY 2010, the SEC recently reported that it had obtained orders requiring the payment of approximately $1.03 billion in penalties by

[1] The SEC's fiscal year begins on October 1. References to FY 2010 are to the year that commenced on October 1, 2009 and ended on September 30, 2010.

securities law violators. This is almost three times the amount it obtained in FY 2009. That record reflected a return to the SEC's halcyon years between 2004 and 2006 in terms of its imposition of civil money penalties, although a few actions account for a substantial portion of last year's billion dollar figure.

- The Commission also obtained orders requiring disgorgement of $1.82 billion in illicit gains last year, a $189 million drop-off from FY 2009, but in line with the figures in several prior years.

- Finally, in FY 2010, case closings were projected to increase 32% over the prior year.

The major policy change to the Division of Enforcement's program last year was the announcement and implementation of a series of new measures designed to encourage individuals and companies to cooperate in investigations and actions. In January 2010, the SEC issued a policy statement setting forth for the first time formal guidelines to evaluate and potentially reward cooperation by individuals in investigations and enforcement actions. At the same time, the Commission authorized the use of a number of new "cooperation tools" designed to establish incentives for individuals and companies to cooperate with the Division. These tools include formal written cooperation agreements, deferred prosecution agreements, and nonprosecution agreements with individuals and companies. In the last year, Enforcement entered into approximately 15 cooperation agreements. Moreover, in December 2010, the Commission announced that it had entered into the first nonprosecution agreement under its new initiative.

Last year, the SEC brought cases in the insider trading, fraudulent sales practice and supervisory areas, each of which reflects the kinds of cases that the Commission initiates against broker-dealers or their employees. Moreover, the SEC's efforts to investigate issues surfacing from the financial crisis bore fruit in cases involving the marketing and sales of collateralized debt obligations, subprime mortgage holdings and net asset value. Finally, the SEC once again brought cases involving anti-money laundering, municipal bond transactions and Regulation SHO.

These developments and cases are described in more detail at pages 6 through 67 of this Outline.

Dodd-Frank Wall Street Reform and Consumer Protection Act

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). This landmark legislation contains a number of measures that significantly expand the enforcement authority of the SEC and strengthen its oversight and regulatory authority over the securities markets.

Specifically, the Dodd-Frank Act enhances the SEC's ability to prosecute aiding and abetting and control person cases. The legislation also extends the statute of limitations for securities laws violations and expands the application of the antifraud provisions and the jurisdiction of federal courts in actions brought by the SEC in certain cases. With the new legislation in place, the SEC has several enhanced remedies, including the ability to impose collateral bars and the authority to impose civil penalties in cease-and-desist proceedings against any person found to have violated the securities laws. The incentives and protections afforded to securities whistleblowers have been significantly increased by, among other changes, permitting the SEC to pay whistleblowers who voluntarily provide original information between 10% and 30% of monetary sanctions exceeding $1 million in cases involving any violation of the securities laws. New Commission whistleblower regulations implementing the Dodd-Frank provisions should be promulgated later this year.

Finally, the Dodd-Frank Act contains certain procedural modifications relating to SEC enforcement actions, including granting the Commission nationwide subpoena power in connection with civil actions filed in federal courts and requiring the SEC to file an enforcement action within 180 days of the Wells notice in certain cases or to notify the affected party of the intent not to file an action.

The Dodd-Frank Act's effect on the SEC's enforcement program is described in more detail at pages 68 through 80 of this Outline.

FINRA

Two significant personnel changes occurred at FINRA in 2010. In July, Susan Axelrod, a longtime NYSE Regulation attorney and senior FINRA official, was appointed Executive Vice President – Head of the Member Regulation Sales Practice Area. In October, FINRA announced that it had appointed J. Bradley Bennett, a lawyer in private practice, as its new Head of Enforcement, effective January 1, 2011.

Similar to comments made by the SEC concerning the use of statistics, FINRA officials have indicated that its Enforcement program should not be evaluated solely on the fines it levies on firms and individuals. Rather, the number of cases filed each year, the types of misconduct under investigation and the size and financial wherewithal of the broker-dealers involved should also be taken into account.

In 2010, FINRA's Enforcement staff was active in filing and resolving disciplinary actions. Last year, FINRA filed 1,310 new disciplinary actions – an increase of 13% from the prior year. FINRA also resolved 1,178 formal actions last year; in 2009, it concluded 1,090 such cases.

FINRA's total fines in 2010 appear to have declined when compared to the prior year, but represented a large increase versus 2008. Through November 2010, FINRA reported that it had levied fines of $41.1 million. That figure would represent a decline from the $47.6 million in fine revenue in the prior year, but a significant increase from the $25.9 million in revenue from fines FINRA garnered in 2008. In line with the decline in its overall fine levels, the number of cases with significant penalties dropped sharply in 2010 when compared to 2009. In 2010, FINRA's largest cases (i.e., those with penalties over $1 million), dropped by 70%.

In 2010, FINRA appears to have significantly slowed its use of targeted examination letters, as only four such letters were posted on FINRA's website. These inquiries related to noninvestment company exchange traded products, direct market access, private placement agents soliciting and/or obtaining business with municipalities and public pension funds, and broker-dealer services involving customers of financial institutions. Perhaps, however, the lack of "targeted examination letters" is merely semantics because Enforcement also launched several task forces to investigate certain issues, including Regulation D offerings, municipal securities transactions and day trading.

Last year, FINRA's Department of Enforcement brought cases in a number of traditional areas, including anti-money laundering, email retention, financial reporting, research report disclosures, Regulation SHO, sales material disclosures and supervision. FINRA also returned to such topics as auction rate securities, day trading and credit default swap brokerage rates. Finally, the staff opened new fronts by bringing cases involving high-frequency trading, mortgaged-backed securities and retail sales of collateralized mortgage obligations and reverse convertible notes.

These developments and cases are described in more detail at pages 81 through 139 of this Outline.

NYSE Euronext

In June 2010, FINRA and NYSE Euronext announced that they had completed the previously announced agreement under which FINRA assumed responsibility for performing the market surveillance and enforcement functions previously conducted by NYSE Regulation. Under the agreement, FINRA assumed the regulatory functions for three exchanges: the New York Stock Exchange LLC, NYSE Arca, Inc. and NYSE Amex LLC. NYSE Euronext, through its subsidiary NYSE Regulation, remains ultimately responsible for overseeing FINRA's performance.

These developments and six cases with fines of $200,000 or more are described in more detail at pages 140 through 147 of this Outline.

Personnel Changes and New Specialized Unit Chiefs[2]

Over the last two years, the Division of Enforcement undertook "the most profound reorganization in [its] history."[3] One of the most far-reaching changes was the creation of five national specialized units within the Enforcement Division, which enabled the staff to focus on complex areas of the securities laws and to enhance the specialization of its personnel. On January 13, 2010, the Commission announced the leadership of these units:

- **Asset Management** – This unit, focusing on investigations concerning a broad range of asset managers, including investment advisers, mutual funds, hedge funds and private equity funds, is led by co-Chiefs Bruce Karpati and Robert Kaplan. The unit has launched several projects, including a Bond Fund Initiative (focusing on disclosure and valuation issues in mutual fund bond portfolios), a Problem Adviser Initiative (attempting to detect problem investment advisers by reviewing such persons' representations regarding their education, experience and past performance), and a Mutual Fund Fee Initiative (examining whether mutual fund advisers are charging retail investors excessive fees).[4]

- **Market Abuse** – This unit is concentrating on investigations involving broad market abuses and complex market manipulation schemes perpetrated by institutional investors, market professionals, and other traders. The unit is led by Daniel Hawke; the Deputy Chief is Sanjay Wadhwa. Several initiatives are being undertaken by this unit, including the establishment and improvement of the SEC's electronic Blue Sheet system to identify potential relationships among traders who may be

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2 Unless otherwise noted, the information regarding these personnel changes was drawn from SEC press releases available on the Commission's website.

3 *See* Robert Khuzami, Speech to the Society of American Business Editors and Writers (Mar. 19, 2010), available at: http://www.sec.gov/news/speech/2010/spch031910rsk.htm; *see also* Mr. Khuzami's Testimony Before the United States Senate Committee on the Judiciary Concerning Investigating and Prosecuting Fraud after the Fraud Enforcement and Recovery Act, Sep. 22, 2010 available at: http://www.sec.gov/news/testimony/2010/ts092210rk.htm ("Khuzami Senate testimony").

4 *See* Khuzami Senate testimony.

acting in concert. Moreover, the unit is currently creating an Analysis and Detection Center to help staff attorneys conducting investigations into complex trading schemes by examining strategies across all types of securities.

- **Structured and New Products** – Led by Unit Chief Kenneth Lench and Deputy Unit Chief Reed Muoio, this unit is focusing on derivatives and other complex financial products, including credit default swaps, collateralized debt obligations and securitized investments. New initiatives for this unit include reviews of reverse convertible notes, auto-callable notes, residential mortgage-backed securities, principal protected notes and total return swaps.

- **Foreign Corrupt Practices** – A unit that focuses on violations of the Foreign Corrupt Practice Act, which bans U.S. companies from bribing foreign officials for government contracts and other business opportunities, is headed by Cheryl Scarboro.

- **Municipal Securities and Public Pensions** – Led by Unit Chief Elaine Greenberg and Deputy Unit Chief Mark Zehner, this unit is concentrating on misconduct in the municipal securities market and several areas in the public pension fund space, including offering and disclosure fraud, tax fraud, pay-to-play and public corruption, public pension accounting and disclosure, and valuation and pricing fraud.

At the February 11, 2010 SEC Speaks conference, the then-newly appointed chiefs reported that their units already had achieved positive results. For example, the Market Abuse Unit noted that it was taking a proactive approach to combating "organized" insider trading among large institutions and associated persons and had penetrated these rings, as reflected in recent enforcement actions and settlements. Other unit chiefs forecasted their units' ability to better recognize, react to, and prevent market abuses.[5] Indeed, later events confirmed these comments – as described in this Outline, the Structured and New Products Unit brought and settled the well-publicized Goldman Sachs collateralized debt obligation case.

In May 2010, Mr. Khuzami stated that 20% of the Division of Enforcement's personnel had been assigned to the five specialized units.[6] By Fall, Mr. Khuzami and senior enforcement officials reported that all of the units had been fully staffed and are represented in offices throughout the country. The units also hired industry experts to work directly with the Enforcement staff and

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[5] These comments were reported by Morgan Lewis' Patrick D. Conner and E. Andrew Southerling in their Law Flash titled "The SEC Speaks 2010: Faced Paced Reform Continues," available at: http://www.morganlewis.com/pubs/SecuritiesLF_SECSpeaks2010_11feb10.pdf

[6] Notes of comments made by Mr. Khuzami on May 7, 2010 at the SIFMA Compliance & Legal Society Annual Seminar in Washington, DC.

Commission accountants, and the SEC is using these units as a platform to improve training.[7]

Additional personnel changes relating to the SEC's enforcement efforts took place last year, including the following:

- In January, the SEC appointed Carlo di Florio as the Director of the Office of Compliance Inspections and Examinations ("OCIE"). As the Director of OCIE, Mr. di Florio has responsibility for, among other things, the Commission's investment adviser, broker-dealer, and investment company examination programs. Mr. di Florio joined the SEC from PricewaterhouseCoopers.

- In February, the SEC announced that Rhea Kemble Dignam had been named Director of the Commission's Atlanta Regional Office. Although Ms. Dignam joined the SEC from Ernst & Young, earlier in her career, she served in several senior roles in the U.S. Attorney's Office in the Southern District of New York. Also that month, the Commission appointed William Hicks as the Associate Regional Director of Enforcement in the Atlanta Regional Office. Prior to his promotion, Mr. Hicks had been a member of the SEC staff for more than 25 years.

- In March, Howard Scheck rejoined the SEC as Chief Accountant for the Division of Enforcement. He previously had been a partner at Deloitte Financial Advisory Services and had also worked at the SEC for 10 years.

- In April, the Commission's New York Regional Office appointed Robert Keyes as Associate Regional Director and Chief of Regional Office Operations. In this newly created position, Mr. Keyes assists the Regional Director and other senior officers in managing the enforcement and examination caseload. Mr. Keyes joined the SEC staff in 1996.

- In May, the SEC named Richard Levine as Associate General Counsel for Legal Policy in the Office of the General Counsel. The Commission noted that Mr. Levine will provide legal and policy advice to SEC Commissioners on many matters, with a particular focus on enforcement, corporate disclosure and accounting. He has worked for the SEC for more than 25 years.

- Also in May, the SEC promoted Gerald Hodgkins to Associate Director of the Division of Enforcement to fill the position previously held by Frederic Firestone. Mr. Hodgkins joined the Commission staff in 1997.

[7] *See* Khuzami Senate testimony. Unit staffing was also discussed by senior Enforcement staff at the ABA Annual Business Law conference held on Nov. 19, 2010 in Washington, D.C.

- In July, the Commission announced that its longtime Chief Counsel of the Division of Enforcement, Joan McKown, was leaving the SEC to enter private practice. Ms. McKown spent 24 years working for the SEC. She served as Chief Counsel of the SEC since 1993 and was responsible for creating enforcement policies and reviewing proposed enforcement actions prior to their recommendation to the Commission for approval. In November, the SEC appointed Joseph Brenner, a partner at a prominent Washington law firm as the new Chief Counsel in the Enforcement Division.

- In August, the SEC announced that after almost 18 years at the SEC, Christopher Conte, an Associate Director in the Division of Enforcement, was leaving the agency. In December, Stephen Cohen assumed this position in the senior ranks of the Enforcement Division after having spent the past two years as Senior Advisor to SEC Chairman Schapiro.

- Also in August, Matthew Martens was appointed Chief Litigation Counsel of the Division of Enforcement, with responsibility for oversight of the Commission's litigation program. Mr. Martens was formerly an Assistant United States Attorney in the Western District of North Carolina.

- In November, James Clarkson retired from the Commission after more than 40 years of service, including 32 years as the Director of Regional Office Operations in the Enforcement Division.

Implementation of Enforcement's Restructuring

In 2010, Enforcement worked on implementing its restructuring project, which included flattening its management ranks by removing the Branch Chief position and, for the most part, making those individuals frontline investigators. This change also reduced staff-to-supervisor ratios and unnecessary bureaucracy.

Over the last two years, the Division also established and staffed two new offices: the Office of the Managing Executive and the Office of Market Intelligence.

The Office of the Managing Executive was created in 2009 to oversee a number of administrative and support functions, including information technology, human resources, and data collection and analysis. Of note, this past year, due to the improved capabilities to track cases implemented by the Office, the Division's case closing process was enhanced; as the year drew to an end, the SEC was projecting an increase in terminated cases in FY 2010 versus those closed in FY 2009.[8]

[8] *See* Khuzami Senate testimony.

The Office of Market Intelligence is working on an important Commission initiative – the handling, tracking and distributing for investigation tips, complaints and referrals received at the SEC. Moreover, in 2010 the Office successfully established a system to assess and assign for investigation such information. The Office now includes specialists in market surveillance, accountants and lawyers. Interestingly, an FBI agent was recently embedded into the Office. Finally, the Office is responsible for attempting to identify new trends and techniques used by market participants who engage in securities fraud.

Enforcement Statistics

As described above, it is clear that, in 2010, the Division of Enforcement spent a considerable amount of time and effort taking steps to implement the changes arising from the comprehensive internal review and reorganization it had begun in the prior year. Commission officials also expressed an intention to evaluate the Enforcement Division's performance based on qualitative, instead of solely quantitative, metrics going forward.[9] Indeed, SEC Chairman Mary Schapiro and Mr. Khuzami have emphasized that metrics reflect the number of cases brought, but not the effect and impact of those actions.[10]

Consistent with that philosophy, the SEC is focusing on its "National Priority" or "High Impact" actions, which the Commission hopes will be widely covered by the media and affect the future conduct of market participants. At the end of FY 2010, National Priority or High Impact cases comprised 3.26% of the Division of Enforcement's active docket. In FY 2010, 33 such actions were filed.

Several of the metrics traditionally used to measure enforcement activity demonstrate that, in FY 2010, the SEC's Division of Enforcement actively and aggressively pursued misconduct affecting the U.S. markets.[11] The year's statistics are described below.

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[9] *See id.* and Mary Schapiro, Testimony Before the United States House of Representatives Committee on Financial Services Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises Concerning Oversight of the U.S. Securities and Exchange Commission: Evaluating Present Reforms and Future Challenges (July 20, 2010), available at: http://www.sec.gov/news/testimony/2010/ts072010mls.htm ("Schapiro House Testimony")

[10] *See* Khuzami Senate Testimony and Schapiro House Testimony.

[11] As noted previously, the SEC's fiscal year begins on October 1st. References to FY 2010 refer to the year that began on October 1, 2009 and ended on September 30, 2010. The FY 2009 statistics in this section were taken from the Commission's Select SEC and Market Data – Fiscal 2009 report available on the SEC's website at: http://www.sec.gov/about/secstats2009.pdf, Mr. Khuzami's Dec. 11, 2009 Congressional testimony, available at: http://sec.gov/news/testimony/2009/ts121109rk.htm and the SEC's 2009 Performance and Accountability Report available at: http://sec.gov/about/secpar2009.shtml. The data for FY 2010 is available at: http://www.sec.gov/about/secpar2010.shtml, Khuzami Senate testimony, and Select SEC and Market Data – Fiscal 2010 report available at: http://www.sec.gov/about/secstats2010.pdf.

New Investigations and Total Enforcement Actions

The Division **opened 531 formal investigations**. By comparison, in FY 2009, the SEC issued 496 formal orders of investigation.

Last year, the Commission **brought 681 enforcement actions**, a slight increase from the 664 cases initiated last year. FY 2010's 681 cases also constitute the highest number of actions since at least FY 2001. The number of cases the SEC is able to bring in FY 2011 bears watching as in mid-December 2010, the media reported that the Commission was slowing the pace of certain investigations due to the Congressional budget impasse.[12]

Categories of Cases

The major categories of cases and the number of actions within each include:

Type of Case	Number of Actions	% of Total Actions
Securities Offering Cases	144	21
Issuer Reporting and Disclosure	126	18
Investment Advisers/Investment Companies	112	16
Delinquent Filings	106	16
Broker-Dealer	70	10
Insider Trading	53	8
Market Manipulation	34	5

Of note, in one of the Commission's core areas – **regulation of broker-dealers** – the SEC's actions **declined significantly to 70 cases** in FY 2010 from 109 in the prior year. This represents a 36% decrease year-over-year. Of course, as seen above, the Enforcement staff devoted considerable resources to cases against other regulated entities, including investment advisers and mutual fund companies. Taken together, it is clear that the SEC continues to closely regulate financial institutions.

Consistent with the SEC's tough talk last year, the SEC brought **53 insider trading cases**, up from 37 in FY 2009. Moreover, the number of defendants sued by the SEC in last year's cases represented a significant increase over the prior year. Specifically, there were 138 defendants in the 53 cases brought last year versus 85 such individuals in the prior year's 37 actions.

[12] *See* "Regulator is Slowed by Budget Impasse," Wall Street Journal, Dec. 15, 2010 at p. C1.

SEC Coordination with Criminal Authorities and Referrals to Other Agencies

In the last several years, a significant amount of attention has been paid to the increasing "criminalization" of the federal securities laws. In FY 2010, once again the evidence reflects that the SEC continued to work closely with criminal prosecutors. Last year, there were **139 criminal actions** relating to Commission cases, down slightly from FY 2009's 154 cases.

The Commission also works closely with other regulators. In FY 2010, **492 SEC investigations were referred** to self-regulatory organizations or other state, federal and foreign authorities for enforcement.

Internally Generated Cases, Emergency Relief and First Time Actions

Since the Madoff scheme came to light in December 2008, and the subsequent criticism aimed at the Commission's failures to uncover that fraud, the SEC has tried to enhance its ability to turn internally-generated tips, audits or other prospects into investigations. Last year, **almost 22%** of investigations opened during FY 2010 **came from referrals within the Commission or other internal analysis**.

The SEC leadership has indicated that a top priority is to move quickly to stop and punish misconduct affecting the securities markets. However, last year two statistics used to examine how quickly the SEC moved to stop ongoing misconduct reflected a marked decline. The Commission **sought emergency relief in federal courts in 37 cases**; that technique was used 71 times in FY 2009. The Commission also sought **57 asset freezes** to preserve money for the benefit of harmed investors in FY 2010 versus 82 such actions in the prior year. Of course, these two measures may not necessarily indicate that the SEC moved more slowly than in the past, but rather can also be explained by the fact that there may have been fewer cases that required such emergency action.

On a related note, last year the Commission **filed 67% of its first enforcement actions within two years** of starting an investigation or inquiry. That figure represents a 3% decrease year-over-year. However, the last two years compare favorably to the Commission's statistics in FY 2008 and 2007 when it filed 62% and 54% of its first enforcement actions within two years of commencing an investigation or inquiry.

Successful Outcomes

Last year, the Commission continued its record of "successfully" resolving the vast majority of its cases. Specifically, in FY 2010 the SEC reported that it had obtained a **"favorable" outcome**, including through litigation, settlement or a default judgment, in **92% of its cases**. (The Commission calculates this measure on a per-defendant basis.) Interestingly, this is exactly the same percentage the Commission achieved in FY 2007, FY 2008 and FY 2009.

Penalties, Disgorgement and Distributions to Injured Investors

For FY 2010, the SEC recently reported that it had obtained orders requiring the payment of approximately **$1.03 billion in penalties** by securities law violators. This is almost three times the amount it obtained in FY 2009. Indeed, as shown in the table below, FY 2010 reflected a return to the SEC's halcyon years between 2004 and 2006 in terms of its imposition of civil money penalties, although a few actions account for a substantial portion of last year's billion dollar figure. Specifically, the SEC extracted large settlements from State Street ($50 million fine), Citigroup ($75 million penalty), Bank of America ($150 million penalty to be distributed to shareholders) and Goldman Sachs ($300 million penalty to be paid to the U.S. Treasury and another $250 million to be provided to harmed investors).

The Commission also obtained orders requiring **disgorgement of $1.82 billion** in illicit gains last year, a $189 million drop-off from FY 2009, but in line with the figures in several prior years.

Fiscal Year	Civil Money Penalties	Disgorgement
2004	$1.2 billion	$1.9 billion
2005	$1.5 billion	$1.6 billion
2006	$975 million	$2.3 billion
2007	$507 million	$1.093 billion
2008	$256 million	$774 million
2009	$345 million	$2.09 billion
2010	$1.03 billion	$1.82 billion

Last year the SEC distributed almost **$2 billion to injured investors** from 42 separate Fair Funds.

Case Closings

In connection with Enforcement's efforts to improve its administrative functions, the staff has improved its closing process for terminated or completed investigations. In FY 2010, **case closings were projected to increase 32%** over the prior year.

Insider Trading, FBI Memorandum of Understanding and Operation Broken Trust

Insider Trading

As we reported last year, in November 2009, President Obama established an interagency Financial Fraud Enforcement Task Force to strengthen the country's efforts to combat financial crime.[13] The DOJ plays the lead role on the Task Force and the SEC, the Treasury Department and the Department of Housing and Urban Development serve on its steering committee. The Task Force includes senior officials from more than two dozen U.S. governmental agencies. The Task Force does not include representatives from FINRA. This initiative is yet another example of the SEC's coordination with criminal and other authorities. As outlined below, in 2010, the Task Force's efforts bore fruit.

In an October 2010 speech before the New York City Bar Association, Preet Bharara, Manhattan U.S. Attorney, reiterated that the investigation and criminal and civil prosecution of insider trading continued to be a top regulatory priority. In fact, Mr. Bharara stated that he believed that "insider trading is rampant and may even be on the rise." Mr. Bharara forecasted that the government would soon ramp up its efforts to combat insider trading on Wall Street.[14]

In November and December 2010, prosecutors did just that. At that time, the DOJ's and SEC's broad and far-reaching investigation into a potentially vast network of insider trading activity sprang into public view. Specifically, Mr. Bharara's office charged several consultants or employees of a so-called "expert network" firm with insider trading. This flurry of activity focuses on allegations that the expert network employees or consultants provided material nonpublic information to hedge funds and other investors and has resulted in FBI raids, arrests and guilty pleas. In announcing charges in one case, Mr. Bharara stated that the government's accusations reflect "that a corrupt network of insiders at some of the world's leading technology companies served as consultants who sold out their employers by stealing and then peddling their valuable inside information."[15]

Interestingly, to date the SEC has not commenced any actions in connection with the government's investigation. However, as described below in the case section of this Outline, the Commission has aggressively pursued its own cases against insider trading, particularly on Wall Street. As examples, in the *Galleon* and *Cutillo* cases, the SEC charged more than a dozen hedge fund managers,

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13 *See* Press Release, *President Obama Establishes Interagency Financial Fraud Enforcement Task Force*, Nov. 17, 2009, http://www.sec.gov/news/press/2009/2009-249.htm.

14 *See* Preet Bharara, "The Future of White Collar Enforcement: A Prosecutor's View," remarks before the New York City Bar Association (Oct. 20, 2010).

15 *U.S. v. Shimoon, Longoria, Karunatilaka, and Fleischman* (Dec. 16, 2010) at: http://www.justice.gov/usao/nys/pressreleases/December10/shimoonetalarrestspr.pdf

lawyers and Wall Street professionals in connection with two interconnected insider trading rings.

Memorandum of Understanding with the Federal Bureau of Investigation

In September 2010, the SEC entered into a Memorandum of Understanding with the FBI under which an FBI agent will be embedded within the Division of Enforcement's Office of Market Intelligence, which was created in January 2010 to analyze the tips, complaints and referrals received by the SEC. This initiative is another example of the Commission's coordination with criminal prosecutors to combat financial fraud.[16]

Operation Broken Trust

At a press conference on December 6, 2010, U.S. Attorney General Eric Holder, accompanied by Mr. Khuzami and senior law enforcement representatives of the FBI, the IRS and the CFTC, announced the results of a previously undisclosed, coordinated law enforcement effort directed at financial fraud – Operation Broken Trust – which had been launched on August 16, 2010. Much of the effort has involved prosecuting affinity fraud against members of church groups and community groups. According to General Holder, the nationwide effort has involved enforcement actions against 343 criminal defendants in 231 cases and 189 defendants in 60 civil cases. The conduct encompassed by these cases affected over 120,000 victims. According to the DOJ, the criminal cases involve $8.3 billion in losses while the civil cases involve losses of $2.1 billion.[17]

Notably, given the contrast between the less-than four month's existence of Operation Broken Trust and the large number of victims and the sizeable financial losses, media reports promptly pointed out that many of the investigations either began in the Bush Administration or in the Obama Administration prior to August 16, 2010. The media also contrasted these law enforcement efforts with the dearth of law enforcement actions against mainstream corporate executives.[18]

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16 *See* Khuzami Senate testimony.

17 *See* "Attorney General Eric Holder Speaks at the Operation Broken Trust Announcement," available at: http://www.justice.gov/iso/opa/ag/speeches/2010/ag-speech-101206.html (Dec. 6, 2010).

18 *See* "U.S. Counts Big Results in Fighting Fraud Cases," New York Times, Dec. 6, 2010 available at: http://www.nytimes.com/2010/12/07/business/07ponzi.html?_r=1&scp=2&sq=%22Broken+Trust%22&st=nyt.

Cooperation Initiatives[19]

On January 13, 2010, the Commission announced a series of new measures designed to encourage individuals and companies to cooperate in Enforcement Division investigations and enforcement actions. First, the SEC issued a policy statement setting forth for the first time formal guidelines to evaluate and potentially reward cooperation by individuals in investigations and enforcement actions. Second, the Commission authorized the use of a number of new "cooperation tools" designed to establish incentives for individuals and companies to cooperate with the Division. The enforcement staff now is authorized to execute formal written cooperation agreements, deferred prosecution agreements and nonprosecution agreements with individuals and companies, although a formal witness proffer will be required in most cases before any of these new agreements may be used. These new measures are codified in a revised version of the Division's Enforcement Manual in Section 6, titled "Fostering Cooperation."[20]

The Commission's new cooperation incentives demonstrate the importance it places on individual and company cooperation in its enforcement efforts. In his public statement announcing these new measures, Mr. Khuzami characterized them as a potential "game changer" for the Commission, and recognized that there is "no substitute for the insider's view into fraud and misconduct that only cooperating witnesses can provide."

Framework for Evaluating Cooperation by Individuals

Rewarding cooperation is not a new concept for the Commission. In the SEC's 2001 "Seaboard Report," it set standards to evaluate cooperation by corporations.[21] In the January 2010 policy statement, the SEC set forth, for the first time, the way in which it will evaluate whether, how much, and in what

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

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

[21] Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship and Cooperation to Agency Enforcement Decisions, SEC Release Nos. 34-44969 and AAER-1470 (Oct. 23, 2001) (http://www.sec.gov/litigation/investreport/34-44969.htm) (the Seaboard Report). In the Seaboard Report, the Commission set forth four broad measures for evaluating cooperation by companies. These measures are: self-policing, self-reporting, remediation, and cooperation with law enforcement. The factors in the Seaboard Report are now formally incorporated into the Enforcement Manual as Section 6.1.2 (Framework for Evaluating Cooperation by Companies).

manner to credit cooperation by individuals. In the policy statement, the Commission identifies four core factors to determine how to measure and reward cooperation by individuals on a case-by-case basis: (1) the assistance provided by the individual; (2) the importance of the underlying matter; (3) the societal interest in holding the individual accountable for his or her misconduct; and (4) the appropriateness of cooperation credit based upon the personal and professional profile of the cooperating individual. For each of these criteria, the Commission has set forth specific considerations that it and the enforcement staff will take into account.

Individual Assistance

In evaluating the individual's assistance, the SEC will assess, among other things, the value and nature of the individual's cooperation in its investigation. For example, the Commission will consider the timeliness of the cooperation (whether the individual was the first to report the misconduct to the SEC, and whether the cooperation was provided before he or she had knowledge of the investigation) and whether the cooperation was voluntary. The Commission will also consider whether the individual provided nonprivileged information not requested by the staff or that otherwise might not have been discovered. In addition, the SEC will assess whether the individual encouraged others who might not have otherwise participated to assist the staff in the investigation.

Importance of the Underlying Matter

In evaluating the importance of the underlying matter, the SEC will consider the character of the investigation, including whether the subject matter of the investigation is a Commission priority, the type of securities violations, the age and duration of the misconduct, the repetitive nature of the misconduct, and the amount and type of harm or potential harm to investors. The SEC will view most favorably cooperation in priority investigations that involve serious, ongoing or widespread violations.

Interest in Holding the Individual Accountable

The Commission also will assess the societal interest in holding the individual fully accountable for his or her misconduct. The SEC will consider the severity of the misconduct within the context of the individual's knowledge, training, experience and position of responsibility at the time of the violations, whether the individual acted with intent, and any efforts undertaken to remediate the harm caused by the misconduct. The Commission will also evaluate the degree to which the individual tolerated illegal activity, such as whether he or she took steps to prevent the misconduct from occurring or continuing (such as notifying the SEC or other law enforcement agency), or, in the case of a business organization, whether he or she notified management not involved in the misconduct, the board of directors or the auditors of the company.

Profile of the Individual

Finally, the Commission will consider the cooperating individual's personal and professional risk profile in determining whether it is in the public interest to award cooperation credit. Under this factor, the SEC will consider the individual's history of lawfulness, the individual's acceptance of responsibility for past misconduct, and the opportunity for the individual to commit future transgressions in light of his or her occupation (for example, whether he or she serves as a licensed professional, an associated person of a regulated entity, a fiduciary, officer or director of a public company, or a member of senior management).

New Cooperation Tools for Individuals and Companies

The Commission's cooperation initiative also arms the staff with new tools to encourage individuals and companies to report violations and provide assistance to the agency. These tools, which are in the revised version of the Enforcement Manual, authorize the staff to enter into formal written cooperation agreements, deferred prosecution agreements, and nonprosecution agreements.[22] The DOJ has regularly used these cooperation tools in criminal investigations and prosecutions; however, they have not been available to the SEC in enforcement matters until now.

Cooperation Agreements

Cooperation agreements are formal written agreements in which the Director of Enforcement agrees to recommend to the Commission that a cooperator receive credit for cooperating in investigations or related enforcement actions. Under certain circumstances, the Enforcement Director may agree to make a specific enforcement recommendation. In exchange, the Division must conclude that the individual or company has provided or is likely to provide substantial assistance to the Commission such as full and truthful testimony and information, including producing all potentially nonprivileged documents and materials to the SEC. If the Division agrees to make a specific enforcement recommendation to the Commission, the cooperation agreement should include the specific recommendation and an agreement by the cooperating individual or company to resolve the matter without admitting or denying the alleged violations.

The Enforcement Manual instructs the staff that, prior to seeking a cooperation agreement, the staff should require a potential cooperating individual or company to execute a proffer agreement and to make a detailed proffer of the information

[22] The Commission also streamlined its process for obtaining immunity requests when a party is cooperating with the staff. Under its new process, the Commission has delegated authority to the Enforcement Director to make immunity requests directly to the Department of Justice. *See* http://www.sec.gov/rules/final/2010/34-61339.pdf. Previously, the staff was required to file a formal action memorandum with the Commission seeking a formal Commission order to make such a request.

that he or she is prepared to share with the staff.[23] In addition, the enforcement manual instructs the staff to consider the standard cooperation analysis with respect to individuals (Section 6.1.1) and companies (Section 6.1.2, the Seaboard Factors) when assessing whether to recommend that the Division enter into these agreements with an individual or company.

Senior SEC Enforcement officials have indicated that since January 2010, the Division has entered into approximately 15 cooperation agreements, and have noted that more are in the pipeline. These agreements arose in a variety of matters, including financial fraud, FCPA and insider trading; the majority involved parallel criminal proceedings and most were entered into in the early stages of an investigation.

In addition, the Enforcement staff has formed a "Cooperation Committee" comprised of five to six senior officials to review and approve proposed cooperation agreements.[24]

Deferred Prosecution Agreements

Deferred prosecution agreements are formal written agreements in which the Commission agrees to forego an enforcement action against a cooperator. These agreements are executed only if the individual or company agrees, among other things, to cooperate fully and truthfully, including producing all potentially relevant nonprivileged documents and materials, and to comply with express prohibitions and undertakings during a period of deferred prosecution, which generally should not exceed five years.

Deferred prosecution agreements may require a cooperator to agree either to admit or not to contest underlying facts that the SEC could assert to establish a violation of the federal securities laws. The Enforcement Manual suggests an admission or agreement not to contest relevant facts underlying the alleged offenses is appropriate for licensed individuals (attorneys, accountants), regulated individuals, fiduciaries, officers and directors of public companies, and repeat offenders.

As with cooperation agreements, the staff should consider the standard cooperation analysis with respect to individuals (Section 6.1.1) and companies (Section 6.1.2, the Seaboard Factors) and require a potential cooperating

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[23] Proffer agreements are not a new tool to the Commission staff. A proffer agreement is a written agreement providing that any statements made by a person, on a specific date, may not be used against that individual in a subsequent proceeding. The Commission may use statements made during the proffer session as a source of leads to discover additional evidence and for impeachment or rebuttal purposes if the person testifies or argues inconsistently in a subsequent proceeding. The Commission may also share the information provided by the proffering individual with appropriate authorities in a prosecution for perjury, making a false statement, or obstruction of justice.

[24] These issues were discussed at the ABA Annual Business Law conference described above.

individual or company to execute a proffer agreement before seeking authority for a deferred prosecution agreement.

Nonprosecution Agreements

Nonprosecution agreements are formal written agreements entered into under "limited and appropriate circumstances," in which the Commission agrees not to pursue an enforcement action against a cooperator if the individual or company agrees, among other things, to cooperate fully and truthfully in investigations and related enforcement proceedings, including producing all potentially relevant nonprivileged documents and materials, and to comply with express undertakings.

The Enforcement Manual instructs the staff that, in virtually all cases, nonprosecution agreements will not be available for individuals who have previously violated the federal securities laws. Further, nonprosecution agreements should not be executed until the role of the cooperating individual or company and the importance of their cooperation to the staff become clear.

As with cooperation and deferred prosecution agreements, the Enforcement Manual instructs the staff to consider the standard cooperation analysis with respect to individuals (Section 6.1.1) and companies (Section 6.1.2, the Seaboard Factors), and to require a potential cooperating individual or company to execute a proffer agreement prior to seeking authority to enter into a nonprosecution agreement.

Although not part of its public announcement of the cooperation initiatives, the SEC's revised enforcement manual authorizes Assistant Directors, with approval of a supervisor at or above the Associate Director level, to orally inform an individual or company that the enforcement staff does not anticipate recommending an enforcement action against the individual or company based upon the evidence known at the time by the staff. The Commission will, however, authorize these oral assurances only when the investigative record is adequately developed.[25]

As described immediately below, at the end of 2010, the Commission publicized its first nonprosecution agreement.

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[25] *See* Section 6.2.1 *Proffer Agreements* (Enforcement Manual, Jan. 2010). The revised manual has eliminated a prior provision that permitted the staff in limited circumstance to provide a witness with a written assurance that the Commission does not intend to bring an enforcement action against him or her or an associated entity in exchange for the witness's agreement to testify and provide documents. *See* Section 3.3.5.3.1 *Witness Assurance Letters* (Enforcement Manual, Oct. 2008).

SEC Enters Into First Nonprosecution Agreement[26]

On December 20, the Commission announced that it had entered into the first nonprosecution agreement under its year-old cooperation initiative.[27] The SEC's agreement is with Carter's, Inc., a children's clothing marketer, and follows Carter's 2009 discovery of accounting improprieties. This first nonprosecution agreement adds much-anticipated flesh to the skeleton of the cooperation regime that Mr. Khuzami implemented in order to encourage greater cooperation by individuals and companies in SEC investigations.

Companies, particularly those that are also regulated by other agencies or organizations, should take note of some of the collateral consequences of the Carter's nonprosecution agreement. Also of note is the SEC's clarification of some important procedural questions, such as what happens if a cooperator violates its agreement, that were not addressed when the cooperation initiative was announced in January 2010.

The Carter's Investigation

Much of the background of the Carter's investigation is described in the civil complaint filed by the SEC on December 20, 2010 against a former Carter's executive, Joseph M. Elles (the "Elles Complaint"). The Elles Complaint alleges that Elles provided unauthorized, deferred discounts to a significant Carter's customer in order to increase sales to that customer, and concealed these discounts from Carter's accounting personnel.

The Elles Complaint states that Carter's discovered Elles's alleged fraud in or about October 2009, and began an internal investigation shortly thereafter. By January 2010, Carter's had filed amended Forms 10-K and 10-Q for periods as far back as its 2005 fiscal year. In its press release announcing the enforcement action against Elles and its nonprosecution agreement with Carter's, the SEC stated that Carter's self-reported the misconduct, offered "exemplary and extensive cooperation in the investigation, including undertaking a thorough and comprehensive internal investigation," and took other remedial actions.

One possible measure of the extent of Carter's cooperation and the degree to which it factored into the SEC's decision to enter into a nonprosecution agreement in lieu of an enforcement action is the speed with which the Division

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26 This section of the Outline was drawn from "SEC Enters Into First Nonprosecution Agreement as Part of Its New Cooperation Initiative," by Ivan P. Harris, Ben A. Indek, Christian J. Mixter, Meredith S. Auten, published Dec. 22, 2010 and available at: http://www.morganlewis.com/index.cfm/fuseaction/publication.print/publicationID/5f83313e-bd4f-40a9-a1d2-095d37e164a6/.

27 *See* Morgan Lewis White Paper, "The Securities and Exchange Commission Announces New Cooperation Initiative" (Jan. 2010), available online at: http://www.morganlewis.com/pubs/WP_SECAnnouncesNewCooperationInitiative_Jan2010.pdf .

was able to complete its investigation. Accounting investigations are typically complex and lengthy, sometimes taking years to complete. However, based on the timeline set forth in the Elles Complaint, Carter's cooperation appears likely to have helped the Division complete its investigation and bring an enforcement action in just over a year.

The Carter's Nonprosecution Agreement

According to the SEC's press release, Carter's received a nonprosecution agreement based on its apparently extensive cooperation as well as the "relatively isolated nature of the unlawful conduct." The nonprosecution agreement contains several important terms:

Application to "Other Proceedings." One of the key details of the Carter's agreement is its requirement that Carter's cooperate truthfully and fully, not only with the SEC, but "in an official investigation or proceeding by any federal, state, or self-regulatory organization." The agreement refers to these as "Other Proceedings." Many of the cooperation provisions listed below apply equally to SEC investigations and to Other Proceedings.

Document and Information Production. Carter's is required to produce, "in a responsive and prompt manner," all nonprivileged documents, information, and other materials as requested by the Division.

Testimony/Interviews. Carter's is obliged to use its best efforts to secure the full, truthful, and continuing cooperation of current and former directors, officers, employees, and agents for interviews and the provision of testimony in SEC proceedings and in Other Proceedings. This section also applies to trials and other judicial proceedings, including those initiated by other federal, state, or self-regulatory organizations.

Nondenial. Importantly, the Carter's agreement contains a provision, modeled largely after the standard language in settled enforcement actions, that prohibits Carter's from denying, directly or indirectly, the factual basis of any aspect of the agreement but does not require an admission as to any facts. In fact, the agreement permits Carter's to deny the allegations in any legal proceeding in which the SEC is not a party. The agreement also requires Carter's to offer the Division the opportunity to approve any press release issued by Carter's concerning the agreement.

Procedures in the Event of Violation. If Carter's violates the agreement, including in connection with Other Proceedings, the Division may recommend that the Commission bring an enforcement action against Carter's. Before doing so, the Division will offer Carter's the opportunity to make a Wells submission.

Cooperation Letters. As with nonprosecution agreements issued by the Department of Justice (DOJ), the agreement provides the SEC with discretion,

based on a request from Carter's, to issue a letter to any other federal, state, or self-regulatory organization detailing Carter's cooperation.

Application to Purchasers/Successors. If Carter's is later sold, the agreement requires Carter's to include a provision in any sales contract, merger agreement or asset transfer agreement binding the purchasers or successors to the terms of the nonprosecution agreement. In addition, the protections arising from the nonprosecution agreement will not apply to purchasers or successors unless such purchasers or successors "enter into a written agreement, on terms acceptable to the Division, agreeing to assume all the obligations" contained in the nonprosecution agreement.

Takeaways from the Carter's Agreement

As the first nonprosecution agreement issued under the cooperation initiative, the Carter's agreement offers several valuable takeaways for entities that face an SEC investigation.

First, it is significant that the SEC's press release emphasized the "relatively isolated nature of the unlawful conduct." The Elles Complaint further details that Elles acted alone and without the knowledge of Carter's accounting personnel. In announcing its cooperation initiative earlier this year, the SEC set forth a spectrum of possible cooperation tools, including cooperation agreements that offer lesser sanctions in an enforcement action, deferred prosecution agreements and, at the highest level, nonprosecution agreements. The isolated nature of the executive's misconduct may have tipped the scales in favor of a nonprosecution agreement in Carter's case, whereas more pervasive misconduct may have resulted in a lesser reward, or none at all. The SEC's press release is also silent on whether Carter's waived its attorney-client privilege during the course of the investigation; the agreement does not require the company to waive any applicable privileges. The absence of this requirement continues the SEC's and DOJ's recent trend away from considering waivers in evaluating a corporation's level of cooperation.

Second, the application to "Other Proceedings," which was not clearly set forth in earlier SEC pronouncements, presents significant questions for regulated entities, such as broker-dealers and other financial institutions. Because Carter's is a public company in the clothing business, its accounting misconduct presumably raises few other regulatory challenges for the company. However, an entity that is regulated by multiple agencies (such as a broker-dealer that is a FINRA member or a bank subject to various regulatory regimes) would be required under this form of nonprosecution agreement to cooperate in investigations by those other regulators if requested to do so by the Division.

Although FINRA has issued its own cooperation guidelines,[28] other regulators are unlikely to offer the same clarity as the SEC with respect to the rewards for cooperation. The prospect of enforcement actions by those other regulators, or at least the uncertainty over whether cooperation in those Other Proceedings will be rewarded by those regulators, could diminish the value of the SEC nonprosecution agreement. The application of the agreement to "Other Proceedings" also appears broader than the scope of DOJ agreements, which typically require cooperation only with DOJ and other agencies that the DOJ designates.

Third, the inclusion of a somewhat standard nondenial clause in the agreement is a positive development, and may signal a significant departure from DOJ agreements. Some who have analyzed the cooperation initiative have speculated that, as frequently happens in DOJ matters, the SEC may require cooperators to admit or acknowledge the accuracy of certain allegations that form the basis of a cooperation agreement. DOJ agreements typically also contain or attach statements of admitted facts, which the Carter's agreement does not do. Although the Carter's agreement does not rule out such a requirement in the future, the SEC and the Division have made clear that an admission is not required in order to obtain a nonprosecution agreement.

Fourth, the agreement is notable for other departures from standard DOJ practice. Unlike typical DOJ agreements, the SEC's agreement with Carter's does not require that the company enhance its corporate compliance program. The absence of this undertaking may be due to Carter's "extensive and substantial remedial actions" noted in the press release, and it remains possible that future agreements will impose such requirements. Moreover, the SEC imposed no sanctions whatsoever on Carter's, whereas DOJ agreements typically include payment of a monetary penalty.

Fifth, if the Carter's nonprosecution agreement serves as a template for future agreements, the application of certain parts of the agreement to Other Proceedings, combined with the nondenial clause in the agreement, creates some questions about an entity's ability to defend itself in a non-SEC proceeding. On one hand, the agreement requires an entity to cooperate fully in any investigation by another federal, state, or self-regulatory organization. On the other hand, the agreement appears to allow the entity to deny the allegations that form the basis for the agreement in litigation in which the SEC is not a party, which presumably include actions brought by another federal, state or self-regulatory organization. Therefore, it is unclear whether the SEC would view a cooperator's denial of another agency's allegations as a violation of the nonprosecution agreement. Although the Carter's matter is unlikely to raise the

[28] *See* FINRA Regulatory Notice 08-70; *see also* Morgan Lewis LawFlash, "FINRA Provides Guidance on Obtaining Credit for Extraordinary Cooperation" (Dec. 5, 2008), available online at: http://www.morganlewis.com/pubs/Securities_LF_ExtraordinaryCooperation_05dec08.pdf.

question of which of these provisions trumps the other, future actions may require the SEC to resolve the tension between these two provisions.

Finally, the Carter's agreement provides the Division with the relatively unusual opportunity to involve itself in certain corporate activities. The agreement allows the Division to approve corporate press releases relating to the agreement and the terms of agreements with successors relating to the obligations set forth in the agreement. In particular, the successor provision could expose successors to uncertainty as they await Division approval of agreements that govern the successors' ability to benefit from the predecessor's cooperation.

Financial Crisis Inquiry Commission

In an enforcement-related development taking place away from the SEC, in 2009, Congress established a Financial Crisis Inquiry Commission (the "FCIC") to investigate events that caused the collapse of the United States financial markets in 2008. The FCIC is charged with determining what caused the collapse and recommending how to prevent it from recurring. The FCIC has broad powers, including the authority to hold public hearings, take testimony, receive evidence, subpoena documents and witnesses, and obtain information from government agencies. The FCIC also has the power to make criminal referrals to federal and state authorities if evidence of illegal activity is uncovered during its review.[29]

In July 2009, Congress appointed the ten members of the FCIC, which include Phil Angelides, a former Treasurer of California, who will serve as the Chair. In September and November 2009, the FCIC selected its senior staff, which includes several former criminal prosecutors.

The FCIC held its first public hearings on January 13 and January 14, 2010. Thereafter, the FCIC held 17 additional public hearings and interviewed more than 700 witnesses.

The FCIC's report to the President was originally due on or before December 15, 2010. Late last year, the FCIC announced that it would deliver its report in January 2011.

SEC OIG Report Concerning Robert Allen Stanford

As we reported in last year's Outline, the SEC initiated an action in federal district court in February 2009 alleging that Robert Allen Stanford had carried out an $8 billion Ponzi scheme. After receiving tips alleging that the SEC's Fort Worth Office (the "FWO") had not diligently investigated Stanford in response to

[29] *See* Morgan Lewis LawFlash *Washington Spotlight on the Financial Services Industry,* Aug. 13, 2009 available at: http://www.morganlewis.com/pubs/WashingtonSpotlight-FinancialServicesIndustry.pdf. Additional information regarding the FCIC is also available on our website.

concerns that he was perpetrating a Ponzi scheme, the SEC's Office of Inspector General (the "OIG") conducted an investigation and released a report on March 31, 2010 detailing its findings.

The OIG concluded that, by 1997, the FWO knew that Stanford likely was operating a Ponzi scheme. The FWO staff determined in each of four subsequent examinations that Stanford's CDs could not be legitimate and that it was "highly unlikely" that his stated returns could be achieved using his purported strategy. Despite the urging of the examination staff and complaints from investors and an anonymous Stanford employee, the OIG reported that FWO enforcement staff did not conduct a meaningful investigation into Stanford until late 2005 and, during that investigation, failed to detect facts that uncovered the Ponzi scheme. The OIG found that the FWO enforcement staff did not investigate Stanford more thoroughly, in part, because of pressure from enforcement leadership to bring a high number of cases and to focus on "quick hits," rather than pursuing cases, such as a possible action against Stanford, that would have taken more time and involved novel legal theories.

In response to the OIG report, Chairman Schapiro issued a short statement emphasizing the significant changes that have occurred within the SEC since the time period at issue in the OIG report and noting that most of the seven recommendations contained within the report were implemented starting in 2005.[30]

SEC – CFTC Investigation Regarding the "Flash Crash" of May 6, 2010

On the afternoon of May 6, 2010, the U.S. financial markets experienced a precipitous and unprecedented decline in an extremely short period of time followed by a rebound in prices. The SEC, along with the Commodities Futures Trading Commission (the "CFTC"), immediately began an investigation into the causes of what was dubbed the "flash crash." This effort apparently includes gathering and analyzing trading records from many market participants.

On May 18, 2010, the CFTC and SEC released a report prepared jointly by their staffs for a recently formed body called the Joint Advisory Committee on Emerging Regulatory Issues, which is led by the CFTC and SEC Chairs.[31] The report described the staffs' preliminary findings concerning the market events of May 6, 2010. The staffs reported that their preliminary findings included: potential links between the severe decline in the prices of various stock index products and the simultaneous and later waves of selling in individual securities; a general and large mismatch in liquidity; the extent to which the liquidity

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[30] *See* Statement from Chairman Schapiro on OIG Report 526: "Investigation of the SEC's Response to Concerns Regarding Robert Allen Stanford's Alleged Ponzi Scheme," Apr. 16, 2010, available at: http://www.sec.gov/news/press/2010/2010-60.htm.

[31] *See* SEC-CFTC Release Preliminary Findings in Review of May 6 Market Events, May 18, 2010, available at: http://www.sec.gov/news/press/2010/2010-81.htm.

mismatch may have been aggravated by different trading conventions used by various exchanges; the need to examine the use of so-called "stub quotes;" the use of certain kinds of orders, including market orders, stop loss market orders, and stop loss limited orders; and the impact on exchange traded funds.[32]

On September 30, 2010, the CFTC and SEC published a second report entitled "Findings Regarding the Market Events of May 6, 2010." The report builds on the prior study described above. The report describes several key "lessons learned" from the trading activities on May 6. First, the staffs emphasize that automated execution of a large sell order can trigger extreme price movements under stressed market conditions, particularly if the algorithm does not take prices into account. Second, the events of May 6 underscored the interconnectedness of the derivatives and securities markets. Third, many market players use their own types of a trading pause based upon different combinations of market signals. The staffs further observed that uncertainty about the circumstances under which trades would be broken can affect market participants' trading strategy and desire to provide liquidity. Finally, the CFTC and SEC staffs noted that the events of May 6 reflect the important role data play in connection with the use of fully-automated trading strategies and systems.

To date, no disciplinary actions have been taken by either the CFTC or the SEC concerning the events of May 6, 2010.

SEC and IRS Agreement Relating to the Municipal Bond Market

In March 2010, the SEC and the IRS announced that they had entered into a Memorandum of Understanding ("MOU") in which the two agencies agreed to collaborate more closely in their efforts to monitor and regulate the municipal bond market. Among other things, the SEC and the IRS pledged to work together to identify issues and trends concerning tax-exempt bonds and to create strategies to improve the performance of their regulatory responsibilities. Finally, the agencies agreed to share information regarding market risks, practices and the events in the municipal securities arena.[33]

Cooperation with Foreign Regulators

On June 10, 2010, the SEC entered into an MOU with the Quebec Autorité des Marchés Financiers and Ontario Securities Commission to facilitate "consultation, cooperation, and exchange of information" among these regulators concerning cross-border regulated entities.[34] By signing this agreement, each regulator has

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[32] *See* http://www.sec.gov/news/studies/2010/marketevents-report.pdf.

[33] *See* "SEC and IRS Agree to Work More Closely Regarding Municipal Bond Enforcement," Mar. 2, 2010, available at: www.sec.gov.

[34] *See* "SEC, Quebec Autorité des Marchés Financiers and Ontario Securities Commission Sign Regulatory Cooperation Arrangement," June 14, 2010, available at: www.sec.gov.

committed to providing the others with the fullest legally permissible cooperation. This MOU follows cooperation agreements that the SEC reached in recent years with regulators in the United Kingdom, Germany and Australia.

SEC Enforcement Priorities Regarding Broker-Dealers

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

- The marketing and sale of CDOs and other complex derivative products, including reverse convertible notes, auto-callable notes, principal protected notes and total return swaps;
- The valuation of and disclosures relating to subprime securities;
- Municipal securities offerings and transactions;
- High frequency and other trading practices (including layering, spoofing, quote stuffing, abusive co-location and data latency arbitrage, etc.);
- Insider trading by Wall Street professionals;
- Failure to supervise by firms and individual managers; and
- Residential mortgage-backed securitizations and foreclosure practices.

Enforcement Actions[35]

Anti-Money Laundering

Although traditionally a mainstay of FINRA's enforcement program, since 2006, the SEC has also brought several anti-money laundering and suspicious activity report cases. Below is an action involving deficient customer identification program procedures.

A. *In the Matter of Pinnacle Capital Markets LLC* ("Pinnacle") *and Michael A. Paciorek*, Admin. Proc. File No. 3-14026 (Sep. 1, 2010)

1. The SEC settled an administrative proceeding against Pinnacle and Paciorek, its president and chief compliance officer, alleging that the firm did not comply with an AML rule

[35] Unless otherwise apparent from the context of the descriptions of the actions, the cases described herein are settlements in which respondents neither admitted nor denied the allegations against them. Certain cases fall outside of the SEC's FY 2010, but are included here for completeness.

that requires firms to verify and document the identities of their customers.

2. Section 17(a) of the Exchange Act and Rule 17a-8 thereunder require that broker-dealers comply with certain provisions of the Bank Secrecy Act ("BSA"), including the customer identification program ("CIP") rule, under which firms must establish procedures for identifying and verifying their customers.

3. The SEC alleged that from October 2003 through August 2006, Pinnacle did not appropriately verify the identity of a number of its corporate account holders. Further, between 2003 and November 2009, the firm did not verify the information regarding most of its omnibus account holders. In so doing, Pinnacle did not follow its own CIP procedures.

4. Paciorek was alleged to have caused the firm's violations because, as the chief compliance officer, he was responsible for ensuring that Pinnacle met its AML obligations.

5. In settling the SEC's action, Pinnacle and Paciorek agreed to a cease-and-desist order. Pinnacle also consented to a censure and a $25,000 civil penalty.

6. In a related action, the Financial Crimes Enforcement Network (FinCEN) determined that Pinnacle had violated the BSA, and imposed a penalty of $50,000, $25,000 of which includes the SEC's monetary sanction.

7. In connection with a FINRA action earlier in 2010, Pinnacle was fined $300,000 and also agreed to certain undertakings related to its AML program. This case is discussed in more detail in the FINRA section, below.

Fraudulent Trading Scheme

The Commission has historically aggressively pursued fraudulent trading schemes. In 2010, the SEC brought a federal court action against a registered representative in this space.

A. *SEC v. Jose O. Vianna and Creswell Equities, Inc.*, 10-CV-1842 (S.D.N.Y. Mar. 10, 2010 and Oct. 21, 2010)

1. In March 2010, the SEC sued Vianna, a former registered representative of broker-dealer Maxim Group, LLC ("Maxim"), and relief defendant Creswell Equities, LLC ("Creswell").

2. The SEC alleged that between July 2007 and March 2008, Vianna diverted profitable trades from one customer, a large Spanish bank, to another customer, Creswell, based in the British Virgin Islands. Vianna achieved this by manipulating Maxim's order entry system and falsifying records of the orders of both customers.

3. Vianna simultaneously entered orders into the accounts of the Spanish bank and Creswell to trade the same amounts of the same stock. When the market moved in a direction that made the Spanish bank's trades profitable and Creswell's trades unprofitable, Vianna improperly misused his access to Maxim's order system to divert the Spanish bank's profitable trades to Creswell. However, when the Creswell trades were profitable and the Spanish bank's were not, Vianna let the trades remain as originally entered. The effect was to transfer all trading risk from Creswell to the Spanish bank, causing Creswell to realize over $3.3 million in trading profits.

4. To settle the charges, Vianna consented to the entry of a final judgment against him, disgorgement of ill gotten gains (including at least $125,000 in commissions paid) and a civil monetary penalty in amounts to be determined at a later date. Creswell agreed to an entry of judgment ordering it to pay $1,661,650 in disgorgement.

Insider Trading

The SEC continues to aggressively prosecute insider trading by Wall Street professionals. This year saw several cases against investment bankers, a surprise turn in the Pequot saga, and a trial concerning alleged insider trading in the credit default swap market.

In addition to the SEC's prosecutions, in recent months, the United States Attorney for the Southern District of New York announced criminal charges in a seemingly wide-ranging insider trading investigation relating to the work of a

so-called "expert networking" firm. Although it appears that the SEC is also conducting an investigation, as of the date of publication of this Outline, the Commission had not brought any cases.

A. *SEC v. Vinayak S. Gowrish, Adnan S. Zaman, Pascal S. Vaghar, and Sameer N. Khoury* (Defendants) *and Elias N. Khoury* (Relief Defendant), 09-cv-5883 (filed Dec. 16, 2009); *In the Matter of Adnan S. Zaman*, Admin. Proc. File No. 3-13749 (Jan. 14, 2010)

1. The SEC brought a civil action against Vinayak Gowrish (an associate at private equity firm TPG Capital, LLP), Adnan Zaman (a Lazard Freres & Co, LLC investment banker), and two of their friends, Pascal Vaghar and Sameer Khoury, in connection with an alleged insider trading scheme. Three of the four defendants (plus a relief defendant) have settled with the SEC.

2. The SEC alleged that between December 2006 and May 2007, Gowrish and Zaman obtained material, nonpublic information regarding acquisitions involving TPG or Lazard clients. Gowrish and Zaman allegedly tipped this information to Vaghar and Sameer Khoury, who traded based on those tips, ultimately resulting in almost $500,000 in profits. In return, Sameer Khoury and Vaghar paid Zaman and provided him a residence without charging rent. Gowrish received cash payments from Vaghar.

3. Sameer Khoury also allegedly traded in his brother Elias Khoury's account based on the inside information and split the resulting profits with him. Although Elias Khoury permitted his brother to trade in his account, he did not know that Sameer Khoury traded on the basis of material, nonpublic information.

4. Zaman consented to an injunction and a bar from associating with a broker or dealer and to disgorge $78,456. In January 2010, Zaman pled guilty to securities fraud and, in May 2010, was sentenced to 26 months in prison. Also in January 2010, the SEC filed a separate administrative action against Zaman, which he settled by consenting to a bar from associating with any broker or dealer.

5. Vaghar consented to an injunction and to disgorge $366,001; the disgorgement amount was reduced to $33,000, and a civil penalty was waived, based on his

inability to pay. Sameer Khoury consented to an injunction and disgorgement of $198,607; the disgorgement and a civil penalty were waived based on his inability to pay. Relief defendant Elias Khoury consented to disgorge $5,836.

6. The case against Gowrish is ongoing, and the SEC seeks a permanent injunction, disgorgement and a civil penalty.

B. *SEC v. Phillip Macdonald, Martin Gollan and Michael Goodman*, 09-Civ-5352 (S.D.N.Y. Jan. 12, 2010)

1. In our 2009 Outline, we reported on a case in which the SEC charged three defendants with insider trading in advance of public announcements of business deals based on information misappropriated from an investment bank.

2. The SEC alleged that between January and June 2005, Michael Goodman's wife (an administrative assistant at Merrill Lynch Canada, Inc.) informed Goodman about certain potential unannounced business combinations with the expectation that he would keep the information confidential. Goodman instead disclosed the information to his business associates, Macdonald and Gollan, knowing that they would use the information for trading purposes. Macdonald and Gollan purchased securities on U.S. exchanges ahead of the deal announcements. As a result, Macdonald and Gollan earned more than $900,000 and $90,000, respectively, in profits.

3. In 2009, one of the defendants, Michael Goodman, settled with the SEC.

4. In January 2010, the SEC settled charges against Martin Gollan, who consented to a permanent injunction and disgorgement of $91,976.

5. It appears that a settlement has been reached between the SEC and Macdonald, but final judgment is still pending.

C. *SEC v. David R. Slaine*, 10-Civ-754 (S.D.N.Y. Feb. 2, 2010)

1. In our 2007, 2008 and 2009 Outlines, we reported on the *Guttenberg* case in which the SEC charged fourteen defendants, including DSJ International Resources Ltd.

(d/b/a "Chelsey Capital"), in connection with two related insider trading schemes in which Wall Street professionals allegedly traded after receiving tips from insiders at UBS Securities LLC ("UBS") and Morgan Stanley & Co., Inc. ("Morgan Stanley") in exchange for cash kickbacks.

2. In February 2010, the SEC filed a related action in federal district court against Slaine (a former portfolio manager for hedge fund Chelsey Capital) in connection with his involvement in the same insider trading scheme. The SEC alleged that Slaine traded in his personal brokerage account on material, nonpublic information regarding upcoming UBS stock analyst recommendations.

3. In a related criminal proceeding, Slaine pled guilty to conspiracy and securities fraud charges. According to media reports, Slaine, a former Galleon trader, secretly recorded meetings with individuals who have been charged in the Galleon insider trading cases to aid the government's investigation.

4. In September 2010, Slaine consented to a permanent injunction and agreed to pay disgorgement of $836,385. In a related administrative proceeding, Slaine consented to the entry of an order barring him from associating with any investment adviser. No civil penalties were imposed in recognition of Slaine's cooperation in the SEC's investigation and related enforcement action.

D. *SEC v. Igor Poteroba, et al.*,10-Civ-2667 (S.D.N.Y. Mar. 25, 2010)

1. The SEC filed an injunctive action against Russian citizens Igor Poteroba, Aleksey Koval and Alexander Vorobiev for insider trading in which they allegedly obtained approximately $1 million in profits by trading on confidential merger and acquisition information.

2. The complaint alleged that beginning in July 2005, Poteroba served as an investment banker with UBS Securities LLC's Global Healthcare Group in New York. In advance of certain transactions, Poteroba tipped financial professional Koval, who, after trading on the deals, tipped his friend Vorobiev. The group used coded e-mails to tip each other and utilized accounts in their wives' names to conduct additional trades. Both wives have been named as relief defendants.

3. In March 2010, the court issued an emergency order freezing the assets of the defendants and the relief defendants.

4. On October 4, 2010, Court entered a final judgment against Poteroba that permanently enjoins him from future violations of the antifraud and tender offer fraud provisions of the federal securities laws. Poteroba also consented to an order barring him from associating with any broker, dealer or investment adviser.

5. On November 4, 2010, the Court entered a final judgment against relief defendant Anjali Walter (the wife of Aleksey Koval) and ordered her to pay disgorgement of $85,353.

6. The SEC's civil actions against Koval and Vorobiev seeking permanent injunctions, disgorgement of illicit profits, and civil penalties, are ongoing.

7. Poteroba and Koval have pled guilty to related criminal charges and await sentencing.

E. *SEC v. Pequot Capital Management, Inc.* ("Pequot") *and Arthur J. Samberg*, 10-Civ-00831 (D. Conn. May 27, 2010); *In the Matter of Pequot Capital Management, Inc. and Arthur J. Samberg*, Admin. Proc. File No. 3-13928 (June 8, 2010); *In the Matter of David E. Zihlka*, Admin Proc. File No. 3-13913 (May 27, 2010)

1. The SEC filed a settled insider trading action in federal district court against Pequot, a hedge fund adviser, and its chairman, Arthur Samberg, concerning the firm's trading in the common stock of Microsoft.

2. The SEC alleged that in April 2001, Samberg sought information concerning Microsoft's quarterly earnings estimates from David Zihlka, a Microsoft employee who had accepted an offer of employment from Pequot. Zihlka allegedly contacted Microsoft employees and learned that Microsoft would meet or beat earnings estimates. Zihlka allegedly conveyed the material, nonpublic information that he obtained from the Microsoft employees to Samberg, who traded on the information for funds managed by Pequot and passed the information to a friend. The Pequot funds earned nearly $14.8 million from the trades.

3. Pequot and Samberg consented to permanent injunctions, to disgorge jointly and severally more than $15.2 million, and for each to pay $5 million civil penalties.

4. In a separate administrative proceeding, Pequot agreed to a censure, and Samberg agreed to a bar from association with an investment adviser, except for certain activities aimed solely at winding down Pequot.

5. Also in a separate administrative proceeding, the SEC charged Zilkha with violating federal insider trading laws. That matter is ongoing.

6. This case received significant media attention, in part, because former SEC staff attorney Gary Aguirre attempted to investigate Pequot's trading in 2005, but according to Aguirre, was stymied by senior Enforcement Division personnel from doing so. The SEC terminated Aguirre for insubordination. Aguirre sued the SEC for wrongful termination, a case that settled in June 2010 for $755,000. In the past few years, the OIG issued two reports related to these issues. In one report, the OIG concluded that SEC Enforcement staff supervisors failed to fulfill their management responsibilities and that their conduct raised serious concerns about the impartiality and fairness of the Pequot investigation. In the second report, the OIG concluded that Enforcement staff supervisors failed to manage Aguirre properly and allowed inappropriate reasons to factor into their decision to terminate him.

7. Interestingly, on July 23, 2010, the SEC announced that it had awarded $1 million to Glen and Karen Kaiser (Zilkha's ex-wife) for information and documents that the couple provided to the Commission that led to the Pequot and Zilkha cases. The Commission reported that this is the largest award it had ever paid for information provided relating to an insider trading action.[36]

[36] *See* SEC Litigation Release No. 21601 (July 23, 2010).

F. *SEC v. Jon-Paul Rorech and Renato Negrin*, 09-Civ-4329 (S.D.N.Y. June 25, 2009)

1. In 2009, the SEC filed an action against Renato Negrin (a Millennium Partners, L.P. portfolio manager) and Jon-Paul Rorech, a Deutsche Bank Securities, Inc. ("Deutsche Bank") salesman, charging insider trading in the credit default swaps ("CDS") of VNU N.V. ("VNU"), the holding company of Nielson Media. This was the first CDS insider trading case brought by the SEC.

2. Deutsche Bank served as lead underwriter for a VNU bond offering. The SEC alleged that Rorech learned about a change in a proposed VNU bond offering that likely would increase the price of CDS on VNU bonds and tipped Negrin about the bond news. After being tipped, Negrin placed orders with Deutsche Bank for €20 million of VNU CDS over two days. Negrin's trades profited $1.2 million after the news broke.

3. Notably, the SEC persuaded the court that the Commission has enforcement authority concerning CDS. On December 10, 2009, the court denied defendants' motion to dismiss, which was predicated on a jurisdictional argument that CDS are privately negotiated contracts and were not securities-based swap agreements. The court explained that, in passing the Commodity Futures Modernization Act, Congress intended to prohibit in trading securities-based swap agreements what it prohibited in trading securities.

4. After a trial in June 2010, the court issued a written decision dismissing the charges, finding that there was no evidence that Rorich and Negrin violated the insider trading laws and rejecting the SEC's claim that Negrin and Rorech discussed inside information on two unrecorded telephone calls. Moreover, the court confirmed its prior jurisdictional ruling.

G. *SEC v. Brien Santarlas,* Civil Action No. 09-CV-10100 (S.D.N.Y. July 7, 2010)

1. The Court entered a judgment of permanent injunction against Brien Santarlas for an insider trading case that the SEC had filed in December 2009. Santarlas was an attorney employed by a large law firm.

2. The SEC alleged that Santarlas had misappropriated from his law firm material, nonpublic information regarding two corporate acquisitions involving firm clients. Santarlas obtained the deal-related information by accessing confidential deal documents through the law firm's computer network. He then used this information to tip a proprietary trader at Schottenfeld Group, LLC in exchange for cash kickbacks. The trader/tippee traded on this information and then tipped others. In November 2009, the SEC charged nine others involved in the scheme by filing its first amended complaint in the *Galleon* matter (*see* above).

3. To settle the charges, Santarlas consented to entry of final judgment enjoining him from future violations of the federal securities laws, and ordering disgorgement of $32,500 and a $32,500 civil penalty. In a related administrative proceeding, the Commission suspended Santarlas from appearing or practicing before the Commission as an attorney. In a parallel criminal case, Santarlas previously pled guilty to charges of securities fraud and is awaiting sentencing.

H. *SEC v. Richard A. Hansen, et al.*, 10-Civ-5050 (E.D. Pa. Sept. 27, 2010)

1. The SEC brought a civil action against Richard A. Hansen (a registered representative and former chairman of Keystone Equities Group) and his longtime friend, Stuart Kobrovsky (a retired stockbroker), in connection with an alleged insider trading scheme.

2. The SEC alleged that between 2006 and 2007, Hansen was tipped concerning pending corporate acquisition targets by his business associate Donna B. Murdoch. Murdoch, in turn, had received this material, nonpublic information from James E. Gansman, a former Ernst & Young ("E&Y") partner, who had learned of the pending acquisitions through his work for E&Y. Gansman and Murdoch settled insider trading actions with the SEC. Both were also charged criminally.

3. The SEC alleged that Hansen traded on inside information concerning at least five corporate acquisitions of E&Y clients through his daughter's and Murdoch's accounts. Hansen allegedly tipped information about one of the acquisitions to Kobrovsky, who traded based on that tip.

4. The SEC claims that Hansen and Kabrovsky knew or recklessly disregarded that the tips were based on Gansman's breach of duty to E&Y. Specifically, the SEC alleged that Murdoch told Hansen that Gansman was the source of the tips, that he was a partner at E&Y, and that the information was derived from Gansman's work. Hansen and Kobrovsky allegedly realized collective illegal trading profits of at least $215,345.

5. Kobrovksy agreed to settle the insider trading charges against him in September 2010. He consented to a final judgment permanently enjoining him from committing future violations of the securities laws and stating that he was liable for disgorgement of $163,000. The final judgment also provided that the SEC would waive disgorgement, prejudgment interest, and a civil penalty due to Kobrovsky's inability to pay.

6. The case against Hansen is ongoing. The SEC seeks a permanent injunction, disgorgement and a civil penalty.

7. In a parallel criminal proceeding, Hansen was charged with securities fraud and conspiracy to commit securities fraud.

I. *SEC v. Galleon Management, LP, et al.* ("Galleon"), 09-Civ-8811 (S.D.N.Y. Oct. 16, 2009)

1. The SEC charged Galleon, a hedge fund advisory firm, Raj Rajaratnam, its founder, another hedge fund (New Castle Funds LLC), and five other individuals, including executives at IBM, McKinsey, and Intel with perpetrating an insider trading scheme that involved extensive and recurring insider trading ahead of various corporate announcements. In November 2009, the SEC amended its complaint to include new charges against nine additional individuals and four more hedge funds and trading firms.

2. The SEC alleged that the defendants were part of a widespread insider trading ring in which certain participants traded based on material, nonpublic information concerning corporate events, such as acquisitions and earnings announcements involving at least twelve companies (*e.g.*, Polycom, Google, Hilton Hotels, Sun Microsystems, and Sprint Nextel).

3. Some of the defendants allegedly shared material, nonpublic information in exchange for compensation but did not trade. Other defendants allegedly traded in their own accounts, in the accounts of tippers, and/or on behalf of institutions, such as hedge funds.

4. In January 2010, the SEC again amended its complaint, this time to file additional charges of insider trading against Rajaratnam and Anil Kumar, a friend of Rajaratnam's and former Galleon investor who had been senior partner and director of the global consulting firm, McKinsey & Co. The new allegations raise the total illicit trading profits or losses avoided from the scheme from $33 million, as alleged in the initial complaint, to more than $52 million.

5. In the operative complaint, the SEC alleged that, between 2003 and 2009, Rajaratnam paid Kumar $1.75 million to $2 million for material, nonpublic information to generate almost $20 million in illicit profits at Galleon. The SEC also alleged that Kumar reinvested with Galleon the funds he received from Rajaratnam, which resulted in a combined total profit of $2.6 million for his participation in the scheme.

6. Also in January 2010, the SEC settled charges against defendants Ali Far and Choo-Beng Lee, who were cofounders of Spherix Capital, an unregistered hedge fund investment adviser. Far and Lee consented to permanent injunctions and to be jointly and severally liable for more than $1,335,000 in disgorgement and a civil penalty of approximately $668,000.

7. In April 2010, the SEC settled insider trading charges against another defendant, Schottenfeld Group, LLC ("Schottenfeld"), a registered broker-dealer. The SEC alleged that four Schottenfeld traders used material, nonpublic information to trade in the stocks of three public companies for Schottenfeld's accounts. Schottenfeld consented to a permanent injunction, to disgorge approximately $460,000, and to pay a civil penalty of approximately $230,000. This penalty was reduced to that amount (*i.e.*, fifty percent of disgorgement) in recognition of Schottenfeld's agreement to cooperate in the SEC's investigation.

8. In May 2010, the SEC settled insider trading charges against Kumar, who consented to a permanent injunction, to disgorge $2,600,000, and to pay a civil penalty in an amount to be set by the court no later than November 2011.

9. In October and November 2010, the SEC settled insider trading charges against Roomy Khan, a former Galleon and Intel Corp. employee, and Rajiv Goel, another former Intel employee. The SEC alleged that Khan and Goel provided material, nonpublic information to Galleon on numerous occasions. Both defendants consented to permanent injunctions. Khan and Goel also consented to pay disgorgement of $1.85 million. The Court will determine at a later date whether Khan and Goel will be required to pay civil monetary penalties.

10. The SEC seeks injunctions, disgorgement, civil penalties, and orders barring the remaining defendants from acting as officers or directors of any registered public company.

11. There are criminal proceedings pending against Rajaratnam and others, and additional defendants have pled guilty to insider trading charges.

J. *SEC v. Thomas Hardin*, 10-Civ-8600 (S.D.N.Y. Nov. 15, 2010)

1. In another case related to the *Galleon* matter, the SEC filed insider trading charges against Hardin, a former managing director at Lanexa Management LLC, a hedge fund investment adviser, relating to two corporate takeovers and a quarterly earnings announcement. The SEC alleged that Hardin received material nonpublic information from *Galleon* defendant Roomy Khan. Hardin allegedly traded based on this information and passed the information to others who traded, resulting in illegal profits of at least $950,000.

2. The SEC seeks a permanent injunction, disgorgement and a civil penalty. The case is ongoing.

3. Hardin has pled guilty to related criminal charges and is awaiting sentencing.

K. *SEC v. Lanexa Management LLC* ("Lanexa") and *Thomas C. Hardin*, 10-Civ-8599 (S.D.N.Y. Nov. 15, 2010 and *SEC v. Franz N. Tudor*, 10-Civ-8598 (S.D.N.Y. Nov. 15, 2010)

1. Also in November 2010, the SEC filed a second insider trader action against Hardin and also sued Lanexa, his former employer, in connection with another insider trading ring involving two former corporate attorneys, including Brien Santarlas (*see* above).

2. According to the SEC's complaint, the two former attorneys at provided the fraudulent tips concerning corporate takeovers to Zvi Goffer, a former trader at Schottenfeld Group LLC ("Schottenfeld"), in exchange for kickbacks. Goffer allegedly passed the material, nonpublic information to another Schottenfeld trader, who tipped Hardin. Hardin then placed trades related to one of those takeovers on behalf of Lanexa, a hedge fund.

3. The SEC also sued Tudor, another former Schottenfeld trader, for trading based on material, nonpublic information that he obtained from Goffer, resulting in illegal profits of approximately $75,000.

4. Several of the individuals involved in these matters have been criminally charged; some of the defendants have pled guilty, while others are contesting the charges.

5. The SEC seeks disgorgement and other relief. The cases are ongoing.

Marketing and Sales of Collateralized Debt Obligations

The SEC has been investigating the marketing and sales of a number of complex derivative products since the economic crisis of late 2008. The Commission's lawsuit and subsequent settlement with Goldman Sachs received national and international attention. The matter was initiated by the new Structured and New Products Unit and resulted in the largest civil penalty ever imposed against a Wall Street firm.

A. *SEC v. Goldman Sachs & Co.* ("Goldman Sachs") *and Fabrice Tourre*, 10-CV-3229 (S.D.N.Y. Apr. 16, 2010)

1. The SEC brought an action against Goldman Sachs and one of its employees, Fabrice Tourre, alleging fraud in connection with the sale and marketing of a synthetic collateralized debt obligation ("CDO").

2. The SEC alleged that in 2007, as the U.S. housing market and related securities were beginning to decline, Goldman Sachs created and marketed a synthetic CDO that was connected to the performance of subprime residential mortgage-backed securities. The marketing materials for the CDO, including the offering memorandum and term sheet, stated that the portfolio of residential mortgage-backed securities underlying the CDO was selected by an experienced third party, ACA Management LLC ("ACA").

3. According to the SEC's complaint, a hedge fund, Paulson & Co. ("Paulson"), played a major and undisclosed role in the portfolio selection process, despite the fact that its economic interest was adverse to investors. Specifically, Paulson allegedly sold short the securities portfolio after helping to select it by entering into credit default swaps with Goldman Sachs, which provided protection on certain elements of the CDO's structure. As a result, Paulson allegedly had an incentive to choose securities for the portfolio that would ultimately decline in credit quality.

4. The SEC also alleged that Tourre was primarily responsible for structuring the relevant CDO and that he prepared the marketing materials and communicated with investors. The complaint alleged that Tourre knew about Paulson's short interest and its participation in selecting the portfolio but did not disclose this information to investors. The SEC further alleged that Tourre was responsible for misleading ACA into believing that Paulson was an equity investor in the CDO and therefore had interests aligned with ACA Management.

5. Paulson allegedly paid Goldman Sachs approximately $15 million to create and market the CDO, which was finalized on April 26, 2007. By late October 2007, most of the residential mortgage-backed securities in the portfolio had declined in credit quality, and by the end of January 2008, 99% of the portfolio securities had been downgraded.

6. The SEC alleged that investors in the CDO lost more than $1 billion, while Paulson's short positions resulted in an approximately $1 billion profit.

7. The SEC's lawsuit alleged that Goldman Sachs and Tourre's conduct violated Sections 17(a)(1), (2) and (3) of the Securities Act of 1933 ("Securities Act") and Section 10(b) of the Securities Exchange Act ("Exchange Act") of 1934 and Rule 10b-5 thereunder and sought injunctive relief, disgorgement, and penalties.

8. Paulson was not charged with any wrongdoing in this matter.

9. On July 15, 2010, the SEC announced a $550 million settlement with Goldman Sachs, which, as noted above, is the largest SEC penalty ever assessed against a Wall Street firm. In its settlement, the Commission stated that $250 million of the penalty will go to harmed investors and $300 million will be paid to the U.S. Treasury. In addition to the monetary sanction, Goldman Sachs agreed to comply with a number of undertakings for three years, including actions regarding its product review and approval process, the role of both internal and external legal counsel, and the education and training of certain personnel involved in the structuring or marketing of mortgage securities offerings.

10. Although the SEC's complaint charged the firm with violations of Section 10(b) of the 1934 Act and Rule 10b-5 and Section 17(a) of the 1933 Act, the final judgment enjoined Goldman Sachs only from violating Section 17(a) of the 1933 Act.

11. As is typical in such resolutions, Goldman Sachs neither admitted nor denied the SEC's allegations, but as part of the settlement, it acknowledged that the marketing materials for the CDO product "contained incomplete information," and that it was a "mistake" not to disclose Paulson's role in the selection of the portfolio and its adverse economic interest.

12. The SEC's case against Tourre is ongoing, and on November 1, 2010, after briefing concerning Tourre's motion for judgment on the pleadings, the Court granted the SEC's request to amend its complaint, which it did on November 22, 2010.

13. At the request of members of the House of Representatives, the SEC Office of Inspector General ("OIG") conducted an investigation into whether the SEC improperly coordinated with other governmental entities, including the White House and members of Congress, regarding the timing of the Goldman case to affect the pending financial regulatory reform legislation. The OIG found that no inappropriate coordination had occurred.

Municipal Bond Actions

The Commission has called for greater scrutiny of the municipal securities market. The matter immediately below, which reflects the SEC's efforts to shine a light on certain practices, was resolved through the issuance of a so-called 21(a) report, rather than a formal enforcement action. In addition, the Commission brought a case regarding alleged bid rigging in the municipal bond market.

A. *Report of Investigation re JP Morgan Securities Inc.*, Securities Exchange Act Release No. 61734 (Mar. 18, 2010)

1. The SEC investigated JP Morgan Securities Inc. ("JPMSI") for violating MSRB Rule G-37, which prohibits a broker, dealer, or municipal securities dealer from underwriting municipal bonds for an issuer within two years after the broker, dealer, or municipal securities dealer makes a political contribution to an official of that issuer. Although no disciplinary action was taken in this matter, the SEC decided to release the results of its investigation to reaffirm its prior guidance regarding Rule G-37.

2. The SEC's investigation revealed that between July 2002 and September 2004, the vice chairman of JPMorgan Chase's global investment banking, asset management, and private wealth businesses supervised, among other things, its U.S. municipal securities. The vice chairman was the lone JPMorgan Chase officer who had responsibility for all of JPMSI's businesses and actively promoted JPMSI's activities. He served as CEO of JPMorgan Chase's investment bank and served on its executive committee.

3. In August 2002, the vice chairman collected $8,000 in political campaign donations from JPMorgan Chase and some of its senior officials for the California state treasurer (and personally made a $1,000 personal contribution). In

the two years following these contributions, JPMSI participated as senior manager or comanager in more than 50 negotiated underwritings for California state agencies. The underwritten bonds sold in the aggregate for more than $15.8 billion, and JPMSI received approximately $37 million in investment banking fees from these deals.

4. Although the vice chairman was not a director, officer, or employee of JPMSI, the SEC concluded that he was "associated" with JPMSI, as the term is defined in the Exchange Act. The Commission issued its report to remind firms that the applicability of Rule G-37 depends on whether a person has a financial incentive to make a contribution in an effort to obtain underwriting business, not merely the person's title or employment status.

B. *SEC v. Larry P. Langford, et al.*, CV-08-0761 (N.D. Al. July 24, 2010)

1. As we reported in our 2008 and 2009 Outlines, the SEC brought a federal district court action against Larry P. Langford, the former mayor of Birmingham, Alabama, Blount Parrish & Co. ("Blount Parrish"), its chairman William B. Blount ("Blount"), and Albert W. LaPierre ("LaPierre"), an Alabama political lobbyist. The charges stem from the allegations that Langford accepted bribes from Blount in exchange for the right of Blount Parrish to participate in municipal bond offerings and security-based swap transactions.

2. The SEC alleged that Langford received more than $156,000 in undisclosed cash and benefits over the course of two years from Blount and that, during 2003 and 2004, Langford selected Blount Parrish to participate in every Jefferson County municipal bond offering and security-based swap agreement transaction, from which it received over $6.7 million in fees. The scheme was conducted with the assistance of LaPierre, who was used as a conduit to conceal the payments.

3. In July 2010, the court entered Final Consent Judgments of Permanent Injunction against Blount, Blount Parrish, and LaPierre in this matter. The Final Judgments dismissed the SEC's claims for disgorgement, prejudgment interest and civil penalties.

C. *In the Matter of Banc of America Securities LLC* ("BAS") Admin. Proc. File No. 3-14153 (Dec. 7, 2010)

1. The SEC's settled administrative proceeding against BAS was part of a coordinated resolution of additional investigations conducted by the Internal Revenue Service ("IRS"), the Antitrust Division of the Department of Justice ("DOJ"), twenty State Attorneys General and the Office of the Comptroller of the Currency ("OCC").

2. The alleged conduct underlying the settled actions included bid rigging and other deceptive practices in connection with the marketing and sale of tax-exempt municipal bond derivatives contracts.

3. The SEC alleged that from 1998 through 2002, BAS engaged in improper bidding practices involving the temporary investment of proceeds of tax-exempt municipal securities in reinvestment products, including guaranteed investment contracts, repurchase agreements and forward purchase agreements.

4. Specifically, BAS allegedly provided information to favored bidders concerning bids submitted by others and obtained "off-market courtesy bids" to enable favored bidders to win. These improper practices allegedly affected the price of the reinvestment products and jeopardized the tax-exempt status of the underlying municipal securities.

5. Notably, BAS self-reported its violative conduct, cooperated extensively with the numerous investigations, implemented personnel changes and other remedial measures and agreed to pay approximately $36 million in disgorgement and interest and another $101 million to other federal and state authorities for its conduct. As a result of these remedial and cooperative actions, BAS was allowed to enter the DOJ's Antitrust Corporate Leniency Program and to avoid paying any SEC civil penalty.

6. BAS was censured and consented to a cease-and-desist order.

7. On September 9, 2010, Douglas Campbell, a former BAS officer who had participated in the underlying violative

conduct, pled guilty to two counts of conspiracy and one count of wire fraud. In a related SEC action, Campbell agreed to a bar from associating with a broker, dealer, or investment adviser.[37] Due to his cooperation, however, the SEC did not impose a civil penalty.

Net Asset Value

The lawsuit discussed below is an example of the SEC's pursuit of alleged wrongdoing in the asset valuation area. This matter is also noteworthy because of a decision by an SEC administrative law judge ("ALJ") concerning the SEC staff's use of subpoenas.

A. *In the Matter of Morgan Asset Management, Inc.* ("Morgan Asset"); *Morgan Keegan & Company, Inc.* ("Morgan Keegan"); *James C. Kelsoe, Jr.; and Joseph Thompson Weller, CPA*, Admin. Proc. File No. 3-13847 (Apr. 7, 2010)

1. The SEC commenced an administrative proceeding against Morgan Asset (an investment adviser), Morgan Keegan (registered broker-dealer), Kelsoe and Weller in which it alleged that the respondents engaged in a fraudulent scheme to materially inflate the net asset value ("NAV") of certain funds managed by Morgan Asset.

2. Between 2004 and 2008, Morgan Asset managed five funds through Kelsoe, who was a senior Morgan Asset portfolio manager and a Morgan Keegan Managing Director. Each of the funds held securities backed by subprime mortgages. The funds adopted procedures for the internal pricing of these securities using the "fair value" method, which required a valuation committee to be established in order to value the securities in "good faith." In regulatory filings, the funds stated that Morgan Asset's valuation committee would determine the "fair value" of securities. However, the funds actually delegated this task to Morgan Keegan, whose employees comprised the majority of the valuation committee.

3. The SEC alleged that Morgan Keegan and Morgan Asset's valuation committee violated the funds' internal pricing procedures by relying on false information provided by Kelsoe. Between January 2007 and July 2008, Kelsoe sent

[37] *In the Matter of Douglas Lee Campbell,* Admin. Proc. No. 3-14152 (Dec. 7, 2010).

to Morgan Keegan's fund accounting department approximately 262 "price adjustments" concerning the price of specific portfolio securities. The fund accounting department relied on these inflated price adjustments when calculating the funds' NAVs. The fund accounting department did not request that Kelsoe provide documentation supporting the price adjustments, did not record which securities had been assigned prices by Kelsoe, and did not record which third-party broker-dealer quotes had been overridden by Kelsoe.

4. The SEC also alleged that Kelsoe falsely inflated the dealer quotes obtained from broker-dealers and failed to inform the fund accounting department that certain bonds held by the funds had declined substantially in value. In addition, Kelsoe allegedly fraudulently misrepresented the funds' performance in letters to investors and regulatory filings because he knew that the funds' reported performance was based on improperly inflated NAVs.

5. The SEC further alleged that Weller, who was the head of the fund accounting department and a member of the valuation committee, knew or was highly reckless in not knowing about the violations of the funds' internal pricing procedures. In addition, Morgan Keegan, acting through Weller and its fund accounting department, failed to follow reasonable pricing procedures to calculate accurate NAVs.

6. On the same day, FINRA brought an action against Morgan Keegan regarding the marketing and sales of certain bond funds. That case is described in the FINRA section below.

7. On July 12, 2010, an SEC ALJ published an interesting opinion regarding the staff's use of subpoenas after the filing of the action. By way of background, eight days after the SEC issued the order instituting these proceedings, the Associate Regional Director of the Atlanta Regional Office authorized the Enforcement staff to open a second investigation that the respondents asserted was functionally identical to the first action and was opened in order to gather additional evidence for use in the first action. The ALJ agreed with the respondents and noted that the Division of Enforcement took a risk by asking the Commission to institute proceedings before the Division completed its investigation. Among other determinations, the ALJ refused

to permit the SEC staff to introduce in the first action evidence obtained in the second investigation.

8. The matter is ongoing.

Ponzi Schemes

Since Bernard Madoff's arrest in December 2008, the SEC has aggressively pursued a wide-range of Ponzi scheme cases. One case below concerns a promissory note scheme; the other is related to the Madoff matter.

A. *SEC v. Gregory Todd Froning*, Civil Action No. 3:10-cv-01503 (N.D. Tex. Aug. 2, 2010)

1. The SEC filed a settled civil injunctive action against Froning, a Texas-based registered representative, for allegedly misappropriating more than $800,000 from fifteen investors with whom he had brokerage and advisory relationships.

2. The SEC alleged that, between 2005 and 2009, Froning solicited investors through an unregistered offering of promissory notes that were convertible to equity interests in a defunct financial planning company that he owned. Although Froning represented that the offering proceeds would be used to fund company expenses, he diverted the funds to his own personal bank account and used them to make Ponzi payments to other investors.

3. The SEC sought a permanent injunction against Froning, as well as disgorgement, and a civil penalty. After the Court's entry of the injunction, the SEC instituted settled administrative proceedings (Admin. File No. 3-14011) barring Froning from association with any broker, dealer or investment adviser. The issue of disgorgement and civil penalty will be decided at a later time.

B. *SEC v. Cohmad Securities Corp.* ("Cohmad") *et al.*, 09-Civ-5658 (S.D.N.Y. Nov. 3, 2010)

1. As we previously reported in our 2009 Outline, the SEC brought a civil action against Cohmad, a New York-based broker-dealer, the firm's owner and chairman (Maurice J. Cohn), the firm's president and chief operating officer (Marica B. Cohn), and the firm's vice president for marketing

(Robert M. Jaffe), in connection with its enforcement actions arising from the Madoff Ponzi scheme.

2. In its complaint, the SEC alleged that for more than twenty years, defendants operated as Bernard Madoff Investment Securities's ("BMIS") in-house marketing arm and received hundreds of millions of dollars in exchange for referring billions of dollars of investments and approximately 800 accounts to BMIS.

3. The complaint also alleged that defendants helped to conceal Madoff's fraud by, among other steps, making false filings with the SEC and maintaining inaccurate books and records that hid Cohmad's business with Madoff.

4. In February 2010, Judge Stanton dismissed certain of the Commission's claims against defendants, including claims against all defendants under Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 206(1) and 206(2) of the Exchange Act and Rule 15b7-1 thereunder.

5. On November 2, 2010, the SEC filed a settled amended complaint to which the defendants consented to the entry of partial judgments enjoining them from further violations of federal securities laws. The SEC also filed a settled administrative action against Jaffe barring him from association with any broker, dealer or investment adviser.

6. As against each defendant, the issue of disgorgement, prejudgment interest, and civil penalty will be decided at a later time.

Proxy Disclosures

Early in 2010, the settlements in the SEC's proxy cases against Bank of America received Court approval, ending a long-running and high-profile battle.

A. *SEC v. Bank of America Corporation* ("B of A"), 09-Civ-6829 (S.D.N.Y. Aug. 3, 2009); *SEC v. Bank of America Corporation*, 10-Civ-0215 (S.D.N.Y. Jan. 12, 2010)

1. As we reported in our 2009 Outline, in an action filed on August 3, 2009, the SEC charged B of A with violating

federal proxy rules by failing to disclose its prior agreement authorizing Merrill Lynch & Co. ("Merrill Lynch") to pay year-end bonuses to employees of up to $5.8 billion. In September 2009, U.S. District Judge Jed Rakoff rejected as "neither fair, nor reasonable, nor adequate" the SEC's initial proposed settlement with B of A, whereby the firm had agreed to pay a civil penalty of $33 million.

2. In a second federal court action filed on January 12, 2010, the SEC alleged that B of A failed to disclose prior to the merger vote that Merrill Lynch had incurred a net loss of $4.5 billion in October 2008 and had billions of dollars in estimated losses in November 2008 that, together, represented one-third of the value of the merger and more than 60 percent of the aggregate losses the firm sustained in the preceding three quarters combined. Judge Rakoff ruled that the charges relating to Merrill Lynch's losses should be filed in a separate action from the charges relating to the bonus disclosures.

3. Before approving a joint settlement of both actions, Judge Rakoff ordered the parties to submit to the court testimony and other evidence from the New York Attorney General's investigation to reconcile perceived differences in the interpretations of the facts offered by the parties in the SEC case and the NYAG based on its own investigation. After initially refusing to make its transcripts available to the SEC, the NYAG's office agreed to provide them to the court for *in camera* review.

4. Without accepting the SEC's findings over the NYAG's "more sinister interpretation of what happened," Judge Rakoff concluded that the conclusions drawn by the SEC were reasonable and supported by substantial evidence.

5. To settle the matter, B of A consented to paying a $150 million penalty, an amount that Judge Rakoff labeled "modest" and "paltry" in light of his conclusion that the merger "could have been a Bank-destroying disaster if the U.S. taxpayer had not saved the day." Despite labeling the settlement "far from ideal," "misguided," and "half-baked justice at best," the court, "while shaking its head," approved the settlement based on its conclusion that he owed substantial deference to the SEC's judgment.

6. Unlike the proposed settlement that Judge Rakoff rejected as coming at the expense of victimized shareholders, the $150 million penalty will be distributed solely to B of A shareholders that were harmed by the Bank's alleged disclosure violations and not to former legacy Merrill Lynch shareholders or B of A officers or directors who had access to the undisclosed information.

7. As part of the settlement, B of A also must implement several remedial initiatives for three years. These protocols include: independent auditing of the firm's internal disclosure controls; certification by the firm's CEO and CFO of all annual and merger proxy statements; retention of disclosure counsel; and steps to improve the transparency of compensation principles and decision making.

Sales Practices

In mid 2010, the Commission resolved a litigated action involving certain fraudulent sales practices of a broker-dealer. In September 2010, the Commission commenced failure to supervise proceedings against three individuals involved in this case.

A. *SEC v. Aura Financial Services, Inc.* ("Aura") *et al.*, 09-Civ-21592 (S.D. Fl. July 14, 2010)

1. In July 2010, resolving a case initiated by the SEC one year earlier, a court entered a final judgment against Aura Financial Services, Inc. ("Aura") in connection with fraudulent sales practices by five Aura registered representatives.

2. The SEC alleged that between October 2005 and April 2009, Aura and its registered representatives fraudulently induced fifteen customers to open Aura brokerage accounts. Defendants allegedly opened many of the accounts as margin accounts, despite the fact that they had not discussed the risks of margin with their clients. Defendants allegedly traded the accounts in a manner that was inconsistent with their unsophisticated clients' investment objectives and risk tolerances by engaging in excessive trading in (or churning) the accounts in order to increase commissions.

3. During 2008, churning of these accounts generated total gross commissions and fees of almost $1 million, of which

approximately $650,000 was paid out to the registered representatives and approximately $350,000 was retained by Aura. During that same time period, the accounts lost over $3.5 million.

4. The SEC alleged that Aura failed to take reasonable steps to prevent the churning by its registered representatives despite the fact that it was aware of high turnover in the accounts and had received several customer complaints about the involved registered representatives. While Aura responded by sending letters to the involved account holders and asked them to sign and return the letter, it knew that most letters were never signed and made no attempts to follow up. Further, Aura allegedly was aware that FINRA had filed a disciplinary proceeding in May 2008 against one of the registered representatives (Ronald Hardy, Jr.) and his supervisor concerning the falsification of new account forms at a prior employer.

5. In July 2009, the court entered default judgments against three involved registered representatives, Raymond Rapaglia, Peter Dunne, and Hardy. In January 2010, the court entered a judgment against Hardy, issuing an injunction and ordering Hardy to disgorge $228,362 and to pay a $130,000 civil penalty.

6. Aura had previously consented in October 2009 to an injunction, to disgorge ill-gotten gains, and to pay a civil penalty in an amount to be determined by the court. In accordance with this agreement, the Court entered an order in July 2010 permanently enjoining Aura from violating the securities laws, ordering it to pay disgorgement of $348,837, prejudgment interest and a civil penalty of $650,000.

7. In September 2010, the SEC commenced administrative proceedings against Aura's president and principal owner (Timothy M. Gautney) and two former Aura employees (Robert A. Bellia and Eric S. Blum) for allegedly failing to reasonably supervise three former registered representatives in two branch offices. The SEC alleged that these three respondents failed to follow up on red flags of excessive trading, failed to follow heightened supervisory procedures, and/or failed to implement reasonable policies and procedures to prevent and detect churning by its registered representatives. The case is ongoing.

Securities Offerings

Last year the SEC resolved a case brought in 2009 regarding a fraudulent securities offering scheme involving unregistered broker-dealers.

A. *SEC v. Regions Bank*, 09-Civ-22821 (S.D. Fla. Sep. 21, 2009)

1. The SEC resolved a federal district court case against Regions Bank ("Regions") for its role in connection with a fraudulent offering scheme by unregistered broker-dealers U.S. Pension Trust Corp. and U.S. College Trust Corp. (collectively, "USPT").

2. In this action initiated in September 2009, the SEC alleged that USPT had offered and sold mutual funds to investors through a trust created at a U.S. bank. Until March 2006, USPT failed to disclose to investors that it charged investors exorbitant sales commissions and insurance premiums. The SEC alleged that Regions had contributed to the fraudulent scheme due to the fact that its predecessor bank had served as trustee for the plans since October 2001. Specifically, Regions had allowed its name to be used in the marketing of the fraudulent offering and it failed to disclose to customers that USPT was charging exorbitant fees and commissions.

3. In September 2010, Regions consented to a judgment pursuant to which a court issued an injunction and ordered Regions to disgorge $1 and pay a civil penalty of $1 million to a Fair Fund for the benefit of investors injured in the USPT offering fraud.

Short Sales

The Commission, like FINRA and its predecessors, the NASD and NYSE Regulation, has focused recently on compliance with its short sale rule, referred to as Regulation SHO. Below is an example of cases in this area brought by both the SEC and NYSE Regulation.

A. *In the Matter of Goldman Sachs Execution & Clearing, L.P.* ("GSEC"), Admin. Proc. File No. 3-13877 (May 4, 2010)

1. The SEC settled an administrative proceeding against GSEC, alleging that the firm's response to the SEC's September 17, 2008 emergency order enacting temporary Rule 204T to Regulation SHO was inadequate.

2. The emergency order required that firms either deliver securities by a trade's settlement date or close fail-to-deliver positions by purchasing or borrowing securities by the beginning of the trading day following the settlement.

3. The SEC alleged that, during a two-month period starting in December 2008, GSEC made erroneous manual calculations, causing the firm to violate the emergency order by failing to timely close out fail-to-deliver positions in approximately 60 securities. The SEC alleged that GSEC's procedures were inadequate because they "relied too heavily on individuals to perform manual tasks and calculations, without sufficient oversight or verification of accuracy."

4. In settling the SEC's action, GSEC consented to a cease-and-desist order and a censure and agreed to pay a $225,000 civil penalty. In considering GSEC's settlement offer, the Commission considered the firm's remedial acts and cooperation with the SEC Enforcement staff's investigation.

5. In accordance with a Hearing Panel Decision issued by NYSE Regulation contemporaneously issued with the SEC's settlement, GSEC also agreed to pay a $225,000 fine to NYSE Regulation.

Subprime Mortgage Holdings

Another hot topic for the SEC concerns companies' subprime holdings and related disclosures to investors. State Street and Citigroup paid large civil penalties to settle cases in this area. Interestingly, in both instances, the Commission also brought charges against individuals.

A. *SEC v. State Street Bank and Trust Company* ("State Street"), 10-Civ-10172 (D. Mass. Feb. 4, 2010)

1. The SEC filed a settled case against State Street, which allegedly misled investors about the extent to which its actively managed Limited Duration Bond Fund ("the LDB Fund") was exposed to subprime mortgage investments.

2. The SEC alleged that offering documents and other communications prepared by State Street caused investors

and prospective investors to believe that the LDB Fund was sector-diversified and was slightly more aggressive than a money market fund, and that it had virtually no exposure to subprime investments.

3. In contrast, however, the LDB Fund allegedly was entirely concentrated in subprime residential mortgage-backed securities and derivatives and held a lower-than-advertised credit quality. Investors allegedly also were misled about the extent to which the LDB Funds' performance was tied to its use of leverage.

4. The complaint also alleged that information about the LDB Fund's exposure to subprime investments was selectively disclosed to certain investors, including clients of State Street's internal advisory groups that provided advisory services to some of the investors in the LDB Fund and the related funds. In order to meet the redemption demands of the better informed investors, State Street sold the LDB Fund's most liquid holdings, causing further harm to those investors who were not privy to the selective disclosure and whose investment in the LDB Fund became even more concentrated in subprime securities.

5. State Street consented to a cease-and-desist order, to pay a $50 million civil penalty, to disgorge more than $7.3 million, and to pay more than $255 million to harmed investors (not including more than $340 million that State Street already paid to harmed investors through settlement of private litigation). State Street also agreed to retain an independent compliance consultant.

6. In September 2010, the Commission charged two former State Street employees with misleading investors concerning their exposure to subprime investments. John Flannery (a chief investment officer) and James Hopkins (a product engineer) were charged in an administrative proceeding with playing a key role in drafting a series of allegedly misleading communications to investors. In announcing this action, Mr. Khuzami, the SEC's Director of Enforcement, stated that "the SEC is committed to identifying and holding accountable those who violated the law and harmed investors through subprime investments." This matter is ongoing.

B. *SEC v. Citigroup, Inc.*, 10-cv-01277 (D. D.C. July 29, 2010); *In the Matter of Gary L. Crittenden* ("Crittenden") and *Arthur H. Tildesley, Jr.* ("Tildesley"), Admin. Proc. File No. 3-13985 (July 29, 2010)

1. The SEC filed a settled action in federal district court against Citigroup that charged the company with issuing material misstatements that drastically understated the company's exposure to subprime mortgages.

2. The complaint alleged that on four occasions between July 2007 and November 2007, Citigroup misled investors during earnings calls and in public filings by representing that it had reduced its subprime exposure from $24 billion at the end of 2006 to less than $13 billion. In reality, the bank's exposure during that period was over $50 billion. Citigroup failed to disclose more than $39 billion of super senior tranches of subprime collateralized debt obligations ("CDOs") and related instruments called liquidity puts.

3. The complaint alleged that internal documents, which were provided to Citigroup's senior management in advance of earnings calls, showed that super senior tranches and liquidity puts were included in the bank's total subprime exposure, but that the bank was excluding these two categories from disclosure because it considered the risk of default on these instruments to be extremely small.

4. Citigroup consented to a penalty of $75 million and to the entry of permanent injunctions.

5. In a separate administrative proceeding, the SEC instituted settled cease-and-desist proceedings against Crittenden, Citigroup's former chief financial officer, and Tildesley, Citigroup's former head of investor relations, for causing Citigroup's misstatements.

6. The SEC's order found that Crittenden and Tildesley helped draft and then approved misstatements about the bank's subprime exposure, and that Citigroup included these misstatements in a Form 8-K filed with the SEC on October 1, 2007.

7. Crittenden agreed to pay a penalty of $100,000, Tildesley agreed to pay a penalty of $80,000, and both consented to the issuance of an order barring further violations.

Supervision

Just as it had in 2009, last year the Commission brought supervision actions not only against firms, but also various individual supervisors. Commenting on its efforts in this area, the SEC recently stated that "in FY 2010, the Commission took a variety of actions against broker-dealers and the individuals designated to supervise them. These cases demonstrate the Commission's commitment to the view that the supervisory role is a critical component in the protection of investors."[38] Significant cases in the supervision area are described below, including a litigated action against a firm's general counsel.

A. *In the Matter of Axiom Capital Management, Inc.* ("Axiom"), Admin. Proc. File No. 3-13786 (Feb. 22, 2010); *In the Matter of David V. Siegel*, Admin. Proc. File No. 3-13787 (Feb. 22, 2010)

1. The SEC commenced administrative proceedings against Axiom and Siegel, an Axiom branch officer manager, in which it alleged that they failed to reasonably supervise a registered representative who defrauded elderly customers.

2. In 2003, Axiom assigned Siegel to be the direct supervisor of Gary J. Gross, a registered representative in Axiom's Boca Raton office. As a result of customer complaints about Gross' conduct while he was employed by his former firm, the State of Florida required Axiom to place Gross on heightened supervision.

3. The SEC alleged that, between 2004 and 2006, Gross recommended to elderly customers unsuitable private placements that he described as riskless, engaged in unauthorized trading, and churned clients' accounts.

4. The SEC alleged that the respondents failed to reasonably supervise Gross by failing to follow Axiom's heightened supervisory procedures. Siegel allegedly failed to monitor Gross' transactions and did not respond to red flags concerning Gross' churning activity. Because Siegel's compensation was partially dependent on the office's net

[38] FY 2010 Performance and Accountability Report, available at: http://www.sec.gov/about/secpar2010.shtml at pg. 155.

commissions, Siegel allegedly profited as a result of Gross' illegal conduct.

5. Axiom settled the matter by consenting to a censure, to pay a $60,000 civil penalty, and to retain an independent compliance consultant.

6. Siegel consented to pay $10,600 in disgorgement and a $15,000 civil penalty, and to a permanent bar from associating with any broker, dealer, or investment adviser in a supervisory capacity.

7. In 2008, Gross consented to an injunction, to pay a civil penalty and disgorgement, and to a permanent bar from association with a broker or dealer.

B. *In the Matter of Salvatore F. Sodano*, Admin. Proc. File No. 3-12596 (Feb. 22, 2010)

1. As we reported in our 2007 Outline, in March 2007, the SEC settled an administrative proceeding against the American Stock Exchange LLC ("Amex"), alleging that, from at least 1999 through 2004, the exchange allegedly failed to surveil adequately for its members' violations of the order-handling rules and also failed to keep and furnish surveillance and other records. At the time, the SEC also initiated a related administrative proceeding against former Amex chairman and CEO Salvatore Sodano.

2. In August 2007, an ALJ granted Sodano's motion for summary disposition on the grounds that the applicable statute only vests the SEC with jurisdiction to bring charges against current officers and directors of an SRO. Sodano had resigned from those positions with Amex by 2005. In December 2008, the SEC reversed the ALJ's decision, concluding that the statute permitted the SEC to censure current *and former* SRO officers.[39]

3. In February 2010, the SEC settled its administrative proceeding against Sodano. The SEC alleged that Sodano, as Chairman and CEO of the Amex, was responsible for

[39] As described below, Dodd-Frank permits the SEC to commence proceedings against individuals formerly associated with various registered entities, including exchanges.

enforcing compliance with regulatory rules. The SEC further alleged that Sodano failed to ensure that the Amex complied with its own rules and satisfied its regulatory obligations. Specifically, Sodano did not establish procedures to correct deficiencies in the Amex's surveillance and enforcement systems, and he unreasonably relied on others to address widespread problems.

4. Interestingly, in settling this matter, the SEC did not impose any sanctions or penalties on Sodano.

C. *In the Matter of First Allied Securities, Inc*. ("First Allied"), Admin. Proc. File No. 3-13808 (Mar. 5, 2010)

1. The SEC filed a settled administrative proceeding against First Allied in which the Commission alleged that firm failed to reasonably supervise one of its registered representatives.

2. Between May 2006 and March 2008, Harold H. Jaschke, a former First Allied registered representative, allegedly engaged in an unauthorized high-risk, short-term trading strategy on behalf of two municipal customers. This strategy, which involved short-term trading in "STRIPS" (Separate Trading of Registered Interest and Principal of Securities) that were financed through the use of repurchase agreements, directly violated the terms of the customers' investment ordinances.

3. The SEC alleged that Jaschke's trading strategy was unsuitable for the customers in light of their investment objectives. Jaschke allegedly lied to the customers about the performance and activity of their accounts and failed to disclose unrealized losses. Jaschke also allegedly engaged in unauthorized trading in the customers' accounts and excessively traded in (or churned) these accounts for his own financial gain.

4. The SEC alleged that First Allied failed to establish reasonable systems designed to detect red flags regarding churning and suitability. The Commission also alleged that First Allied failed to monitor representatives' use of their personal e-mail accounts to conduct firm business and failed to preserve e-mails for the requisite three-year period.

5. First Allied consented to a censure, to disgorge $1,224,606, to pay a $500,000 civil penalty, and to certify to the Commission staff when it implemented improvements recommended by an independent consultant.

6. In the settlement release, the SEC noted the prompt remedial actions taken by First Allied and its cooperation with the Commission staff.

7. In December 2009, the SEC filed a federal court action against Jaschke alleging that he had defrauded two municipalities. In its complaint, the SEC seeks a permanent injunction, disgorgement, and a civil penalty. This case was dismissed in October 2010 following Jaschke's death.

8. Also in December 2009, the Commission settled an administrative proceeding with Jeffrey C. Young, a former Vice President of Supervision and Jaschke's supervisor. The SEC alleged that Young failed to respond adequately to red flags raised by Jaschke's conduct and failed to take reasonable steps to assure that First Allied's suitability procedures were followed. Young was suspended in a supervisory capacity for nine months and fined $25,000.

D. *In the Matter of Prime Capital Services, Inc., et al.*, Admin. Proc. No. 3-13532 (Mar. 16, 2010)

1. The SEC settled an administrative proceeding against Prime Capital Services Inc. ("PCS") and its parent company, Gilman Ciocia, Inc. ("G&C"), in connection with PCS representatives' sale of variable annuities to customers whom they solicited during free-lunch seminars.

2. The SEC alleged that, between 1999 and 2007, PCS representatives sold approximately $5 million of variable annuities to elderly clients in south Florida using misleading sales pitches, and that, in many cases, the investments were unsuitable based on the customers' ages, liquidity, and investment objectives.

3. PCS representatives allegedly told various customers that the variable annuity was guaranteed not to lose money, the customers would receive a guaranteed rate of return, and/or they would have access to invested funds whenever they

needed it. During the time period, at least 23 customers were induced to buy at least 35 variable annuities.

4. The SEC charged PCS with failing to supervise because it did not: implement written supervisory procedures; review and follow up on branch exams; review and approve variable annuity transactions; respond to customer complaints; comply with state regulatory orders; and supervise certain individuals.

5. The SEC alleged that G&C aided and abetted PCS's fraud by arranging free-lunch seminars in and around several senior citizen communities in Florida where the registered representatives recruited senior citizens as customers and induced them into buying variable annuities.

6. In agreeing to settle the matter, PCS and G&C agreed to: (i) censures; (ii) cease-and-desist orders; and (iii) several undertakings, including retaining an independent compliance consultant, placing limitations on the functions that certain employees (including PCS's president and chief compliance officer) could perform, and notifying and making whole affected clients. In addition, PCS agreed to disgorge nearly $100,000, and G&C agreed to pay a civil penalty of $450,000.

7. In November 2009, the SEC settled related charges against Christine Andersen, a PCS compliance officer, for failing to supervise. Andersen consented to paying a $10,000 civil penalty, to a one-year suspension, and to cooperate with the SEC staff's investigation.

8. In an initial decision issued in June 2010, PCS president Michael Ryan and chief compliance officer Rose Rudden were ordered to each pay a $65,000 civil penalty and were barred from association in a supervisory capacity with any broker, dealer, or investment adviser. PCS representatives Eric Brown, Matthew Collins, Kevin Walsh, and Mark Wells were ordered to cease-and-desist from further wrongdoing, to each pay a $130,000 civil penalty and were barred from association with any broker, dealer, or investment adviser. They also must disgorge the following amounts: Brown - $41,992; Collins - $2,915; Walsh - $24,790; and Wells - $6,609.

E. *In the Matter of Theodore W. Urban*, Admin Proc. No. 3-13655 (Sep. 8, 2010)

1. In our 2009 Outline, we reported on settled proceedings brought against Ferris, Baker Watts, Inc. ("Ferris"), its former CEO, its former director of retail sales and a registered representative, Stephen Glantz ("Glantz"), who was engaged in market manipulation. The former CEO and former director of retail sales settled failure to supervise charges regarding the activities of Glantz, the registered representative.

2. As to Ferris, the SEC's settlement described its alleged failure to design reasonable systems to implement its written supervisory policies and procedures to prevent and detect violations of the securities laws and failing to file Suspicious Activity Reports ("SARS").

3. Contemporaneously with the filing of the settled actions against Ferris and the three former employees, the SEC instituted a failure to supervise proceeding against Theodore Urban ("Urban"). Mr. Urban was Ferris' general counsel and headed three departments: Compliance, Human Resources and Internal Audit. The SEC alleged that Urban ignored and/or failed to adequately follow up on numerous red flags concerning the registered representative's trading, including several issues to which he was alerted by the Compliance Department.

4. On September 8, 2010, following a lengthy hearing, Chief Administrative Law Judge Brenda Murray issued a fifty-seven page decision. Although Chief Judge Murray found that Urban "did not have any of the traditional powers associated with a person supervising brokers," she nevertheless concluded that he was Glantz's supervisor because his "opinions on legal and compliance issues were viewed as authoritative and his recommendations were generally followed by people in [his firm's] business units, but not by Retail Sales."

5. Chief Judge Murray determined, however, that Urban had acted reasonably under the facts and circumstances presented and dismissed the proceeding.

6. The Division of Enforcement petitioned the Commission for a review of the dismissal; Urban cross-petitioned for a review

of Chief Judge Murray's ruling that he was Glantz's supervisor.

7. Urban also petitioned for the Commission to summarily affirm Chief Judge Murray's decision. On December 7, 2010, the Commission denied Urban's motion because "a normal appellate process" rather than a summary affirmance was appropriate as "the proceeding raises important legal and policy issues, including whether Urban acted reasonably in supervising Glantz and responded reasonably to indications of his misconduct, whether securities professionals like Urban are, or should be legally required to "report up," and whether Urban's professional status as an attorney and the role he played as FBW's general counsel affect his liability for supervisory failure."

8. This matter is being closely watched by the industry in light of Chief Judge Murray's holding that significantly expands potential supervisory liability for legal and compliance personnel.[40]

F. *In the Matter of World Group Securities, Inc.* ("WGS"), Admin. Proc. File No. 3-14132 (Nov. 22, 2010)

1. The SEC filed a settled administrative proceeding against WGS in which it alleged that WGS failed to enforce a reasonable system of supervisory policies and procedures to prevent and detect fraudulent conduct by its registered representatives. The SEC further alleged that WGS failed to maintain a guideline ratio of registered representatives to supervisors in one of WGS's branches over a 17-month period.

2. During the 17-month period, registered representatives in WGS's Pomona, California branch made unsuitable recommendations to customers concerning the use of home equity to purchase variable universal life insurance policies. At the time, WGS had three branch supervisors overseeing the activities of 185-225 registered representatives.

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

3. The SEC further alleged that WGS failed to ensure that the branch manager complied with the company's directions to achieve 40-to-1 and 20-to-1 ratios of registered representatives to supervisors in the branch. The branch manager also allegedly failed to communicate WGS's policies and did not hold quarterly meetings to discuss WGS's policies or supervisory and compliance updates. As a result, certain registered representatives in the Pomona branch office were unaware of the firm's policies, which caused them to make unsuitable recommendations.

4. WGS settled the matter by consenting to a censure and paying a $200,000 civil penalty. WGS also consented to an undertaking to retain an outside vendor to provide suitability training to all of WGS's registered representatives annually for two years focusing on the suitability of (1) variable universal life insurance policies and (2) using home equity to purchase securities.

G. *In the Matter of The Buckingham Research Group, Inc.* ("Buckingham Research"), *Buckingham Capital Management, Inc.* ("Buckingham Capital") *and Lloyd R. Karp*, Admin. Proc. File No. 3-14125 (Nov. 17, 2010)

1. The SEC filed a settled administrative proceeding against Buckingham Research, Buckingham Capital and Karp in which it alleged that Buckingham Research (a registered broker-dealer and institutional equity research firm principally providing research to hedge funds and other institutional investors) and its subsidiary Buckingham Capital (a registered investment adviser) failed to establish, maintain and enforce policies and procedures reasonably designed to prevent the misuse of material, nonpublic information.

2. Buckingham Capital and Buckingham Research share certain facilities and executives, and maintain adjoining space. The SEC alleged that the firms' material, nonpublic information policies and procedures failed to account for the nature of their interconnected businesses.

3. According to the SEC, although Buckingham Research had a written procedure to address the misuse of material, nonpublic information, it did not follow its written procedure. In addition, the SEC alleged that Buckingham Capital's written policies and procedures were not sufficiently clear to

enable employees to understand their responsibilities. The SEC further alleged that Buckingham Capital created "replacement" compliance documents in lieu of incomplete or missing compliance records and produced them to SEC examination staff without disclosing that such records were "replacements."

4. As to Karp, who was the chief compliance officer of Buckingham Research and Buckingham Capital, the SEC alleged that he failed to discharge his responsibility for establishing and administering the firms' compliance programs. According to the SEC, "Karp was aware of [certain] compliance weaknesses and failures and either failed to act or failed to correct them."

5. The respondents settled the matter as follows: Buckingham Research and Buckingham Capital agreed to censures and to pay civil penalties in the amounts of $50,000 and $75,000, respectively. Karp agreed to a censure and to pay a $35,000 civil penalty. The respondents also consented to cease-and-desist orders.

6. Buckingham Research and Buckingham Capital further agreed to retain an independent consultant to conduct a comprehensive review of their policies, practices and procedures.

Unregistered Offerings

Although a stated FINRA priority, the SEC apparently is also interested in unregistered securities offerings, as evidenced by the action described below.

A. *In the Matter of Ronald S. Bloomfield, Robert Gorgia, Victor Labi, John Earl Martin, Sr., and Eugene Miller*, Admin. Proc. File No. 3-13871 (Apr. 27, 2010)

1. The SEC filed administrative proceedings against the president, chief compliance officer, and three registered representatives of Leeb Brokerage Services, Inc. ("Leeb"), a defunct broker-dealer, for facilitating unregistered sales of penny stocks to investors.

2. The SEC alleged that Leeb's clients routinely delivered large blocks of penny stocks into their Leeb accounts. Leeb's

registered representatives allegedly then sold the stock to the public without conducting a reasonable inquiry to confirm that a registration statement was in effect and also failed to respond to clear red flags that the customers' trades were illegal.

3. The SEC also alleged that Leeb's president and chief compliance officer, who supervised the registered representatives, failed to carry out their supervisory responsibilities. Specifically, the supervisors failed to respond to red flags that allegedly should have caused the supervisors to more closely examine the activities of the registered representatives and their clients.

4. The SEC further alleged that in response to the suspicious trading by Leeb's clients, the firm should have filed suspicious activity reports but did not do so in violation of the Bank Secrecy Act.

5. In December 2010, the SEC settled its charges against Miller, Leeb's president. Miller consented to a cease-and-desist order, certain undertakings, a $50,000 civil penalty, and a one-year suspension from associating with any broker or dealer in a supervisory capacity. The case against the remaining respondents is ongoing.

Last year's financial reform bill contained several new measures expanding the SEC's enforcement authority and strengthening its oversight and regulatory authority over the nation's securities markets.

Landmark Legislation Gives SEC New Enforcement Capability

On July 15, 2010, the U.S. Senate passed the Dodd-Frank Wall Street Reform and Consumer Protection Act. President Obama signed the bill into law on July 21, 2010. This landmark legislation contains an array of important new measures that significantly expand the enforcement authority of the SEC and strengthen its oversight and regulatory authority over the securities markets.[42] These new measures will dramatically improve the SEC's "real-time enforcement" abilities, as it attempts to deliver on its promise to move more swiftly in enforcement actions to restore investors' faith in the markets.[43]

Many important questions related to the new legislation, such as whether fiduciary duties will be imposed on broker-dealers, whether the SEC will attempt to restrict mandatory predispute arbitration, and whether aiding and abetting liability for securities laws violations will be extended to private civil actions, have yet to be answered. The compromises that were necessary for passage of the Dodd-Frank Act resulted in the authorization of studies and granting of agency rulemaking authority without specific mandates as to any particular outcome. Thus, additional significant changes to the enforcement and regulatory landscape

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41 This section of the Outline was drawn from "Landmark Legislation Gives SEC New Enforcement Capability," by Patrick D. Conner and E. Andrew Southerling, published July 19, 2010 and available at: http://www.morganlewis.com/index.cfm/publicationID/46016ef8-bbc4-41dc-a8fa-18dc8c6df911/fuseaction/publication.detail.

42 The key provisions within the legislation related to SEC regulation and enforcement are contained principally within Title IX, "Investor Protections and Improvements to the Regulation of Securities"; subtitle A, "Increasing Investor Protection"; subtitle B, "Increasing Regulatory Enforcement and Remedies"; and subtitle H, "Municipal Securities."

43 Morgan Lewis has published several articles about the SEC's reform efforts, including: "SEC Announces New Cooperative Initiatives," available at: http://www.morganlewis.com/pubs/WP_SECAnnouncesNewCooperationInitiative_Jan2010.pdf; and "SEC Speaks 2010: Fast-Paced Reform Continues in 2010," available at: http://www.morganlewis.com/pubs/SecuritiesLF_SECSpeaks2010_11feb10.pdf.

will continue to be considered and debated for some time while agency study and rulemaking proceeds.

Nevertheless, existing provisions in the Dodd-Frank Act that do not require further consideration before becoming effective, many of which are highlighted below, provide substantially increased enforcement capabilities to the SEC.

Changes to SEC Enforcement and Market Oversight

Extension of Liability and Jurisdictional Regulations

Aiding and Abetting Liability[44]

Prior to the Dodd-Frank Act's passage, the Exchange Act and the Investment Advisers Act of 1940 ("Advisers Act") permitted the SEC to bring actions for aiding and abetting violations of those statutes in federal civil proceedings. The Dodd-Frank Act extends the SEC's enforcement authority to prosecute those who aid and abet primary violators of the federal securities laws under the Securities Act and the Investment Company Act of 1940 ("Investment Company Act"), and codifies the SEC's authority to impose penalties against aiders and abettors under the Advisers Act. The Dodd-Frank Act therefore brings the SEC's federal civil enforcement authority in line with its existing administrative authority to institute proceedings and seek sanctions against regulated entities and individuals for aiding and abetting violations.[45]

In addition, the Dodd-Frank Act clarifies the SEC's authority to pursue aiders and abettors for *reckless*, as well as *knowing*, conduct. The preexisting law permitted the SEC to charge individuals who knowingly provided substantial assistance to primary violators. The courts have been split, however, on the question of what constitutes knowing assistance, with some courts holding that "knowingly" meant what it said – actual knowledge, rather than recklessness. The Dodd-Frank Act resolves this issue and makes clear that the knowledge requirement can be satisfied by reckless conduct.

Control Person Liability under the Exchange Act[46]

The Dodd-Frank Act amends the Exchange Act to permit the SEC to impose joint and several liability on control persons. Under the preexisting statute, control persons were liable, to the same extent as persons they controlled, to any *person* to whom the controlled person was liable.[47] Although the SEC routinely brings enforcement actions against individuals based on control person liability, some

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44 Dodd-Frank Act §§ 929M, 929N, and 929O.

45 *See, e.g.*, Exchange Act § 15(b)(4)(E); Investment Advisers Act § 203(e)(6).

46 Dodd-Frank Act § 929P(c).

47 Exchange Act § 20(a).

disagreement among the courts existed based on the preexisting language as to whether control person liability is available as an enforcement mechanism to the SEC. In *SEC v. First Jersey*, 101 F.3d 1450 (2d Cir. 1996), the court upheld the SEC's authority to pursue an enforcement action under the Exchange Act control person provision; the court in *SEC v. Coffey*, 493 F.2d 1304 (6th Cir. 1974), however, held that the SEC had no such authority. The Act resolves the issue, giving the SEC authority to pursue such actions.

Extension of Statute of Limitations for Securities Laws Violations[48]

The Dodd-Frank Act extends the statute of limitations for the prosecution of a "securities fraud offense" from five years to six years following the commission of the offense. The Dodd-Frank Act defines a securities law offense to include criminal securities fraud and willful violations of the Securities Act, the Exchange Act, the Advisers Act, the Investment Company Act, and the Trust Indenture Act of 1939. Previously, the SEC and the federal government were subject to a five-year statute of limitations set forth under 28 U.S.C. § 2462 for enforcement actions seeking civil penalties.

Expansion of the Application of Antifraud Provisions[49]

The Dodd-Frank Act modifies the market manipulation provisions of Section 9 and the short sale provisions of Section 10(a)(1) of the Exchange Act to extend to any security other than a government security, rather than only to securities registered on a national securities exchange. Further, the Dodd-Frank Act extends Section 9(b) of the Exchange Act, which relates to puts, calls, straddles, and options, to expressly cover transactions that do not occur on a national exchange. Additionally, the Dodd-Frank Act modifies Section 9(c) of the Exchange Act, which relates to the endorsement or guarantee of puts, calls, straddles, or options, to specifically cover all broker-dealers, rather than only members of a national securities exchange. The Dodd-Frank Act also amends Section 15(c)(1)(A) of the Exchange Act to bring exchange transactions within its antimanipulation restrictions.

Extraterritorial Jurisdiction[50]

The Dodd-Frank Act expands the jurisdiction of federal courts in actions brought by the SEC or the DOJ that allege violations of the antifraud provisions of the Securities Act, the Exchange Act, and the Advisers Act. Congressional leaders have stated that the purpose of this provision is to make clear that in actions or proceedings brought by the SEC or DOJ, the specified provisions of the Securities Act, the Exchange Act, and the Advisers Act may have extraterritorial

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[48] Dodd-Frank Act § 1079A (Financial Fraud Provision). This provision adds a new Section 3301 to Chapter 213 of Title 18 of the U.S. Code.

[49] Dodd-Frank Act § 929L.

[50] Dodd-Frank Act § 929P(b).

application, and that, for potential Securities Act or Exchange Act violations, extraterritorial application is appropriate regardless of whether the securities are traded on a domestic exchange or the transactions occur in the United States, when the conduct within the United States constitutes "significant steps in furtherance of the violation" or when conduct occurring outside the United States has a "foreseeable substantial effect" within the United States.[51]

The Dodd-Frank Act's provisions concerning extraterritoriality of the federal securities laws are intended to rebut the presumption against extraterritorial application of the federal securities laws that the U.S. Supreme Court announced recently in its decision in *Morrison v. National Australia Bank*, No. 08-1191, wherein the Court ruled that, for purposes of private rights of action, antifraud provision Section 10(b) of the Exchange Act applies only to transactions listed on U.S. stock exchanges and securities transactions within the United States. Thus, while the Dodd-Frank Act does not override the Court's decision, it prevents the potential extension of the Court's decision to actions brought by the SEC or DOJ.

Jurisdiction over Formerly Associated Persons[52]

The Dodd-Frank Act authorizes the SEC to institute proceedings against persons formerly associated with a registered entity (such as the Municipal Securities Rulemaking Board ("MSRB"), broker-dealers, government securities brokers or dealers, investment companies, national securities exchanges, registered securities associations, registered clearing agencies, self-regulatory organizations, and public accounting firms). This authorization is consistent with FINRA rules that permit the agency to bring suits against persons formerly associated with a member within two years after the effective date of the person's termination or cancellation of registration, or, in the case of a nonregistered person, two years after the date that the person ceased to be associated with the member.[53]

Enhanced Remedies

Collateral Bars for Securities Laws Violators[54]

In *Teicher v. SEC*, 177 F.3d 1016 (D.C. Cir. 1999), the court held that the SEC lacked authority to impose "collateral bars" on violators of the securities laws. The new Dodd-Frank Act permits the SEC to impose collateral bars, so that, for example, a person who had violated the Exchange Act provisions relating to broker-dealers could be barred not only from the broker-dealer business, but also the municipal securities dealer business regulated under other provisions of the

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[51] Congressional Record, June 30, 2010, at H 5237.

[52] Dodd-Frank Act § 929F.

[53] FINRA By-laws Article V, Section 4(a).

[54] Dodd-Frank Act § 925.

Exchange Act and the investment advisory business regulated by the Advisers Act. The new Dodd-Frank Act permits the SEC, in one stroke, to remove a violator from the financial industry entirely.

Civil Penalties in Cease-and-Desist Proceedings[55]

The Dodd-Frank Act increases the SEC's existing enforcement authority by permitting the SEC to seek civil penalties in cease-and-desist proceedings against any person found to have violated the securities laws. Under preexisting law, the SEC could impose civil penalties in administrative proceedings only against regulated entities and associated persons. The new Dodd-Frank Act primarily affects public companies, their officers and directors, and their accountants by granting the SEC administrative penalty authority over them.

Securities Whistleblower Incentives and Protections[56]

The Dodd-Frank Act includes new whistleblower provisions designed to motivate those with inside knowledge to come forward voluntarily and assist the SEC in identifying and prosecuting persons who have violated federal securities laws. Previously, the SEC had the authority to compensate individuals for providing information leading to the recovery of civil penalties in insider trading cases, but the total amount of bounties that could be paid from a civil penalty could not exceed 10% of the collected penalties.[57]

The Dodd-Frank Act expands the SEC's current bounty program to cover *any* potential violation of the securities laws and requires the SEC to pay whistleblowers who voluntarily provide original information between 10% and 30% of monetary sanctions exceeding $1 million from a successful judicial or administrative action brought by the SEC, although the SEC would have discretion to set the reward between those points. In determining the amount of the award, the SEC is required to consider a number of factors, such as the significance of the information provided and the degree of assistance provided, along with the programmatic interest of the SEC in deterring securities laws violations.

Moreover, under the Dodd-Frank Act, SEC whistleblowers subject to retaliatory discrimination may directly file suit in federal district court instead of having to first file a complaint with the Department of Labor. Such actions must be filed no more than six years after the date of the alleged violation, or three years after the date when facts material to the right of action are known or reasonably should have been known by the employee alleging the violation. No action, however,

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[55] Dodd-Frank Act § 929P(a).

[56] Dodd-Frank Act §§ 922–924, and 929A.

[57] Exchange Act § 21A(e).

may be brought more than 10 years after the date on which the violation occurred.

In addition, the Dodd-Frank Act expands the whistleblower protections already in place under the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley")[58] to expressly prohibit retaliation against whistleblowing employees of subsidiaries and affiliates of publicly traded companies, extends the current statute of limitations for Sarbanes-Oxley whistleblower claims from 90 days to 180 days, and permits a jury trial. The Dodd-Frank Act also extends whistleblower protections to employees of nationally recognized statistical rating organizations (credit-rating agencies).

The Dodd-Frank Act requires the SEC to promulgate final rules implementing the provisions of its whistleblower program within 270 days after its enactment and requires the SEC to create an office to administer the program.

Proposed Whistleblower Rules

On November 3, 2010, the SEC proposed rules to implement the SEC whistleblower provisions of Dodd-Frank Act. The proposed rules attempt to balance the tension between encouraging whistleblowers to come forward while simultaneously discouraging people from bypassing their company's internal compliance programs.[59]

Whistleblowers Protected from Retaliation

One of the key components of Regulation 21F is that the definition of "whistleblower" reflects the SEC's view that the anti-retaliation protections of the Dodd-Frank Act do not depend on a finding of an actual violation of securities laws. The proposed regulations define a whistleblower as an individual who "alone or jointly with others . . . provide[s] the commission with information relating to a *potential* violation of the securities laws." This definition tracks the statutory definition, but adds the "potential violation" language. This standard does not require an actual violation for the anti-retaliation protections to apply.

In addition, the SEC makes clear that the anti-retaliation protections do not depend on whether the whistleblower ultimately qualifies for a monetary award.

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[58] Sarbanes-Oxley Section 806 creates protections for whistleblowers who report securities fraud and other violations from retaliation by their public company employers.

[59] With the exception of new information regarding the creation and staffing of the SEC's Whistleblower Office, this section of the Outline was drawn from "SEC's Proposed Rules for Implementing Dodd-Frank Whistleblower Provisions: Important Implications for Employers," by Sarah E. Bouchard, Thomas A. Linthorst, Robert M. Romano and Christian J. Mixter, published Nov. 12, 2010 and available at: http://www.morganlewis.com/index.cfm/fuseaction/publication.detail/publicationID/cd8ce0db-435c-484f-b3f9-0b81c3df5a86.

Award Eligibility

Section 922 of the Dodd-Frank Act authorizes the SEC to provide monetary rewards of 10% to 30% of the monies recovered to individuals who voluntarily provide the SEC with original information that leads to recoveries of monetary sanctions of more than $1 million in criminal and civil proceedings.

To be considered for an award, a whistleblower must (1) voluntarily provide the SEC (2) with original information (3) that leads to the successful enforcement by the SEC of a federal court or administrative action (4) in which the SEC obtains monetary sanctions totaling more than $1 million. The proposed rules relating to an individual's eligibility to receive the award reflect the SEC's attempt to balance its interest in receiving high-quality information directly from whistleblowers against its desire to encourage whistleblowers to utilize internal compliance procedures.

Voluntary submission. To obtain an award, the proposed regulations require that the whistleblower come forward voluntarily – meaning before the whistleblower receives any request, inquiry, or demand from the SEC, Congress, other government authority, or the Public Company Accounting Oversight Board. The whistleblower's submission will not be considered voluntary if the whistleblower had a preexisting legal or contractual duty to report the securities violations at issue.

"Original information." Another key component of the proposed rules is the requirement that the whistleblower provide "original information" to qualify for an award. This "original information" must be provided to the SEC after July 21, 2010, when the Dodd-Frank Act was enacted.

"Independent knowledge or independent analysis." Any "original information" provided must also be derived from the whistleblower's "independent knowledge or independent analysis." The regulations exclude certain categories of information from being treated as derived from independent knowledge or analysis.

For example, under the proposed rules, the SEC would not generally consider information obtained through an attorney-client privileged communication to be derived from independent knowledge or analysis. The carve-out for attorneys reflects the SEC's concern that the monetary incentives of the SEC whistleblower program may deter companies from consulting with attorneys about potential securities laws violations.

Similarly, the SEC's proposed rules would exclude any information gained through the performance by an independent public accountant of an engagement required under the securities laws, if the information relates to a violation by the engagement client or its directors, officers, or other employees. This exception

reflects the SEC's recognition of the role of independent public accountants and their preexisting duties under securities laws to detect and report illegal acts.

The SEC also will not consider information to be derived from independent knowledge or analysis if the whistleblower obtained the information as a person with legal, compliance, audit, supervisory, or governance responsibilities for an entity, and if the information was communicated to the whistleblower with the reasonable expectation that the whistleblower would take steps to cause the entity to respond appropriately to the violation, unless the entity did not disclose the information to the SEC within a reasonable time or proceeded in bad faith.

Here, the SEC attempts to reconcile the tension between the potential bounty available to whistleblowers and the SEC's recognition that effective internal compliance programs promote the goals of federal securities laws. This exclusion ceases to apply if the company does not come forward with the information within a reasonable time or proceeds in bad faith. At that point, the company's internal compliance officers could submit the information to the SEC and potentially qualify for a bounty.

Similarly, if any individual reports information to the company's internal compliance team or other similar departments, the individual has 90 days to submit the information to the SEC, while receiving credit as if they had reported the information to the SEC on the date they disclosed it internally. This provision is also designed to promote internal compliance, but does not require internal reporting prior to disclosure to the SEC.

The SEC has considered requiring internal reporting first, and is requesting comment on "all aspects of the intersection between 21F and established internal systems for the receipt, handling, and response to complaints about potential violations of law." The SEC is also requesting comment as to whether it should give favorable consideration to prior internal reporting in determining the amount of the award.

Another exclusion applies to any other information obtained from or through an entity's legal, compliance, audit, or similar functions. This would apply to employees who learn about potential violations because a compliance officer made inquiries about the conduct, and not from any other source.

Fraud and misconduct. The proposed rules render persons who engage in fraud or misconduct ineligible for an award. A whistleblower is ineligible for an award if the whistleblower knowingly and willfully makes any false, fictitious, or fraudulent statement or representation or uses any false writing or document knowing that it contains false, fictitious, or fraudulent statements. With respect to misconduct, the SEC will not count towards the $1 million threshold any sanctions that the whistleblower is ordered to pay, or that are ordered against a company whose liability is based substantially on the whistleblower's conduct.

The SEC is considering taking the misconduct issue a step further by excluding persons who report their own misconduct from the definition of whistleblower. The SEC has requested comment on whether the definition of "whistleblower" should be limited to those who provide information about potential violations of securities laws "by another person," which would exclude persons who report their own potential violations. This would mean that the person who has information concerning their own misconduct would not only be disqualified from the bounty; they also would not be considered a whistleblower subject to protection from retaliation.

Additional Rules

In addition to these and other substantive provisions relating to how a person can qualify for an award, the proposed rules describe procedures for submitting information to the SEC and for claiming an award. If the whistleblower satisfies the rules to qualify for an award, the SEC will then decide the amount of the award, which, as previously noted, will be between 10% and 30% of the monetary sanctions that the SEC and other authorities are able to collect. In determining the amount of the award, the SEC will consider, among other factors, whether the award enhances the SEC's ability to enforce the federal securities laws, protects investors, and encourages the submission of high-quality information from whistleblowers.

Significantly, the proposed rules would prohibit any action to impede a whistleblower from communicating directly with the SEC about a potential violation, such as by enforcing or threatening to enforce a confidentiality agreement.

Submission of Comments

The comment period ended on December 17, 2010.

Whistleblower Office

Dodd-Frank requires the SEC to create a Whistleblower Office to administer the program.[60] However, at the end of 2010, the SEC announced that due to budget uncertainties, the Commission was deferring the creation and staffing of the Office. According to the SEC, existing staff within the Enforcement Division will temporarily fulfill the functions that would have been undertaken by the new Whistleblower Office.

Notwithstanding the delay in establishing the Whistleblower Office, the SEC has reported that since the enactment of Dodd-Frank, the Commission had already

[60] *See* "Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act – Dates to be Determined," available at: http://www.sec.gov/spotlight/dodd-frank/dates_to_be_determined.shtml. In addition to deferring the creation and staffing of the Whistleblower Office, the SEC is also postponing setting up four other offices required to be created by Dodd-Frank.

seen a slight increase in the number of tips and complaints it had received as well as an uptick in the quality of such submissions.[61]

Regulation of Municipal Securities[62]

The Dodd-Frank Act strengthens oversight of municipal securities and enhances municipal investor protections. The Dodd-Frank Act requires municipal advisers who provide advice to a municipal securities issuer with respect to municipal financial products or the issuance of municipal securities, or who undertake a solicitation of a municipal entity, to register with the SEC. The Dodd-Frank Act also grants the SEC authority to regulate and sanction municipal advisers for fraudulent conduct and other violations of the federal securities laws.

The Dodd-Frank Act imposes a fiduciary duty on municipal advisers and associated persons when advising municipal issuers, and instructs the MSRB to adopt rules reasonably designed to prevent conduct inconsistent with this fiduciary duty. The Dodd-Frank Act imposes liability on municipal advisers for breaches of this fiduciary duty and for fraudulent, deceptive, or manipulative acts or practices.[63]

In addition, the Dodd-Frank Act expands MSRB rulemaking authority over broker-dealers, municipal securities dealers, and municipal advisers and permits the MSRB to regulate *advice* provided by these entities and individuals to issuers (until now the MSRB had the authority to regulate municipal securities transactions), and requires the MSRB to set professional standards for municipal advisers.[64]

Further, the Dodd-Frank Act provides for enhanced interaction between the SEC and MSRB. For example, the Dodd-Frank Act authorizes the MSRB to provide guidance and assistance to the SEC (and FINRA) in enforcement actions concerning MSRB rules, and to share fines collected by the SEC and FINRA for MSRB rule violations; the Dodd-Frank Act also establishes an Office of Municipal Securities within the SEC to administer the SEC's rules with respect to municipal securities dealers, advisers, investors, and issuers and to coordinate directly with the MSRB for rulemaking and enforcement actions.

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[61] Testimony before Congress of Mary L. Schapiro available at: http://www.sec.gov/news/testimony/2010/ts093010mls.html on Sep. 30, 2010.

[62] Dodd-Frank Act §§ 975, 976, and 979.

[63] The statutory imposition of a fiduciary duty on municipal advisers in this context is consistent with the Supreme Court's ruling in *SEC v. Capital Gains Research Bureau, Inc.*, in which the Court held that investment advisers are deemed to be fiduciaries who owe their clients an affirmative duty of utmost good faith, owe their clients full and fair disclosure of all material facts, and are required to employ all reasonable care to avoid misleading their clients. 375 U.S. 180, 194–99 (1963).

[64] These provisions become effective October 1, 2010.

The Dodd-Frank Act also instructs the Government Accountability Office to conduct several studies of the municipal securities markets, including a study of the disclosure required to be made by issuers of municipal securities.[65] The SEC has demonstrated an acute interest in investor disclosure related to municipal securities. In May 2010, the SEC unanimously approved rule changes designed to improve the quality and timeliness of securities disclosures of municipal issuers.[66] Among other things, the new rules require a broker, dealer, or municipal underwriter to reasonably determine that an issuer has agreed to provide notice of certain important events – *without regard to materiality* – within 10 days after the event's occurrence. These events include the failure to pay principal and interest, financial difficulties experienced by the issuer such as unscheduled payments by parties backing the issuance, and rating changes.

Additional Procedural Enhancements for Enforcement Actions

Nationwide Service of Subpoenas[67]

The Dodd-Frank Act grants the SEC nationwide subpoena power in connection with civil actions filed in federal courts. The legislation allows the SEC to serve subpoenas "at any place within the United States" in federal civil actions and would remove geographical restrictions imposed by Rule 45(c)(3)(A)(ii) of the Federal Rules of Civil Procedure. The SEC already has authority to serve subpoenas nationwide in administrative proceedings.

"Speedy Trial Act" for Commencement of SEC Enforcement Actions[68]

The Dodd-Frank Act also requires that the SEC file an enforcement action within 180 days after notifying a person in writing that it intends to recommend that an enforcement action be instituted against that person, or provide notice to the Director of the Division of Enforcement of its intent to not file an action. However, the SEC may seek an extension of this deadline if the Director of Enforcement determines, upon notice to the Chairman of the SEC, that the investigation is sufficiently complex that the filing of an action cannot be completed within the 180-day deadline.

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[65] Under the Exchange Act, the SEC and MSRB currently are precluded from requiring disclosure in municipal offerings. *See* Exchange Act §15B(d) (known as the "Tower Amendment").

[66] These rule changes amend Exchange Act Rule 15c2-12, which generally prohibits underwriters from purchasing or selling municipal securities unless they reasonably have determined that the municipality or other designated entity has agreed to make certain information available to investors on an ongoing basis, such as annual financial statements, payment defaults, rating changes, and prepayments. The rule changes became effective December 1, 2010 and can be found at: http://www.sec.gov/rules/final/2010/34-62184a.pdf. The SEC's press release announcing these measures can be found at: http://www.sec.gov/news/press/2010/2010-85.htm.

[67] Dodd-Frank Act § 929E.

[68] Dodd-Frank Act § 929U.

Protecting Confidentiality of Materials Submitted to the SEC[69]

As originally enacted, the Dodd-Frank Act provided limitations on disclosure of certain information that registered persons and entities provided to the SEC pursuant to its examination authority, if such information had been obtained by the SEC for purposes of surveillance, risk assessments, or other regulatory and oversight activities. The Dodd-Frank Act also provided that the SEC shall not be compelled to disclose such information, except in circumstances limited to congressional or other federal agency requests, or a federal court order issued in connection with an action instituted by the DOJ or SEC.

After this provision became law, certain members of Congress raised concerns that it included overly broad and vague exemptions from the Freedom of Information Act ("FOIA"). Specifically, lawmakers and others debated whether the law as originally drafted impermissibly provided the SEC with unrestrained discretion to withhold **all** records obtained from regulated entities through the Commissions examination process from public disclosure under FOIA.

In support of the law, Chairman Schapiro explained to lawmakers that because the Dodd-Frank Act mandated increased SEC oversight responsibilities, including new authority over hedge funds, private equity funds, and venture capital funds, the Commission would be required to expand and improve its examination and surveillance capabilities. Chairman Schapiro stated that in order for the SEC to successfully fulfill these responsibilities, all regulated entities – including those newly regulated entities under Dodd-Frank – needed to be able to provide the Commission with access to sensitive and proprietary information without concern that such information would later be made public. Chairman Schapiro maintained that existing public disclosure exemptions under FOIA were insufficient because, among other things, they did not clearly apply to all registrants or information required to be submitted during SEC examinations; thus, the broad exemption authority was necessary, and limiting SEC authority to protect sensitive and proprietary information would render registrants reluctant to cooperate with the agency and hinder the Commission's ability to provide the type of risk-focused regulatory oversight to best protect investors.[70]

After much back and forth and debate, Congress disagreed with the SEC's position and concluded that existing FOIA exemptions provided more than sufficient protection to regulated entities from having to reveal genuinely sensitive or proprietary information in response to FOIA requests.[71] Accordingly, Congress repealed this provision of Dodd-Frank and President Obama signed

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[69] Dodd-Frank Act § 929I.

[70] *See* Letter from SEC Chairman Schapiro to the Honorable Barney Frank, Chairman, U.S. House of Representatives Committee on Financial Services dated July 30, 2010 and letter to the Honorable Darrell Issa, Ranking Member, U.S. House of Representatives Committee on Oversight and Government Reform dated August 24, 2010.

[71] *See* Letters from Darrell Issa to Chairman Mary Schapiro dated August 6 and September 15, 2010.

revised legislation in early October 2010. In the new law, Congress revoked the SEC's broad exemptive authority and clarified that any entity for which the Commission is responsible for regulating, supervising, or examining, would fall within the existing scope of FOIA and any applicable exemptions.[72]

Sharing Privileged and Other Information with Other Authorities[73]

The Dodd-Frank Act allows the SEC and other domestic and foreign law enforcement authorities to share privileged information without waiving any privilege applicable to that information. Further, the Dodd-Frank Act provides that the SEC shall not be compelled to disclose privileged information obtained from a foreign securities or law enforcement authority if the authority represents to the SEC in good faith that the information is privileged.

The Dodd-Frank Act, however, *does not* include a provision contained in the original House Bill that would have permitted a federal court to grant the SEC access to certain information and materials related to matters occurring before a grand jury otherwise subject to the grand jury secrecy rule.

[72] Senate Bill S.3717 entitled, "A bill to amend the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940 to provide for certain disclosures under section 552 of title 5, United States Code (commonly referred to as the Freedom of Information Act), and for other purposes.

[73] Dodd-Frank Act § 929K.

Personnel Changes

Two significant FINRA personnel changes occurred in 2010. First, Executive Vice President Robert Errico, Head of the Member Regulation Sales Practice Area, left FINRA at the end of March 2010. Susan Axelrod, a longtime NYSE Regulation/FINRA attorney and a senior regulatory official, was appointed to succeed Mr. Errico on July 21, 2010.

Second, on March 18, 2010, FINRA announced that Susan Merrill was resigning from her position as Executive Vice President and Chief of the Department of Enforcement to return to private practice. On October 21, 2010, FINRA stated that it had appointed J. Bradley Bennett, a partner at the law firm Baker Botts in Washington, DC, as its new Head of Enforcement, effective January 1, 2011.

Enforcement Statistics

Similar to comments made by the SEC concerning the use of statistics, FINRA officials have indicated that its Enforcement program should not be evaluated solely on the fines it levies on firms and individuals. Specifically, FINRA has emphasized that its fine levels may not be a true reflection of enforcement activity and that the number of cases filed each year, the types of misconduct under investigation and the size and financial wherewithal of the broker-dealers involved should also be taken into account.[74]

Keeping this view in mind, we note that last year FINRA filed more new disciplinary actions and resolved a greater number of formal cases than it did in 2009. Its total fines appear to have declined when compared to the prior year, but represented a large increase versus 2008. The number of cases with large fines also significantly decreased in a year-over-year comparison. The specific figures are recited below.

In 2010, FINRA filed 1,310 new disciplinary actions – an increase of 13% from the 1,158 in the prior year. FINRA also resolved 1,178 formal actions last year; in 2009, it had concluded 1,090 such cases. Last year, FINRA expelled 14 firms

[74] *See* comments of James Shorris, then-Acting Chief of Enforcement, in “FINRA Fines on Pace to Fall This Year,” Reuters (Jul. 30, 2010).

from its membership (compared to 20 in the prior year), barred 288 people (versus 383 in 2009) and suspended 428 individuals (an increase over the 363 such actions in the prior year).[75]

Through November 2010, FINRA reported that it had levied fines of $41.1 million.[76] That figure would represent a decline from the $47.6 million in fine revenue in the prior year, but a significant increase from the $25.9 million in revenue from fines FINRA garnered in 2008.[77]

In line with the decline in its overall fine levels, the number of cases with significant penalties dropped sharply in 2010 when compared to 2009, as shown in the following table:[78]

Fine Range	2008	2009	2010
$100,001 to $250,000	45	34	27
$250,001 to $500,000	10	20	13
$500,001 to $750,000	4	6	7
$750,001 to $1,000,000	2	3	3
$1,000,001 to $1,500,000	2	4	1
$1,500,001 or more	0	6	2
Total	63	73	53

Last year FINRA brought 20 fewer cases with fines over $100,000, representing a 37% decline from 2009. Significantly, in 2010, FINRA's largest cases (*i.e.*, those with penalties over $1 million), dropped by 70%.

Finally, FINRA announced that it had ordered the payment of nearly $8 million in restitution to investors through November 30, 2010.

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[75] *See* FINRA Statistics page available at: http://www.finra.org/Newsroom/Statistics/.

[76] *See* "FINRA 2010 Year in Review," available at: http://www.finra.org/Newsroom/NewsReleases/2010/P122662.

[77] *See* FINRA Annual Financial Report, available at: http://www.finra.org/web/groups/corporate/@corp/@about/@ar/documents/corporate/p122204.pdf.

[78] The information in the table was collected based on our review of FINRA's monthly "Disciplinary and Other FINRA Actions" publications and FINRA news releases issued between January and December 2008, 2009 and 2010.

FINRA Enforcement Priorities

Process Issues and Priorities Outlined in Mid-2010

At the May 2010 SIFMA Compliance & Legal Annual Seminar, James Shorris, FINRA's Executive Vice President and then-Acting Chief of the Department of Enforcement, described three "process" issues and listed a "baker's dozen" of FINRA's current enforcement priorities.[79]

Process Issues

- **Consistency of staffing models:** The Department of Enforcement now has one consistent staffing model, which includes investigators and lawyers working together on teams.

- **The use of task forces:** FINRA is using task forces, when appropriate, to investigate particular issues and will continue to do so in the future. Examples include teams looking at Regulation D offerings, municipal securities transactions, and day trading.

- **On-site investigations:** According to Mr. Shorris, FINRA's Enforcement Department effectively used a new technique, on-site enforcement investigations, in numerous auction rate securities investigations in late 2008 and early 2009. FINRA will continue to use this process more frequently in fraud and other high-profile investigations.

Priorities

- **Regulation D offerings:** FINRA is concerned about suitability and potential fraud in these kinds of offerings. In addition to the Provident Asset Management case, additional actions will be forthcoming. Firms should consult Regulatory Notice 10-22 regarding obligations to conduct a reasonable inquiry in connection with Regulation D offerings.

- **Illegal distributions of stock and related penny stock scams:** FINRA has brought several actions in this area. Previously it had issued Regulatory Notice 09-05.

- **Ponzi schemes and other frauds:** Ponzi schemes and other fraudulent misconduct raise questions for FINRA about the supervisory practices of member firms.

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[79] Notes of comments made by Mr. Shorris at the SIFMA Seminar.

- **Fixed income trading and sales:** Mr. Shorris noted that the sales of bond funds (*e.g.*, the FINRA action concerning Morgan Keegan) and markup issues are priorities.

- **Exotic products:** Mr. Shorris discussed leveraged ETFs and Regulatory Notice 09-31 with respect to this topic.

- **Stock-for-cash programs:** This issue relates to offshore companies that lend money to investors and receive securities as collateral. Concerns have been raised regarding the offshore companies' liquidation of collateral rather than the maintenance of such collateral until the end of the loan.

- **Principal protected notes:** Mr. Shorris referenced Regulatory Notice 09-73.

- **Reverse convertibles:** Mr. Shorris expressed concern regarding the qualifications of customers to purchase these products and the use of put options.

- **Equity indexed annuities ("EIAs") and variable annuities:** FINRA is looking into sales practices (including switching and exchanges) and supervision of EIAs and variable annuities.

- **Auction rate securities:** Enforcement has seemingly cleared its docket of ARS advertising and sales practice cases and is now moving on to "more serious" actions.

- **Day trading**

- **Municipal securities transactions:** FINRA is looking into underwriters who engage in swap transactions that are too costly for municipalities that are unsophisticated. Investigators are also looking at potential conflicts of interest in this area.

- **Life settlements**[80]

Additional Priorities Described in Late 2010

At the November 2010 SIFMA Compliance and Legal Society Fall Seminar, Mr. Shorris outlined two additional enforcement priorities.[81]

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[80] Interestingly, on July 22, 2010, the SEC released a staff report that recommends that life settlements be defined as securities and issued an Investor Bulletin to describe the key issues concerning life settlements and several of the risks of such investments. *See* "SEC Releases Report of the Life Settlements Task Force," July 22, 2010, available at: www.sec.gov.

- **Proprietary Trading:** FINRA is concerned about proprietary desk traders who have traded through their position or dollar limits and firms' supervisory gaps in this area.

- **Chasing Yield:** The staff at FINRA is concerned about the incentives that brokers have to obtain high payouts from sales of structured or other products to retail investors who are seeking higher yields in the current low interest rate environment.

In his December 2010 U.S. Senate testimony, FINRA Vice Chairman Stephen Luparello, described another FINRA priority:

- **High-frequency and algorithmic trading:** The staff is examining these trading activities to identify potentially manipulative trading strategies, including wash sales, frontrunning, insider trading, marking the open or close, and layering. According to Mr. Luparello, "FINRA is aggressively pursuing these types of illegal trading practices that inappropriately undermine legitimate market trading."[82]

Targeted Examination Letters

In 2009, FINRA stepped up its use of targeted examination letters, canvassing member firms on at least eight topics, ranging from hedge fund advertising and sales literature to retail municipal securities transactions to retail Forex trading.

In 2010, FINRA appears to have significantly slowed its use of this examination/investigative technique, as only four letters were posted to the Targeted Examination Letters page on FINRA's website. Perhaps, however, this is merely semantics because, as noted below, Enforcement has launched several task forces to investigate certain issues.

The first letter, which was posted in June 2010, requested that firms provide information regarding communications relating to noninvestment company exchange traded products ("ETPs"). Among other things, the request seeks copies of advertisements, sales literature and institutional sales material promoting noninvestment company exchange traded products, evidence regarding the written approval by a registered principal of advertisements and sales literature, offering documents, and firms' written supervisory procedures "concerning the production, approval and distribution of ETP communications" in effect between November 2009 and May 2010.

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81 *See* "FINRA to Bring Prop Trading Cases," Compliance Reporter, Nov. 22, 2010.

82 *See* "Testimony Before the Subcommittee on Securities, Insurance, and Investment Committee on Banking, Housing, and Urban Affairs," Dec. 8, 2010, available at: www.finra.org/Newsroom/speeches/Luparello/P1222605.

In August 2010, FINRA announced that it was conducting an examination of broker-dealers that provided Direct Market Access, Naked Access, Electronic Access or Sponsored Access (collectively referred to by the staff as "DMA") to customers during the period January 1, 2009 to August 2010. The staff sought information, data and documents regarding 10 separate requests, including a detailed description of the recipient's DMA business and operations, customer account documentation, written supervisory procedures (including those that relate to the firm's AML program), information regarding master/sub-accounts, trader log-ons, position and credit limits and copies of any risk assessments regarding DMA business undertaken by the firm.

In October 2010, FINRA began a review of firms acting as or working with placement agents in soliciting and/or obtaining business with municipalities and public pension funds. In connection with this examination, the staff sent a letter requesting seven categories of documents and information, including a list of the third parties used to solicit and/or obtain business, the services and costs of those entities, the firms' own compensation structure for their services, and copies of relevant written policies and procedures.

Also in October 2010, FINRA's Strategic Initiatives Group within the Enforcement Department began an inquiry concerning broker-dealer services involving customers of financial institutions, including federal and state-chartered banks. To commence that inquiry, the staff sent a detailed 14-item request to firms covering a more than two-year period. Among other things, FINRA sought: copies of networking and brokerage affiliate arrangements; descriptions of sales contests; cash and non-cash incentives and other promotions aimed at obtaining securities business from financial institution customers; information regarding the methods used to solicit securities business from current customers of financial institutions; a description of customer information sharing arrangements; sample copies of various disclosures; copies of advertisements and sales literature; firms' written supervisory procedures; copies of exception reports used to monitor financial institution customer solicitation activity; and internal audit procedures. FINRA also asked firms to create and produce data regarding all customer complaints and arbitrations. Significantly, the staff sought copies of certain branch office audits conducted by the firms.

FINRA Assumption of Market Surveillance and Enforcement Functions Previously Conducted by NYSE Regulation

Last June, FINRA and NYSE Euronext announced that they had completed the previously announced agreement under which FINRA assumed responsibility for performing the market surveillance and enforcement functions previously conducted by NYSE Regulation. Pursuant to the agreement, FINRA assumed regulatory functions for the New York Stock Exchange, NYSE Arca and NYSE Amex. Most of the approximately 225 staff members who performed these functions for the three NYSE Euronext exchanges were transferred to FINRA.

At the end of this Outline, we provide further information regarding this regulatory change and describe several key cases brought last year.

Access to FINRA Letters of Acceptance, Waiver and Consent and Complaints

Prior to April 2010, persons interested in obtaining copies of Letters of Acceptance, Waiver and Consent ("AWCs") and complaints described in press releases were obligated to request those documents from FINRA. Beginning on April 7, 2010, FINRA began to routinely attach copies of AWCs and complaints to its press releases.

Publication of NASDAQ Exchanges Disciplinary Decisions

NASDAQ Stock Market LLC ("NASDAQ"), NASDAQ OMX PHLX, and NASDAQ Options Market LLC ("NASDAQ Options") began publishing their disciplinary actions on their websites in 2010. FINRA carries out these disciplinary actions on behalf of the exchanges under a Regulatory Services Agreement. The disciplinary actions are available as follows:

For NASDAQ at:
http://www.nasdaqtrader.com/trader.aspx?id=ndisciplinaryactions

For NASDAQ OMX PHLX at:
http://www.nasdaqtrader.com/Micro.aspx?id=phlxdisciplinaryactions

For NASDAQ Options at:
http://www.nasdaqtrader.com/Trader.aspx?id=NOMDisciplinaryActions

Encryption of Certain Information Provided to FINRA

By way of background, FINRA Rule 8210 requires firms to produce documents, information and testimony to the staff in connection with its investigations and examinations. In recent years, the staff has often requested that information, data and documents be provided in electronic format. In certain instances, such productions contain customer personal information.

Effective December 29, 2010, Rule 8210 was amended to require that information provided to FINRA on a portable media device (including CD-ROM and DVD) must be encrypted using certain protection standards. In addition, the staff must be provided with information regarding access to the information (*e.g.*, a password) in a communication separate from the data being produced.

Cooperation with Foreign Regulators

In 2009, FINRA signed Memoranda of Understanding ("MOU") with Canada and France. In 2010, FINRA signed two more MOUs.

On June 18, 2010, FINRA and the Australian Securities and Investments Commission ("ASIC") entered into a Memorandum of Understanding to promote and support greater cooperation between the two regulators. The MOU establishes a framework for mutual assistance and the exchange of information between ASIC and FINRA. According to FINRA, the MOU will help the regulators investigate possible instances of cross-border market abuse in a timely manner, exchange information on firms under common supervision of both regulators, and allow more robust collaboration on approaches to risk-based supervision of firms. This agreement follows a similar agreement that the SEC entered into with ASIC in August 2008.

On September 20, 2010, FINRA announced that it had entered into an MOU with the United Kingdom's Financial Services Authority ("FSA") to support more robust cooperation between the two entities. According to FINRA, the MOU establishes a strong framework for enhancing the ability of the FSA and FINRA to oversee the largest securities firms and markets. The agreement will facilitate information exchanges on firms and individuals under common supervision, support collaboration on investigations and enforcement actions, and allow further sharing of regulatory techniques, including approaches to risk-based supervision of firms.

Dodd-Frank Wall Street Reform and Consumer Protection Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act mostly focuses on federal issues and federal regulatory issues and agencies. However, one interesting part of the legislation concerns the SEC's oversight of FINRA. In particular, the law requires the Comptroller General of the U.S. to submit to Congress a report evaluating the SEC's oversight of FINRA with respect to, among other topics: FINRA's corporate governance, including its identification and management of conflicts of interest; the examinations conducted by FINRA and the expertise of the examination staff; the executive compensation practices of FINRA; the cooperation and assistance provided by FINRA to state regulators; how the funding of FINRA is used to support its mission; the policies regarding the employment of former FINRA staff by member firms; and the effectiveness of FINRA's rules.[83] The first report is due by July 2012; thereafter reports are required to be submitted to Congress on a three-year cycle.

FINRA Enforcement Actions

Anti-Money Laundering ("AML")

FINRA has brought many AML cases over the last several years, including a number with significant fines. Three settlements reached in 2010, and a litigated case, are described below.

[83] Dodd-Frank Act § 964.

A. *Penson Financial Services, Inc.* (“Penson”) (Feb. 2, 2010)

1. FINRA alleged that Penson failed to establish and implement an adequate AML compliance program during the period October 1, 2003 through May 31, 2008.

2. According to FINRA, Penson’s system for detecting, reviewing, and reporting suspicious activity was inadequate. Specifically, FINRA alleged that Penson did not allocate sufficient resources to its AML compliance program, did not use appropriately risk-based criteria to generate AML exception reports, and did not regularly review penny stock deposits and liquidations.

3. FINRA alleged that in 2007, Penson committed additional resources to its AML compliance program, and, in December 2007, implemented a sophisticated automated system to assist its review of potentially suspicious activity. However, FINRA alleged that, despite these improvements, Penson failed to conduct timely investigations of potentially suspicious activity flagged by the automated system on approximately 129 occasions.

4. FINRA also alleged that Penson’s AML training program was deficient, that Penson failed to assess AML risks for certain foreign financial institution correspondent accounts, and that the firm’s written AML procedures were deficient.

5. FINRA further alleged that, between March 31, 2007 and May 31, 2008, Penson failed to report required information to INSITE accurately and failed to provide certain information to its introducing broker-dealers concerning charges required to be taken to the introducing broker-dealers’ net capital.

6. Penson consented to a censure, a fine of $450,000, and an undertaking to have all personnel within its AML compliance department complete 16 hours of training.

B. *Pinnacle Capital Markets, LLC* (“Pinnacle”) (Feb. 2, 2010)

1. FINRA alleged that between January 2006 and September 2009, Pinnacle failed to establish and implement AML procedures reasonably designed to verify the identity of customers and to detect and report suspicious activity.

2. Pinnacle operates as an on-line business and has a customer base of mostly foreign individuals or firms. FINRA alleged that, although nearly all of Pinnacle's customers reside in jurisdictions that have heightened money laundering risk, Pinnacle relied on AML procedures drafted by a third-party vendor that were not designed to allow the firm to evaluate or monitor the AML risk of its foreign customer base. For example, according to FINRA, the firm's suspicious activity review procedures contained a list of 18 red flags taken directly from a FINRA notice, most of which did not apply to Pinnacle's business model.

3. FINRA further alleged that Pinnacle's customer identification procedures were inadequate and impractical given Pinnacle's customer base and that Pinnacle failed to detect, investigate, or file suspicious activity reports on potentially suspicious activity within customer accounts.

4. One of Pinnacle's foreign financial institutional customers domiciled in Latvia had an account with Pinnacle with 55 subaccounts, some of which had additional subaccounts. According to FINRA, Pinnacle failed to obtain the required customer identification information for these subaccounts and failed to detect irregular trading patterns in these subaccounts. In March 2007, the SEC filed a complaint for injunctive relief against this foreign financial institution and certain unknown traders alleging an international on-line "pump and dump" scheme involving Pinnacle and other broker-dealers, although Pinnacle was not named as a defendant in that action.

5. Pinnacle consented to a censure and a fine of $300,000, and undertook to: (1) have its registered personnel complete three hours of AML training, and (2) hire an independent consultant to review its AML program.

C. *Department of Enforcement v. Sterne, Agee & Leach, Inc.* ("Sterne Agee") (Mar. 5, 2010)

1. In this contested matter, FINRA alleged that, between April 2002 and July 2005, Sterne Agee failed to develop and implement an adequate AML program because its systems were not sufficiently automated. FINRA also alleged that, from July 2006 to April 2007, Sterne Agee's AML program was deficient because, among other reasons, it did not have

adequate procedures for reviewing physical securities certificates, monitoring journal transfers, or identifying direct foreign financial institution accounts. FINRA further alleged that the firm failed to have written procedures to comply with enhanced due diligence requirements of the USA PATRIOT Act, failed to identify certain accounts as foreign bank accounts, and failed to implement certain customer identification procedures.

2. The Hearing Panel determined that, with respect to the Department of Enforcement's allegations that Sterne Agee's AML systems were not sufficiently automated, the Department of Enforcement failed to demonstrate that it was unreasonable for Sterne Agee to have relied on a system with a substantial manual component to fulfill its AML detection requirements. Specifically, the Hearing Panel found that Sterne Agee's system could be reasonably expected to detect and cause the reporting of suspicious activity and transactions.

3. The Hearing Panel concluded that, during the time period of the alleged violations, FINRA provided firms with little guidance on the degree of system automation required to maintain a reasonable AML program. The Hearing Panel also found that Sterne Agee's written procedures for identifying and reviewing transactions, as well as its training program, were adequate.

4. Notwithstanding the foregoing, the Hearing Panel concluded that Sterne Agee's program failed to detect and obtain certifications for foreign banks, did not have written due diligence procedures to comply with the USA PATRIOT Act, and failed to implement certain customer identification procedures for delivery versus payment accounts.

5. The Hearing Panel imposed a $40,000 fine on Sterne Agee.

D. *Brookville Capital Partners LLC, formerly known as New Castle Financial Services LLC* ("New Castle"), (Jun. 7, 2010)

1. FINRA settled a matter with New Castle in which it alleged that the firm, through its chief compliance officer and other compliance officers, principals, and registered representatives, engaged in certain violations, including:

(a) Anti-Money Laundering and related violations from October 2005 through August 21, 2008, including failing to establish and implement an adequate AML program and procedures, failing to identify, investigate, and respond to red flags in connection with suspicious account activity, failing to timely file a Suspicious Activity Report, and failing to provide AML training in 2006;

(b) improperly facilitating the distribution of approximately 20 million shares of various unregistered securities from September 2007 through March 2008;

(c) selling securities to 50 public investors in December 2007 using a private placement memorandum that failed to disclose a convicted felon's association with the issuer;

(d) operating an unregistered branch office for approximately six months in violation of the restriction on business expansion in the firm's membership agreement;

(e) at various times from June 2008 through October 2009, failing to maintain accurate books and financial records, filing inaccurate FOCUS reports, failing to maintain minimum net capital requirements on two dates, and improperly classifying and accounting for funds;

(f) engaging in improper telephone solicitations for an approximately four-month period by making materially false representations and omitting material facts in connection with the sale of securities to four potential customers and using misleading telemarketing scripts that were not approved by a registered principal; and

(g) numerous other compliance-related and supervisory violations.

2. New Castle consented to a censure, a $200,000 fine, and undertakings to retain an independent consultant to review the firm's policies, systems, and procedures and to have each of its associated persons complete 16 hours of AML

continuing education training. The firm also agreed to cooperate in any investigations of any persons in connection with past events described in the AWC, including promptly producing information and documents without the need for a Rule 8210 request.

Auction Rate Securities ("ARS")

FINRA settled two ARS cases in early 2010 and, after reportedly failing to reach an amicable resolution, filed a complaint in a third matter. These cases add to the more than a dozen actions brought by FINRA in this space to date.

A. *US Bancorp Investments, Inc.* ("US Bancorp") (Apr. 22, 2010)

1. FINRA settled a matter with US Bancorp in which it alleged that the firm engaged in certain violations relating to the sale and marketing of ARS.

2. FINRA alleged that the firm used internal marketing materials prepared by other securities firms that did not provide a balanced or adequate disclosure of risks of ARS, describing ARS as a "great place for short-term money" and a "cash alternative," but failing to disclose the liquidity risks of ARS. Other materials allegedly compared ARS yields to those of money market securities but failed to disclose the material differences between the investments, including differences in liquidity, safety and potential fluctuation of return.

3. FINRA alleged that US Bancorp failed to maintain procedures reasonably designed to ensure that the firm marketed and sold ARS in accordance with applicable laws and rules.

4. FINRA further alleged that ARS were added to US Bancorp's approved product list without first being subjected to the firm's usual due diligence process.

5. US Bancorp consented to a censure and a $275,000 fine.

6. In setting the sanction, FINRA took into account that, in September 2008, US Bancorp voluntarily offered to repurchase at par all ARS held in its customer accounts.

B. *HSBC Securities, Inc.* (“HSI”) (Apr. 22, 2010)

1. FINRA settled a matter with HSI in which it alleged that the firm engaged in certain violations relating to the sale and marketing of ARS and failed to retain certain e-mails and instant messages.

2. FINRA alleged that, between May 2006 and February 2008, HSI made negligent misrepresentations and omissions of material facts to customers concerning the safety and liquidity of ARS and used advertising and marketing materials that were not fair and balanced and did not provide a sound basis for evaluating the facts about purchasing ARS.

3. HSI also allegedly sold restricted, and therefore unsuitable, ARS to certain nonqualified customers.

4. FINRA further alleged that HSI failed to retain certain e-mails and internal instant messages and failed to maintain adequate supervisory procedures concerning its ARS sales and marketing activities and its retention of certain e-mails and instant messages. (The AWC noted that HSBC had previously been fined by the NYSE for e-mail retention issues.)

5. HSI consented to a censure, a $1.5 million fine, and an undertaking to repurchase ARS from certain current customers who had not accepted HSI’s voluntary offer to repurchase the ARS in 2008, as described below, and certain former customers.

6. In setting the sanction, FINRA took into account HSI’s voluntary remediation to customers prior to the entry of the AWC, which included HSI’s voluntary offer to repurchase ARS from its customers in 2008. As of July 2008, HSI had repurchased more than 90% of its then-current customers’ ARS holdings and, in October 2008, offered to repurchase all of the remaining ARS held in those customers’ accounts.

C. *Thomas Weisel Partners* (“Weisel”) (May 18, 2010)

1. FINRA filed a contested action against Weisel and Stephen “Henry” Brinck, Jr., the firm’s former head of fixed income

and corporate cash management, in connection with the firm’s sales of ARS.

2. FINRA alleges that Brinck faced pressure from more senior Weisel managers to raise $25 million that would be used to pay employee bonuses. Brinck purportedly sold $15.7 million of ARS from the firm’s proprietary account into the accounts of three customers whose accounts the firm managed without the customers’ approval, even though he and the firm had recommended that all corporate cash clients sell their ARS.

3. FINRA alleges that, at the time of the sales, the firm was concerned about the ARS market, which crashed weeks later.

4. FINRA further alleges that the firm made false and misleading statements to two of the customers to induce them to provide retroactive consent, made false statements to FINRA concerning the transactions, and failed to maintain and implement adequate supervisory procedures and an adequate supervisory system.

5. Weisel has repurchased the ARS from the affected customers.

6. The case is ongoing.

Branch Office Sales Practice Issues and Interaction with Regulatory Examiners

The case below generally involves typical branch office sales practice and operational issues, but also includes allegations concerning the interaction between certain individuals and NYSE Regulation examiners.

A. *Merrill Lynch, Pierce, Fenner & Smith Incorporated* (“MLPFS”) (Apr. 2010)

1. FINRA settled a matter with MLPFS in which it alleged that its staff had identified a number of sales practice and operational issues in various branch offices in connection with routine examinations conducted over a three-year period from 2005-2008.

2. FINRA also alleged that, in 2005, MLPFS, through several branch office employees and employees of an affiliate in the Office of General Counsel, made material misstatements to NYSE Regulation examiners relating to an on-site examination concerning nonregistered cold-callers by:

   (a) providing inaccurate and sometimes deceptive information in response to various exam requests, including information about the use of nonregistered cold-callers;

   (b) instructing staff that an unapproved facsimile machine be hidden or removed; and

   (c) providing an inaccurate written statement in response to requests for information during an ongoing investigation.

3. FINRA also alleged that MLPFS failed to properly supervise a registered person who held himself out as an attorney on firm stationery and business cards, even though he was not licensed by any federal or state bar.

4. MLPFS consented to a $300,000 fine.

Credit Default Swaps

Last year, our Outline reported on a FINRA case involving a firm's alleged attempt to influence other interdealer brokerage firms in setting customers' brokerage rates in the wholesale credit default swaps ("CDS") market. The below case is another in this area; in announcing the case against Phoenix Derivatives Group, LLC and certain of its employees, FINRA stated that it continues to investigate matters in this space. Indeed, a few months later FINRA brought a second action.

A. *Phoenix Derivatives Group, LLC* ("Phoenix"), *Marcos Moises Brodsky, John Richard Lines, and Wesley Wang* (June 24, 2010)

   1. FINRA settled a matter with Phoenix in which it alleged that the firm, acting through Brodsky, Lines, and Wang, Phoenix desk coheads and managing directors of the firm, improperly attempted to influence other interdealer brokerage firms in setting customers' brokerage rates in the wholesale CDS market.

2. Interdealer brokerage firms receive fees for matching counterparties in wholesale CDS transactions. FINRA alleged that Brodsky, Lines, and Wang repeatedly communicated with other interdealer brokers in connection with setting brokerage fees. These discussions typically took place after dealers' customers proposed reductions in the brokerage rates to a number of interdealer brokers. Brodsky, Lines, and Wang discussed, among other topics, actual or proposed reactions to such reductions, including the preparation of similar responses to customers.

3. FINRA further alleged that this conduct violated its rules because the respondents attempted to influence improperly another member or person associated with a member.

4. FINRA also alleged that Phoenix's supervisory systems, including its written supervisory procedures, were not reasonably designed to detect such inappropriate activity. In particular, FINRA alleged that the procedures did not include supervisory reviews for anticompetitive activity or more generally for regulatory compliance.

5. The Firm also allegedly failed to conduct supervisory reviews of electronic communications and did not maintain certain instant messages for two periods comprising approximately 10 months in 2005 and 2006.

6. FINRA further alleged that Phoenix's productions of e-mail communications during the course of FINRA's investigation were untimely and incomplete.

7. Phoenix consented to a censure and a $3 million fine, of which $900,000 was joint and several with the individual respondents ($350,000 with Brodsky, $100,000 with Lines, and $450,000 with Wang). Brodsky, Wang, and Lines also consented to suspensions from acting in all capacities of one month, two months, and three months, respectively.

8. FINRA contemporaneously settled cases with five CDS brokers at other interdealer firms: Thomas J. Lewis and Matthew A. Somers, formerly of Chapdelaine Corporate Securities & Co.; John P. Thompkins, formerly of CreditTrade (US) Corp.; Michael B. Jessop, formerly of Tullett Liberty Inc.; and Eric Ridder, formerly of Creditex Group, Inc. The assessed fines equaled $1.3 million, and

the brokers were suspended from the industry for various periods.

B. *Department of Market Regulation v. GFI Securities LLC, Michael Scott Babcock, Stephen Falletta, Donald Patrick Fewer, Stephen Louis Scotto, and Lainee Dale Steinberg* (Sep. 27, 2010)

1. FINRA's Department of Market Regulation filed a complaint against GFI Securities LLC and five of its registered representatives on September 27, 2010 alleging that the respondents colluded to frustrate customers' efforts to gain competitive rates on certain credit default swap transactions.

2. According to FINRA, in 2005 and 2006, GFI Securities LLC was one of only a few firms that brokered interdealer CDS transactions. The market was opaque and illiquid, which allowed those firms to charge high commission rates for their services. As interdealer CDS transactions increased in volume, the CDS market became more liquid, causing CDS customers, which typically were large investment and commercial banks, to seek lower commission rates for CDS transactions.

3. The complaint alleges that the individual respondents and their counterparts at other firms colluded to prevent customers from obtaining lower commission rates for CDS transactions by resisting fee schedules proposed by clients and coordinating responses to fee proposals, thus knowingly engaging in anticompetitive conduct to their customers' disadvantage. FINRA alleges that this conduct violated rules prohibiting such coordinated activity and requiring the respondents to comply with just and equitable principles of trade. FINRA further alleges that this conduct violated the antifraud provisions because the respondents engaged in a scheme to defraud, made material misstatements, and failed to make material disclosures to customers.

4. FINRA alleges that those respondents who had supervisory responsibilities knew or ignored red flags concerning the collusive behavior and that the firm maintained inadequate written supervisory procedures. According to the complaint, GFI failed to review Bloomberg messages until at least mid-2006, failed to document such reviews until at least August 2006, and failed to document supervisory reviews of other instant messages.

5. FINRA seeks fines, disgorgement, and restitution.

Customer Confidential Information

FINRA and its member firms have been keenly focused on protecting confidential customer information. In the matter below, FINRA apparently took into account a number of positive steps taken by the firm after it learned that a hacker had broken into its systems.

A. *D.A. Davidson & Co.* ("D.A. Davidson") (Apr. 12, 2010)

1. FINRA settled a matter with D.A. Davidson in which it alleged that the firm failed to employ adequate safeguards to protect confidential customer information against hackers.

2. The firm maintained its customer records, including account numbers, social security numbers, names, addresses, dates of birth, and other confidential information, on an unprotected web server with a constant internet connection.

3. On December 25 and 26, 2007, an unidentified hacker downloaded confidential information concerning approximately 192,000 customers.

4. FINRA alleged that the database was not encrypted and that the firm never changed the default password for the database. The firm also allegedly failed to review the web server logs, which showed evidence of the system breach.

5. D.A. Davidson learned of the breach when it received an e-mail from the hacker threatening to blackmail the firm. Upon receipt of the threat, D.A. Davidson took remedial measures by disabling the website, reporting the incident to law enforcement officials, and assisting them in identifying the hackers. The firm took additional remedial steps, including: hiring an outside consultant to advise on electronic security, removing sensitive customer information from the database, adding a firewall, deploying additional intrusion prevention software, and installing a repository for server logs and procedures for review of the logs.

6. D.A. Davidson consented to a censure and a $375,000 fine.

7. In setting the sanction, FINRA credited D.A. Davidson for its remedial measures and its significant cooperation with criminal authorities. In addition to the remedial steps outlined above, the firm also: (i) issued a press release about the incident, (ii) provided written notice to customers and established call centers to respond to customer inquiries, (iii) offered a credit-monitoring service to affected customers for two years at a cost to the firm of $1.3 million, and (iv) resolved a class action litigation with affected customers, which included providing loss reimbursement for potential victims of the hacking of up to an aggregate of $1 million. FINRA also considered that, as of the date of the settlement, no customer had suffered any instance of identity theft or other actual damages.

Day Trading

Last year FINRA brought a case involving day trading and SEC Regulation T. This case appears to coincide with FINRA's determination to make day trading an enforcement priority.

A. *Scottrade, Inc.* (Feb. 8, 2010)

1. FINRA settled a case with Scottrade related to customer day trading activities and cash accounts.

2. NASD Conduct Rule 2520 governs day trading margin rules and defines "day trading" as buying and selling, or vice versa, the same security in a day in a margin account. A "pattern" day-trader is a trader who executes four or more day trades within five business days.

3. FINRA alleged that, between February 2006 and October 2007, Scottrade allowed customers who were pattern day traders to day trade in margin accounts in which the equity was less than $25,000, in violation of Rule 2520. FINRA alleged that the firm allowed pattern day traders to execute 171,190 day trades in 11,708 margin accounts that did not meet the $25,000 minimum.

4. Scottrade monitored the accounts of pattern day-trader customers and sent written notification to customers whose accounts fell below $25,000. FINRA alleged, however, that the firm did not adequately restrict the trading of those

customers if the account balance was not properly restored to the $25,000 level.

5. FINRA also alleged that, between February 2006 and January 2007, Scottrade did not obtain payment from customers or cancel or liquidate transactions in 65 instances when a customer did not have sufficient funds in a cash account to meet the costs of the transactions. Scottrade's practice in such situations was to send the customer a sellout letter on the date payment for the transaction was due, which instructed the customer to pay Scottrade within 2 business days. As such, the customer was allowed more days to make payment than permitted under SEC Regulation T.

6. Scottrade consented to a censure and $200,000 fine.

E-mail Retention

The case below is yet another example of FINRA's enforcement efforts in the e-mail retention arena. Of note, the settling firm was also criticized for failing to timely report its deficiencies to FINRA.

A. *Piper Jaffray & Co.* ("Piper Jaffray") (May 24, 2010)

1. FINRA settled a case against Piper Jaffray in which it alleged that the firm failed to retain millions of e-mails between November 2002 and December 2008.

2. FINRA alleged that, due to several operational failures, Piper Jaffray did not retain approximately 4.3 million e-mails. This allegedly affected the firm's ability to comply with e-mail requests from FINRA and possibly other regulatory and civil litigation requests.

3. FINRA also alleged that, although the firm's compliance and IT departments were aware of the e-mail issues as early as April 2003, Piper Jaffray did not report the deficiencies to FINRA until FINRA noted an e-mail was missing in a separate inquiry in 2007. Piper Jaffray informed FINRA of additional e-mail preservation issues in 2008 during the course of FINRA's inquiry into the e-mail retention issues.

4. Piper Jaffray also allegedly committed a number of supervisory violations, including:

   (a) failure to design systems and procedures reasonably designed to detect e-mail retention deficiencies;

   (b) failure to review and supervise electronic communications; and

   (c) failure to ensure that it promptly reported violations of the securities laws, regulations, and rules.

5. Piper Jaffray had been disciplined previously in connection with e-mail preservation issues. In 2002, it settled cases with the NYSE, NASD and SEC, in which it consented to a censure, a $1,650,000 fine, and an undertaking to certify that it had systems and procedures in place with respect to the retention of electronic communications.

6. In connection with the case settled in 2010, Piper Jaffray submitted a Statement of Corrective Action with the Letter of Acceptance, Waiver and Consent, which stated that the firm had made changes to its archival process and other procedures and had retained a third-party consultant in 2009 to perform an audit of the firm's e-mail retention systems and procedures. The Statement noted that the consultant had determined that the firm was in compliance with its internal policies and FINRA's rules and regulations.

7. Piper Jaffray consented to a censure and a $700,000 fine.

Error Account

In the case below, FINRA took action in a matter relating to a firm's use of its error account.

A. *Lazard Capital Markets LLC* ("Lazard") (Jun. 2, 2010)

   1. FINRA settled a matter against Lazard involving alleged improper use of the firm's error account to effect price adjustments for trades for its largest institutional client (the "Advisor") during the period from January 2003 to December 2004.

2. Lazard executed approximately 2,200 equity orders during the period for the Advisor, the majority of which were "not held" orders, which gave Lazard time and price discretion to get the best possible execution of the orders. FINRA alleged that Lazard adjusted the price of 498 not held orders in favor of the Advisor, and the price adjustments, which totaled over $1.3 million, were made in the firm's error account.

3. According to FINRA, Lazard knew or should have known that the entries in its error account were price adjustments and not bona fide errors. Price adjustments for the Advisor during the relevant period accounted for 66% of the total amount in the error account, even though the Advisor accounted for only 7.4% of the firm's net commissions.

4. FINRA also alleged that some of Lazard's communications to the Advisor via the Financial Information Exchange Protocol ("FIX") system contained inaccurate information about prices obtained for the Advisor and that Lazard failed to maintain the FIX communications as required by books and records rules. FINRA further alleged that Lazard failed to maintain accurate books and records because they contained error account entries for transactions that were not bona fide errors.

5. Finally, FINRA alleged that Lazard repeatedly and regularly failed to supervise its error account activity and took no steps to terminate the improper use of an error account, even though the volume and dollar amount were substantial.

6. Lazard consented to the imposition of a censure and a $550,000 fine.

Financial Reporting

Last year FINRA brought an action against a clearing firm relating to a financial reporting issue.

A. *Merrill Lynch Professional Clearing Corp.* ("MLPCC") (Apr. 13, 2010)

1. FINRA settled a matter with MLPCC in which it alleged that the firm, on 78 occasions between 2000 and 2008, submitted inaccurate Form R-1 reports to the New York

Stock Exchange (“NYSE”) concerning the total of all debit balances in securities margin accounts.

2. Member firms of the NYSE were required to report monthly to the NYSE the total of all debit balances in cash and margin accounts. The total “margin debt” was made publicly available and used by market analysts and financial news publications.

3. In April 2008, the firm discovered that it had overstated margin debits on its monthly reports for the previous eight years. The problem occurred when the firm began to erroneously include debits that did not truly reflect margin financing, but instead were attributable to a system of accounting for a particular product called the Enhanced Leverage Product (“ELP”). Clients in ELP self-financed their positions by entering into a stock borrow arrangement with an affiliated entity.

4. MLPCC conducted an analysis and submitted revised monthly reports; approximately 82% of the reports that had been submitted during the eight-year period were inaccurate. For example, amounts in the revised reports for 2006 ranged from 69% to 86% lower than the erroneous amounts originally submitted by the firm. From June 2004 to February 2008, the amounts overstated on a monthly basis ranged from $1.1 billion to $14.6 billion.

5. FINRA alleged that MLPCC did not maintain appropriate procedures of supervision and control, and failed to establish a separate system of follow-up and review concerning the regulatory reporting requirement, causing the firm’s failure to detect that it was overstating margin debit balances on the Form R-1 reports. The firm failed to modify its systems or procedures so that the ELP balances could be identified or excluded from the reports.

6. MLPCC consented to a censure and a fine of $400,000.

Form U-4 Amendments

As an outgrowth of the SEC’s action against Goldman Sachs, FINRA brought a case against the firm involving its Form U-4 amendment protocols.

A. *Goldman, Sachs & Co.* ("Goldman") (Nov. 9, 2010)

1. FINRA settled a matter with Goldman Sachs in which it alleged that between November 2009 and May 2010, the firm failed to update Forms U-4 for two employees who received written notices from the SEC that they were the subject of investigations ("Wells notices"), and the firm failed to have adequate supervisory procedures and systems relating to the filing of Form U-4 amendments.

2. Goldman failed to report a Wells notice issued by the SEC to Fabrice Tourre, a trader who was being investigated by the Commission in connection with an offering of synthetic collateralized debt obligations called ABACUS 2007-ACI. Tourre's counsel received the Wells notice on September 28, 2009 and immediately informed Goldman's Legal Department. Despite the requirement that Form U-4 be amended within thirty days of such notice, Goldman did not amend Tourre's U-4 until May 3, 2010, after the SEC had filed a complaint against Goldman and Tourre.[84] When the firm learned of Tourre's Wells notice, it treated this event as confidential and limited circulation of this information to certain senior staff and attorneys. Goldman did not share the information with the Registrations Group within the firm's Global Compliance Division, which handles the filing of Form U-4 amendments.

3. In addition, an unidentified Goldman employee also received a written Wells notice. Although Goldman's Legal Department was promptly notified of the action, Goldman did not file an amended Form U-4 within the required 30-day period.

4. FINRA alleged that Goldman failed to have adequate supervisory procedures and systems in place to ensure that the Registrations Group received notice of reportable events. Moreover, FINRA alleged that Goldman's written supervisory procedures and divisional supervisory manuals and policies were inadequate because they failed to specifically mention Wells notices or advise that disclosure may be necessary due to a regulatory investigation.

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[84] A summary of the SEC's case against Goldman and Tourre appears in the SEC section of this Outline.

5. Goldman Sachs consented to a censure, a fine of $650,000, and an undertaking to review its supervisory procedures and systems concerning the submission of Form U-4 amendments and certify that it had made any necessary revisions.

6. Interestingly, in September 2010 the UK Financial Services Authority ("FSA") fined Goldman Sachs International £17.5 million for breaching certain FSA Principles. The fine related to the firm's failure to have in place adequate systems and controls to comply with UK regulatory reporting requirements. Specifically, the firm allegedly failed to notify the FSA of matters relating to the SEC's CDO investigation.[85]

High Frequency Trading

Over the last year, regulators have repeatedly expressed concerns about the market impact of high frequency trading. In 2010, this issue became an enforcement priority and, in September, FINRA brought a significant case in this area.

A. *Trillium Brokerage Services, LLC* ("Trillium") (Sep. 13, 2010)

1. FINRA settled a matter with Trillium in which it alleged that, between November 2006 and January 2007, nine proprietary traders at Trillium engaged in an illicit high frequency trading strategy in which they entered numerous, often large, layered, non-bona fide orders in NASDAQ securities, to intentionally create the false appearance of substantial buying or selling pressure in specific stocks.

2. After placing a buy limit order, a trader placed non-bona fide sell orders at prices outside of the NASDAQ best bid or offer. The perceived buying or selling pressure created by the large, non-bona fide orders induced unsuspecting market participants to enter orders that were then executed against the trader's original limit order. Within seconds after the Trillium limit orders were filled, the traders immediately canceled the non-bona fide orders. The scheme allegedly

[85] *See* "FSA Fines Goldman Sachs International £17.5 Million For Weaknesses In Controls Resulting In Failure To Provide FSA With Appropriate Information," (Sep. 9, 2010) available at: http://www.fsa.gov.uk/pages/Library/Communication/PR/2010/141.shtml.

occurred using sell limit orders and layered non-bona fide purchase orders as well.

3. As a result of this strategy, Trillium traders received prices that were better than prices that would have been available to them on at least 46,152 occasions. These trades yielded profits of approximately $575,000, of which Trillium retained approximately $173,000.

4. FINRA further alleged that Trillium, through its Director of Trading and Chief Compliance Officer, failed to have adequate supervisory systems in place to prevent and detect manipulative trading strategies. For example, Trillium did not reasonably review all order activity and did not implement an order monitoring system until July 2007.

5. Trillium consented to a censure and a fine of $1 million. Trillium was also required to disgorge $173,000 in profits.

6. FINRA settled with the nine traders, as well as the Director of Trading and the Chief Compliance Officer. The 11 individuals were fined a total of $802,500 (with fines ranging from $12,500 to $220,000), ordered to disgorge approximately $290,000, and suspended for periods ranging from six months to two years.

Market Manipulation

In 2010, FINRA brought the market manipulation case described below.

A. *Newbridge Securities Corporation* (“Newbridge”) (Jul. 30, 2010)

1. FINRA settled a matter with Newbridge in which it alleged that between 2003 and 2008, the firm violated various securities laws and rules involving market manipulation, sales of unregistered securities, anti-money laundering, supervision, and disclosure. According to FINRA, the violations resulted from customers’ extensive transactions in large numbers of low-priced securities.

2. FINRA alleged that, between February 2004 and August 2004, Newbridge permitted control persons of Global Triad, Inc. (“GTRD”) to conduct manipulative trading in the stock of GTRD. A group of control persons and promoters of the

company allegedly used their Newbridge accounts to execute 20 prearranged, agency cross and/or wash transactions that were intended to generate volume and support or increase the price of the stock.

3. FINRA alleged that during various periods in 2004 and 2005, Newbridge permitted certain control persons or promoters to sell three unregistered securities when no exemption from registration was available. FINRA alleged that Newbridge failed to adequately supervise the registered representatives who participated in sales of unregistered securities and manipulative trading by: (i) failing to ascertain whether the securities were registered, how they were obtained, or whether any exemption from registration applied; and (2) failing to implement adequate systems or controls to enforce its policies and to detect improper cross, wash, and other manipulative trading.

4. FINRA alleged that Newbridge failed to comply with the Bank Secrecy Act, in that it failed to follow its AML procedures, which required the firm to investigate red flags indicating suspicious activity, and to investigate and take appropriate steps, including limiting account activity, contacting a government agency or filing SARs.

5. FINRA also alleged that the firm failed to timely report customer complaints, failed to file Forms U4 or U5 to report disclosable events, and failed to timely amend a Form U4 to report a disclosable event.

6. Newbridge consented to a censure, a $600,000 fine, and a prohibition from penny stock trading and market making in proprietary and customer accounts for a period of one year. Newbridge was also required to hire a consultant to review the firm's systems related to the filing of Forms U4 and U5, disclosure events, and customer complaints.

7. Newbridge's President and Chief Executive Officer also consented to attending eight hours of anti-money laundering training.

Misappropriation

Not surprisingly, FINRA, as well as the criminal authorities, move aggressively in cases of alleged thefts from customers. In the case below, FINRA sanctioned a

firm for allegedly failing to respond to several red flags regarding a broker's activities.

B. *Citigroup Global Markets, Inc.* ("CGMI") (May 26, 2010)

1. FINRA settled a case against CGMI in which it alleged that, between September 2004 and October 2006, CGMI failed to adequately supervise a registered representative, Mark Andrew Singer, who assisted two firm customers, "Customer B" and "Customer S," in allegedly misappropriating approximately $60 million in cemetery trust funds.

2. After the scheme was discovered, Singer, Customer S, and others unrelated to CGMI were criminally charged in various states with an apparent scheme to misappropriate cemetery trust funds and improperly transferring some of those funds to various third parties.

3. Prior to his CGMI employment, Singer's clients at another broker-dealer included Customer B, who owned cemeteries in Michigan. Singer opened trust accounts for the cemeteries and other entities controlled by Customer B, including Summerfield LLC. The funds in the Summerfield account, which FINRA alleged belonged to the cemetery trusts, were invested in a hedge fund.

4. In August 2004, Customer C, another Singer customer, purchased the cemeteries from Customer B, allegedly using the cemeteries' trust funds to do so. Among other things, FINRA alleged that Customer S used the hedge fund investment as a part of the collateral for a $24 million personal line of credit from Citigroup Private Bank.

5. When CGMI hired Singer in September 2004, Customer B transferred his assets, including the cemeteries and Summerfield, to CGMI, and Customer S opened accounts for the cemeteries and Summerfield with Singer. According to FINRA, the accounts opened by Singer on behalf of Customers B, S and others were thereafter used as conduits for improper transfers of cemetery trust funds to various third parties.

6. FINRA alleges that the firm failed to respond adequately to the following red flags:

(a) Singer's prior firm informed CGMI that it had stopped doing business with Customer B because of concerns regarding the movement of funds in his accounts. Although CGMI added Customer B, Summerfield, and the cemeteries to an internal alert system and examined some transactions, FINRA alleged that CGMI's follow-up to the information was inadequate.

(b) Shortly after Singer joined CGMI, numerous rapid transfers of trust funds occurred, which generated alerts from the CGMI system. CGMI conducted a review of these movements and related issues and decided to terminate its relationship with Customer S in February 2005 solely because it concluded that he may have engaged in some unethical self-dealing. However, FINRA alleged that CGMI did not memorialize its decision and failed to ensure that it was carried out. As such, the scheme went undetected until at least October 2006.

(c) Finally, FINRA alleged that CGMI received a letter from a third party that alleged that Singer had improperly handled the cemetery trust accounts, but CGMI failed to conduct a sufficient inquiry into the allegations.

7. CGMI agreed to a censure, to pay a $750,000 fine, and to disgorge $750,000 in commissions to be paid to the cemetery trusts as partial restitution.

8. FINRA settled a separate disciplinary action against Singer in 2009 for failing to cooperate with its investigation. A criminal case against Singer in Tennessee resulted in a mistrial, and criminal charges against him in Indiana are still pending.

Mortgage-Backed Securities

Since late 2008, regulators have devoted a significant amount of resources to investigating various securitized products. The case below demonstrates FINRA's focus in this area.

A. *Deutsche Bank Securities Inc.* (“DBSI”) (Jul. 21, 2010)

1. FINRA settled a matter with DBSI in which it alleged that the firm negligently misrepresented or under-reported data reflecting the percentage of delinquent loans that were included in the loan pool for residential mortgage-backed securities (“RMBS”) that DBSI underwrote and sold to institutional investors in 2006.

2. FINRA alleged that, during 2006, DBSI under-reported in prospectus supplements the percentage of delinquent loans included in the loan pools for six RMBS, worth $2.2 billion, that DBSI underwrote and sold. The method used to calculate the percentage of delinquent loans differed from the calculation method that was described in the prospectus supplements. The percentage of reported delinquencies was significantly lower than it would have been had it been computed under the method described in the prospectus supplement.

3. FINRA also alleged that DBSI under-reported on its website the historical delinquency rates for 16 subprime RMBS that the firm underwrote and sold to institutional investors in 2007. The information appeared in the firm’s required Regulation AB disclosures reflecting data concerning prior securitizations that included similar mortgage loans (“static pool” information).

4. DBSI included in prospectus supplements a reference to the firm’s Regulation AB website for static pool information. DBSI’s outside vendor was under-reporting the delinquency rates on the website due to errors made in tracking the data. DBSI became aware of the errors and sent corrected data to the vendor for 13 of the RMBS, but it was not posted. DBSI was unable to determine the extent of the under-reporting for the remaining three RMBS. No indication was posted on the website to inform customers that the information for the 16 RMBS was inaccurate.

5. FINRA further alleged that DBSI failed to have adequate supervisory systems in place to confirm that it reported accurate static pool information.

6. DBSI consented to a censure and a fine of $7.5 million.

Mutual Fund Operations

In prior years, FINRA focused on mutual fund sales practice cases. The below action is an example of a case in the mutual fund operational space.

A. *AXA Advisors, LLC* (“AXA”) (Jan. 2010)

1. FINRA settled a matter with AXA in which it alleged that AXA failed to keep accurate and complete records relating to its direct mutual fund business.

2. Between 2001 through 2006, AXA created a trade blotter for its direct mutual fund business by matching the data feeds containing records from networking vendors with client information contained in AXA’s systems. Records from networking vendors that did not match AXA’s information were not reflected on AXA’s trade blotter or processed through AXA’s internal compliance and supervisory systems.

3. While the unmatched information varied over the years, FINRA alleged that 9% of all direct mutual fund transactions were not reported on AXA’s books and records. Most of the transactions that did not appear on the trade blotter were not large.

4. FINRA also alleged that no AXA employee was responsible for monitoring the level of unmatched records and that AXA did not have written procedures that addressed the supervision of the matching process.

5. As early as 2000, AXA was aware of the issue and took certain steps to address it. AXA notified FINRA of its recordkeeping deficiencies in 2007, undertook an internal review, and reported its conclusions to FINRA. As part of the review, AXA hired an independent consultant to conduct a retrospective analysis of the transactions that had not been reflected on the trade blotter. The review concluded that the overall level of harm to AXA’s clients was small.

6. During its 2007 review, AXA discovered that certain mutual fund families did not appear on its networking vendors’ data feeds. The excluded records were not of a sufficient volume to materially change AXA’s analysis.

7. AXA consented to a censure and $250,000 fine.

8. In setting the sanction, FINRA took into account the work done by AXA and the independent consultant.

Regulation SHO and Short Sales

Continuing its efforts in the Reg. SHO short selling area, FINRA announced two settlements in May. The sanction in a litigated case was also affirmed by FINRA's National Adjudicatory Council.

A. *Deutsche Bank Securities, Inc.* (May 13, 2010)

1. FINRA settled a matter with Deutsche Bank in which it primarily alleged that the firm violated rules relating to short sale locates, marking, close-outs, and buy-ins.

2. FINRA stated that, between January 3, 2005 and September 30, 2009, the firm implemented customer Direct Market Access ("DMA") trading systems that were designed to block the execution of short sale orders unless a locate had been obtained and documented. However, the firm allegedly disabled its system in certain instances, resulting in an unquantified number of short sales without locates. FINRA further alleged that Deutsche Bank's "Easy To Borrow" list was not properly constructed between January 2005 and approximately April 2007 because it sometimes included hard-to-borrow securities.

3. Between January 3, 2005 and approximately December 2008, the firm allegedly marked client orders long without reasonable grounds and used borrowed shares to make delivery or had fails to deliver. For example, FINRA alleged that, during a sample month of July 2007, Deutsche Bank impermissibly utilized borrowed shares to settle approximately 2,500 long sales (out of approximately six million long sale transactions).

4. Between January 3, 2005 and December 30, 2007, the firm allegedly failed to monitor for Archipelago Exchange threshold securities and thus failed to timely close out fails to deliver in such securities. FINRA further alleged that, between January 2005 and approximately December 2008, the firm did not monitor, effect buy-ins, or obtain a valid

extension for long sales in certain prime brokerage accounts in which Deutsche Bank had not obtained timely possession of the securities after settlement.

5. Finally, FINRA alleged that the firm failed to maintain proper books and records, submitted inaccurate blue sheets, and failed to supervise reasonably with respect to the activities described above.

6. Deutsche Bank consented to a censure and a $575,000 fine.

7. In setting the sanction, FINRA considered that the firm implemented numerous information technology enhancements that minimize the need to lift the automated block and improve the firm's Easy-to-Borrow list process.

B. *National Financial Services LLC* ("NFS") (May 13, 2010)

1. FINRA settled a matter with NFS in which it primarily alleged that the firm failed to obtain locates for certain short sales.

2. FINRA alleged that, between June 2005 and approximately August 2008, NFS customers traded through direct market access trading systems that were designed to block the execution of short sale orders without locates. However, the firm utilized a separate manual request and approval process for approximately 12 prime brokerage customers that did not block an unquantified number of short sale orders that did not have locates.

3. According to FINRA, requests for, and approvals of, the locates for these prime brokerage clients were transmitted via e-mail with NFS prime brokerage personnel and were not required to be entered into NFS's stock loan system at the time of approval. FINRA further alleged that, because the e-mailed locates were not documented in a central location, the firm could not accurately assess its remaining availability in each security during a trading day.

4. FINRA alleged that the firm represented that it had terminated these practices effective February 1, 2008, but that the practices continued thereafter with respect to at least one prime brokerage client.

5. The firm allegedly failed to perform a meaningful post-trade-date review of short sale orders to identify orders executed without a valid locate.

6. Between January 2005 and December 2006, NFS allegedly failed to maintain accurate books and records in that locate request records for approximately 100,000 locates were inaccurately maintained due to a programming error.

7. Finally, FINRA alleged that the firm failed to have an adequate supervisory system for confirming reasonable compliance with the locate requirement.

8. NFS consented to a censure and a $350,000 fine.

C. *Department of Enforcement v. Legacy Trading Co., LLC* ("Legacy") *and Mark Uselton* (Oct. 8, 2010)

1. FINRA brought a contested action against Legacy and Mark Uselton, Legacy's President, CEO, and Chief Compliance Officer, in which it alleged that the respondents violated rules concerning locate and delivery requirements for short sales and failed to cooperate with FINRA's investigation. The Hearing Panel issued a decision on March 12, 2009.

2. The Hearing Panel found that between May 2004 and August 2005, Legacy failed to satisfy the locate and delivery requirements in connection with 2,192 short sales, including 1,216 trades for which Uselton was responsible.

3. In addition, the Hearing Panel determined that the respondents failed to cooperate with FINRA's investigation of their sales practices by failing to respond timely, or at all, to certain of FINRA's requests for information. The Hearing Panel also found that Legacy misrepresented certain facts.

4. Finally, the Hearing Panel found that Legacy failed to maintain certain required records and had inadequate supervisory procedures related to short sales and maintenance of books and records and that Uselton failed to update timely his Form U-4 to reflect FINRA's investigation.

5. According to the Hearing Panel, Uselton failed to provide requested documents to FINRA and gave false testimony

during on-the-record interviews before asserting his Fifth Amendment right not to incriminate himself.

6. As a result of the respondents' failure to cooperate, Legacy was expelled from FINRA membership, and Uselton was barred from associating with any member firm.[86] In addition, the respondents were fined jointly and severally $907,035 for the short sale violations (representing a $100,000 fine in addition to Legacy's profits from the short sale transactions), $50,000 for the books and records violations, and $50,000 for the supervisory violations. Uselton was also fined $2,500 for the Form U-4 violation.

7. The respondents appealed the ruling to FINRA's National Adjudicatory Council, which affirmed the Hearing Panel's findings and sanctions.

Research Report Disclosures

Since the 2003 global research settlement and the subsequent adoption of specific rules to be followed in the publication of research reports, regulators have brought a number of cases regarding research report disclosures. Below is yet another example of this trend.

A. *Morgan Stanley & Co. Incorporated* ("Morgan Stanley") (Aug. 10, 2010)

1. FINRA settled a matter with Morgan Stanley in which it alleged that the firm failed to comply with certain requirements in connection with its issuance of equity research reports.

2. FINRA alleged that between April 2006 and June 2010, Morgan Stanley issued equity research reports that failed to disclose certain required information.

   (a) FINRA alleged that certain reports failed to disclose that the analyst who authored the report (or a family member) owned shares of the subject company's stock.

[86] Legacy ceased to be a member of FINRA in 2008. However, FINRA retained jurisdiction over the firm because the complaint was filed while Legacy was a member firm and related to conduct that occurred while Legacy was still a FINRA member.

(b) FINRA also alleged that the reports contained inaccurate disclosures regarding possible conflicts of interest between Morgan Stanley and the subject company, including: whether the firm managed or co-managed a public offering for the subject company, received or expected to receive compensation for investment banking services provided to the subject company, received compensation for non-investment banking products or services provided to the subject company, or acted as a market maker in the subject company's securities.

(c) FINRA also alleged that the firm failed to include mandatory price charts and disclosures regarding the firm's valuation method for target prices in certain equity research reports.

(d) According to FINRA, these inaccuracies caused approximately 6,836 deficient disclosures in about 6,632 equity research reports and 84 public appearances by research analysts.

3. FINRA further alleged that Morgan Stanley did not disclose in approximately 127,600 monthly account statements sent to customers from August 2007 to February 2008 that independent, third-party research was available from the firm. The requirement to provide customers with this notification was part of a 2003 global settlement agreement concerning research analysts entered into by the SEC, Morgan Stanley, and certain other broker-dealers.

4. According to FINRA, Morgan Stanley had inadequate supervisory systems and procedures to detect and prevent the violations noted above; in particular, the firm had inadequate systems in place to provide reasonable assurance that: (i) outside vendors and firm employees were fulfilling their responsibilities for processing data required for research disclosures, and (ii) research analysts were making appropriate disclosures in connection with certain equity research reports and public appearances. FINRA alleged that between April 2006 and March 2008, the firm did not respond to certain indications that some equity research report disclosures were not correct.

5. In determining the appropriate sanctions in this matter, FINRA considered Morgan Stanley's self-review and self-reporting of some of its disclosure violations and remedial steps taken by the firm, as well as a prior FINRA settlement in 2005 that found the firm violated FINRA's research analyst disclosure rules.

6. Morgan Stanley consented to a censure and an $800,000 fine. The firm also consented to undertakings requiring it to: (i) certify that it had fully implemented certain enhanced processes, procedures, and systems; and (ii) continue to monitor its research reports and public appearances by research analysts and provide written certifications to FINRA every six months, for a period of two years following the effective date of the sanctions, stating that the firm had complied with certain research disclosure requirements.

Retail Sales of CMOs, Reverse Convertible Notes and Certificates of Deposit

Regulators have publicly stated that they are concerned about the so-called "retailization" of exotic products. Last year FINRA also brought a case regarding disclosures made in connection with CD auctions. Below are several cases in these areas.

A. *H&R Block Financial Advisors, Inc.* ("H&R Block") *and Andrew MacGill* (Feb. 16, 2010)

1. FINRA settled a matter with H&R Block in which it alleged that the firm failed to establish adequate supervisory systems and written procedures for supervising retail sales of reverse convertible notes ("RCNs").

2. An RCN is a structured product that consists of a high-yield, short-term note of an issuer and a put option that is linked to the performance of a "linked" asset. Upon maturity of an RCN, the investor receives either the full principal of his investment plus interest, or a predetermined number of shares of the linked asset. In addition to the ordinary fixed income product risks, RCNs carry the additional risk of the underlying linked asset, which, depending on performance, could be worth less than the principal investment.

3. FINRA alleged that, between January 2004 and December 2007, H&R Block sold RCNs without having in place an adequate surveillance system to monitor for

overconcentration in RCNs. As a result, the firm failed to detect and address such overconcentrations in customer accounts.

4. FINRA alleged that H&R Block failed to provide guidance to its supervising managers to enable them to effectively assess suitability related to RCNs.

5. FINRA alleged that, between May 2007 and November 2007, H&R Block broker Andrew MacGill made unsuitable sales of RCNs to a retired couple who invested nearly 40 percent of their total liquid net worth in nine RCNs.

6. H&R Block consented to a censure and to pay a $200,000 fine and $75,000 in restitution.

7. MacGill consented to a fine and disgorgement totaling $12,023 and a 15-day suspension from associating with any FINRA member firm in any capacity.

B. *Ferris, Baker, Watts Inc., N/K/A RBC Capital Markets* (“FBW”), (Oct. 20, 2010)

1. FINRA settled a matter with FBW in which it alleged that between January 2006 and July 2008, FBW made unsuitable recommendations of reverse convertible notes to 57 customers, had inadequate supervisory procedures governing the sale of RCNs, and failed to reasonably supervise accounts that purchased RCNs.

2. According to FINRA, during the relevant period, FBW sold approximately 961 issues of RCNs to over 2,000 accounts without having appropriate guidelines in place for registered representatives.

3. During the relevant period, FBW allegedly sold RCNs to customers who were 85 years or older or who had stated net worths of less than $50,000. FINRA alleged that FBW did not have reasonable grounds to believe that RCNs were suitable for 57 accounts in light of their investment objectives, risk tolerance, age, net worth, and investment experience, and because some of the accounts were over-concentrated in RCNs.

4. Although branch managers reviewed accounts that purchased reverse convertibles by conducting spot checks of daily blotters, FINRA alleged that the firm failed to provide branch managers with guidance or tools to determine suitability or over-concentration, and for this reason, the procedures also were inadequate.

5. FINRA alleged that FBW's written procedures and supervision were inadequate because the firm failed to ensure that RCNs were only sold to customers who could accept the risks of losing principal and illiquidity during the term of the RCN. FBW's written supervisory procedures relating to structured products (including RCNs) stated that recommendations and/or purchases of the product would not be limited only to persons who had approved options accounts and that FBW would prepare a document outlining customer-specific suitability standards for use in recommending such products. FINRA alleged that this was not done, and as such, FBW's written procedures were inadequate.

6. FBW consented to a censure, a $500,000 fine, and agreed to pay restitution of approximately $190,000 to certain customers.

C. *HSBC Securities (USA)* ("HSBC") (Aug. 19, 2010)

1. FINRA settled a matter with HSBC in which it alleged that the firm recommended sales of unsuitable Collateralized Mortgage Obligations ("CMOs") to retail customers without adequately explaining the risks of the product.

2. One type of CMO, an inverse floater CMO, pays an adjustable rate of interest that moves in the opposite direction from an interest rate index. FINRA has advised that they are generally only suitable for sophisticated investors with a high tolerance for risk.

3. FINRA alleged that six HSBC brokers made 43 unsuitable recommendations of inverse floater CMOs to retail customers who did not have a high-risk profile, and 25 of the sales were in excess of $100,000. One broker made 32 of the 43 recommendations.

4. FINRA alleged that HSBC did not provide its brokers who sold CMOs with sufficient training on the product, in particular to inform them that inverse floater CMOs were only suitable for sophisticated investors with high risk tolerance. FINRA also alleged that the firm did not inform brokers of the risks associated with the specific inverse floater CMOs that were offered. FINRA also alleged that the educational materials provided by HSBC to brokers did not meet FINRA's content standards, specifically the brochure did not include a discussion of inverse floater CMOs and did not include a discussion about the risks associated with the purchase of CMOs generally.

5. FINRA further alleged that HSBC failed to provide educational materials to retail customers before the sale of CMOs and did not inform its brokers that they were required to offer such materials to retail customers.

6. FINRA also alleged that HSI failed to maintain and establish a supervisory system and written procedures regarding the sale of CMOs that was reasonably designed to supervise whether the sale of CMOs were suitable for its customers and the attendant risks of the products were fully explained.

7. HSBC consented to a censure and a fine of $375,000. In addition, HSBC paid restitution totaling $320,000 to five customers who lost money on their inverse floater CMO investments.

D. *Zions Direct, Inc.* ("Zions") (Aug. 25, 2010)

1. FINRA settled a case against Zions for failing to disclose participation of its institutional affiliate, Liquid Asset Management ("LAM"), in its on-line certificate of deposit ("CD") auctions and for related advertising violations.

2. According to FINRA, Zions began auctioning CDs issued by Zions-affiliated banks on its website in February 2007. LAM participated in the auctions to purchase CDs on a discretionary basis for its customers, but Zions did not disclose this fact to the auction participants. FINRA alleged that LAM's participation may have disadvantaged other auction participants who may have received lower CD yields than they otherwise would have, and had the potential to

benefit the Zions-affiliated issuing banks that otherwise might have paid higher yields had LAM not participated.

3. Zions amended its disclosures on November 19, 2008 to reflect that LAM might participate in the auctions, but did not disclose the potential impact that LAM's participation could have on the auctions or the potential conflict of interest between the issuing banks affiliated with the firm and Zions' customers who participated in the auctions.

4. FINRA further alleged that Zions' advertising regarding the CD auctions contained misleading, unwarranted and exaggerated claims and that the firm's website was misleading in that it published market clearing yields without adequately disclosing that they typically would not reflect the closing yields at the end of the auctions.

5. Zions consented to paying a $225,000 fine.

Sales Materials

FINRA and the SEC have focused their recent efforts on issues arising from the 2007 and 2008 financial downturn. This case is an example of a litigated matter regarding the marketing and sale of certain bond funds.

A. *FINRA Department of Enforcement v. Morgan Keegan & Company, Inc.* (filed Apr. 7, 2010)

1. FINRA filed a disciplinary complaint against Morgan Keegan, alleging that it marketed and sold certain affiliated bond funds from January 1, 2006 to December 31, 2007 using false and misleading sales materials. Investors in the bond funds allegedly lost over $1 billion.[87]

2. FINRA alleges that Morgan Keegan did not adequately disclose the risks associated with the bond funds and that its marketing materials misled investors. The complaint alleges that Morgan Keegan marketed the Intermediate Fund and the Short Term Fund as fairly conservative, diversified investments, when in fact, the funds were invested in a number of higher-risk products, including asset-backed and

[87] The SEC also sued Morgan Keegan and two executives concerning certain bond funds. That action is described in the SEC section of this Outline.

mortgage-backed securities and were not as diversified as represented.

3. The complaint also alleges that, in connection with the Intermediate Fund, Morgan Keegan did not adequately disclose the risks and suitability information to its registered representatives and did not provide adequate training regarding the fund.

4. FINRA also alleges that each of the bond funds had substantial investments in structured products, including subordinated tranches, that were not disclosed in Morgan Keegan's 2007 marketing materials. In 2007, a downturn in the mortgage-backed securities market had a significant negative impact on the performance and value of bond funds.

5. Finally, FINRA's complaint alleges that Morgan Keegan failed to establish, maintain, and enforce a system, including written supervisory procedures, reasonably designed to comply with NASD's advertising rules in connection with the bond funds and, with respect to the Intermediate Fund, to ensure the adequacy of its training and internal guidance.

6. FINRA seeks monetary sanctions. This matter is ongoing.

Securities Lending

FINRA has been active in the stock loan area for several years. Below are two cases that settled in 2010.

A. *Ramius Securities LLC* ("Ramius") (Feb. 22, 2010)

1. FINRA settled a matter with Ramius regarding supervisory violations concerning its securities lending business.

2. FINRA alleged that, between January 2003 and October 2008, a comanager of Ramius' securities lending department, who was responsible for hard-to-borrow securities, used a finder to locate stock for the firm's lending transactions. The finder, who had previously been barred by the SEC from the industry, was used for approximately 200 of the firm's lending transactions in 2003 and 2004. Ramius' use of the finder was never disclosed in the firm's books and

records because the transaction counterparties paid the finder.

3. Ramius did not have written procedures regarding the use of finders and did not provide oral guidance to its registered representatives. FINRA alleged that, because of the lack of guidance, employees, including those in supervisory positions, had different and conflicting understandings regarding what was a permissible use of finders in stock lending transactions. As a result, the firm did not adequately supervise its use of finders.

4. FINRA also alleged that, between January and May 2004, the firm did not archive Bloomberg e-mails and instant messages sent or received by firm employees.

5. Ramius consented to a censure and $200,000 fine.

B. *KDC Merger Arbitrage Fund, LP* ("KDC") (Jul. 21, 2010)

1. FINRA settled a matter with KDC in which it alleged that between January 2003 and December 2004, former KDC employees engaged in kickback schemes and other arrangements related to stock finder fees through which the employees illicitly received tens of thousands of dollars.

2. Two KDC employees knowingly entered false information into the firm's system stating that finders had located securities or borrowers when, in fact, the finders had performed no legitimate services. Once KDC paid the finders, the finders paid part of their fee to the two KDC employees. The two employees were indicted for this conduct and pled guilty to charges of conspiracy to commit wire fraud. FINRA alleged that a third KDC employee, who was not charged with any crimes, also caused the firm to pay finders whom he knew or should have known had not provided services.

3. FINRA alleged that the firm violated certain books and records requirements because its records inaccurately reflected that finders had participated in and were paid for stock loan transactions when they had not done so.

4. FINRA also alleged that the firm failed to maintain written procedures that were reasonably designed to detect and prevent the improper use of and payment to finders. For example:

   (a) they required supervisors to review securities lending transactions daily, but provided no guidance on how to conduct the review;

   (b) the firm allegedly retained insufficient evidence establishing that a supervisor adequately reviewed KDC's lending activities; and

   (c) the firm had no written procedures requiring supervisors to review electronic communications and no guidance as to how supervisors should review such communications.

5. Additionally, FINRA alleged that the firm failed to retain e-mails between January 2003 and November 2004 and failed to retain electronic communications sent through AOL Instant Messenger between January 2003 and December 2004.

6. KDC consented to a censure and a fine of $350,000.

Supervision

Supervision provides a steady stream of cases for FINRA each year. The cases below reflect recent settlements in this area and an important decision in a litigated matter.

A. *Kenneth D. Pasternak and John P. Leighton v. FINRA* (Mar. 4, 2010)

   1. The National Adjudicatory Council ("NAC") issued a decision dismissing charges that Kenneth Pasternak, former CEO of Knight Securities, L.P. ("Knight"), and John Leighton, former head of the firm's Institutional Sales Desk, failed to reasonably supervise the firm's leading institutional sales trader, Joseph Leighton (John Leighton's brother), in connection with alleged fraudulent sales to institutional customers. The decision brought to a close more than five years of proceedings relating to the alleged conduct.

2. The NAC reversed an April 2007 FINRA Hearing Panel decision, which found that Pasternak and John Leighton had violated FINRA's supervision rule. That ruling fined each respondent $100,000, barred John Leighton in all supervisory capacities, and suspended Pasternak in all supervisory capacities for two years. Those sanctions were vacated by the NAC's decision.

3. The NAC concluded that FINRA (then NASD) failed to satisfy its burden of proof concerning allegations set forth in its March 4, 2005 complaint that Pasternak and John Leighton did not take reasonable steps to confirm that Joseph Leighton adhered to "industry standards" when executing orders for institutional customers. The NAC found that FINRA staff did not establish that the trader contravened any market or regulatory standards when providing execution services to institutional customers. The NAC further found that the preponderance of the evidence did not support the allegation that Pasternak and John Leighton failed to reasonably supervise the sales trader's practices.

4. Finally, the NAC decided that the evidence did not support allegations that Pasternak failed to respond appropriately to certain "red flags" that were raised concerning the manner in which the trader executed institutional customer orders.

5. In August 2005, the SEC filed a separate injunctive action against Pasternak and John Leighton relating to the same issues. In June 2008, a federal judge held that the SEC failed to prove that Pasternak or John Leighton violated the federal securities laws in connection with the firm's alleged failure to seek best execution and dismissed all charges.

6. In April 2005, Joseph Leighton consented to a permanent bar from association with a broker or dealer and to pay over $1.9 million in disgorgement, $660,000 in prejudgment interest, and a $750,000 civil money penalty to settle the SEC enforcement action, as well as a $750,000 fine to settle an NASD action.

7. In December 2004, the NASD and SEC settled enforcement actions against Knight under which Knight consented to pay a $12.5 million fine to NASD, a $12.5 million civil penalty to the SEC, and pay $41 million in ill-gotten profits and $13

million in prejudgment interest into a Fair Fund established by the SEC for compensating harmed investors.

B. *Citigroup Global Markets, Inc.*, FINRA Case No. 20080149558-01 (Apr. 6, 2010)

1. FINRA settled a matter with CGMI in which it alleged that the firm failed to adequately supervise its Direct Borrowing Program ("DBP") because CGMI implemented no supervisory system and inadequate written procedures tailored to the DBP, and failed to disclose material facts to customers who participated in it.

2. FINRA found that, between January 1, 2005 and November 30, 2008, CGMI operated its DBP, through which it borrowed fully paid securities owned in large part by the firm's retail customers. The borrowed securities were pooled and used to facilitate other CGMI clients' short-selling activities. During the relevant time period, CGMI arranged through its DBP for over 4,000 loans, involving over 770 different securities borrowed from over 2,300 customers.

3. FINRA found that CGMI failed to disclose to customers who participated in the DBP certain material information, including that:

   (a) the securities were hard-to-borrow due to short selling;

   (b) the interest rates could be reduced by the firm;

   (c) the brokers received commissions based upon the number of shares loaned for the duration of the loan period;

   (d) while the securities were on loan, dividends were paid as "cash-in-lieu" of dividends and were therefore subject to higher tax rates; and

   (e) shares on loan could be sold by the customers at any time.

4. Branch managers and supervisors were not aware that clients of the brokers they supervised were participating in the DBP. FINRA alleged that the firm's supervisory tools were compromised because securities that were loaned out of the accounts were not reflected in customers' positions; exception reports did not properly detect concentration levels; and supervisors could not ascertain the ongoing suitability of loan transactions.

5. FINRA alleged that three versions of CGMI's publicly distributed marketing materials failed to adequately disclose the risks of the DBP.

6. CGMI consented to a censure, to pay a $650,000 fine, and to comply with an undertaking that, before it reinstitutes the DBP, the firm must establish a supervisory system to monitor the activities of each registered person relating to the DBP.

C. *J.J.B. Hilliard, W.L. Lyons, LLC* ("J.J.B. Hilliard") (Apr. 12, 2010)

1. FINRA settled a matter with J.J.B.Hilliard in which it alleged that the firm failed to have adequate procedures for identifying customer checks deposited from an affiliated introducing broker from April 21, 1999 through December 31, 2005.

2. J.J.B. Hilliard utilized a manual process that occasionally failed to capture certain customer-identifying information from check deposits received.

3. As a result of its failure to have adequate procedures in place, J.J.B. Hilliard was unable to identify the proper customer accounts to post deposits received from the introducing broker. After 60 days, J.J.B. Hilliard transferred the funds to an account designated for abandoned property and eventual escheatment to the Commonwealth of Kentucky.

4. FINRA alleged that more than 8,900 deposits, totaling $133,000 of customer funds, were never properly identified or credited to the appropriate customer accounts and therefore escheated to the Commonwealth of Kentucky.

5. As a result of its failure, J.J.B. Hilliard was unable to maintain proper books and records, prepare accurate customer account statements, maintain possession and control of customer excess margin securities, and properly service customer cash and margin accounts.

6. FINRA alleged that the firm failed to properly account for the unidentified funds through required reconciliations that should also have been included in the firm's computation of net capital and customer reserves.

7. FINRA alleged that the firm also failed to implement adequate procedures in 2004 and 2005 related to employee public appearances, disclosures to the media and the issuance of research reports.

8. FINRA further alleged that the firm failed to comply with rules governing analyst certifications and required disclosures in certain research reports issued between January and June 2005.

9. J.J.B. Hilliard consented to a censure and to pay a $200,000 fine. The firm was also required to set aside $133,817 in an interest-bearing account for five years to reimburse clients who can prove that their funds were not properly deposited.

D. *Westpark Capital, Inc.* ("Westpark") (May 6, 2010)

1. FINRA settled a matter with Westpark, its former Chief Compliance Officer ("CCO"), and its Chief Operations Officer ("COO") in which it alleged that from February 2006 to July 2007, the firm failed to establish and maintain a reasonably designed supervisory system and written procedures and that the officers failed to supervise six brokers who committed sales practice violations that caused losses in at least 19 customer accounts. The brokers worked from two Long Island branch offices that subsequently were closed by the firm.

2. According to FINRA, the brokers executed unauthorized trades, churned and engaged in unsuitably excessive trading, and reported solicited trades as unsolicited.

3. FINRA alleged that the CCO and COO failed to adequately scrutinize the brokers' conduct in general and failed to investigate and address numerous red flags in particular. The red flags included that one of the branch managers had previously been suspended for failure to supervise and certain of the brokers had previously been associated with disciplined and/or expelled firms, had been disciplined themselves, and/or had a history of customer complaints.

4. FINRA alleged that the firm's deficiencies included inadequate heightened supervision, inadequate monitoring for unsuitably excessive trading, no system for analyzing the fairness of markups, and unqualified branch office supervisors.

5. Westpark consented to a censure, a fine of $100,000, and restitution of $300,000. The former CCO consented to a four-month suspension in any principal capacity and a fine of $5,000 and the COO consented to a three-month suspension in any principal capacity and fine of $20,000.

6. In related actions, FINRA barred a former branch manager from acting in any principal capacity and permanently barred two former brokers. The former branch manager also was ordered to pay a $10,000 fine and one of the former brokers was ordered to pay over $110,000 in restitution to customers. A case against a third broker is still pending.

E. *E*Trade Clearing LLC* ("E*Trade") (May 10, 2010)

1. FINRA settled a matter against E*Trade involving alleged supervisory and operational violations during various periods from October 2004 to September 2006 that related to the Firm's failure to adequately prepare for and respond to various operational changes and approximately 833,000 account conversions.

2. FINRA alleged that E*Trade committed five violations. First, FINRA alleged that E*Trade committed supervisory violations by erroneously charging margin interest to approximately 4,000 customers, failing to review and reconcile DTC positions, and failing to promptly deliver physical certificates.

3. Second, FINRA alleged that due to a data entry error by the firm's outside back-office service provider ("service provider"), E*Trade failed to mail January 2006 account statements to 2,530 customers, instead mailing them to other customers. E*Trade self-reported this issue to FINRA.

4. Third, FINRA alleged that E*Trade inadvertently liquidated fractional shares in certain customer accounts without authorization. On or around December 30, 2005, in an effort to clear a backlog of pending requests by certain customers to liquidate fractional shares, E*Trade's service provider implemented an automated solution that began liquidating shares in all customer accounts. The firm discovered the error six days later when approximately 46,000 accounts had been affected. E*Trade reversed all of the erroneous liquidations, totaling approximately $1.4 million.

5. Fourth, FINRA alleged that E*Trade failed to properly acknowledge and report certain customer and operational complaints.

6. Finally, FINRA alleged that E*Trade's possession and control system failed to issue segregation instructions on long positions in suspense accounts.

7. E*Trade consented to the imposition of a censure and a fine of $350,000.

F. *Edward D. Jones & Co., L.P.* ("Edward Jones"), (June 2, 2010)

1. FINRA settled a matter with Edward Jones in which it alleged that between January 31, 2005 and August 2007, the firm failed to establish, maintain, and enforce a supervisory system that was reasonably designed to review and monitor all transmittals of funds from customer accounts to third-party accounts.

2. Edward Jones relied, in part, on an electronic system, which automatically generated exception reports, to monitor customer account activity. One exception report, entitled the Same Outside Address Report ("SOA Report"), was designed to detect when two or more customer accounts at the same branch office sent funds to the same third-party account during a rolling 12-month period.

3. FINRA alleged that the system that generated the SOA Report functioned improperly due to a software coding error, causing reports to be incomplete and inaccurate. As a result of this error, the SOA Report did not detect three wire transfers (two in July 2007 and one in August 2007) totaling over $1 million from two customer accounts to the same third-party account, which was being used by an Edward Jones registered representative who converted more than $3 million in customers' funds.

4. According to FINRA, Edward Jones relied on the malfunctioning SOA Report from its inception in April 2003 until the problem was discovered in 2007, when the firm launched an investigation into wire and check transactions sent to the same third-party account from a single branch office Edward Jones failed to perform any tests during 2005, 2006, or 2007 to validate that the SOA Reports were being generated accurately and completely.

5. FINRA noted that Edward Jones corrected the SOA report and was in the process of settling related customer complaints; the firm already settled with customers identified by FINRA during the investigation.

6. Edward Jones consented to a censure and a fine of $200,000.

TRACE and OATS Reporting

FINRA regularly institutes cases in the TRACE and OATS areas. Below is a late 2010 settlement.

A. *Citigroup Global Markets Inc.* ("Citigroup") (Oct. 22, 2010)

1. FINRA settled a case against Citigroup involving several trading-related matters during various periods from 2005 through 2008.

2. FINRA alleged that Citigroup failed to timely report certain transactions to the Trade Reporting and Compliance Engine ("TRACE") and submitted 143 inaccurate reports to TRACE.

3. FINRA also further alleged that the firm failed to comply with trading requirements, including: reporting the correct

execution times of trades on brokerage order memoranda, using reasonable diligence to obtain best execution, and charging mark-ups or mark-downs that were fair and reasonable.

4. According to FINRA, Citigroup also failed to correctly report to Nasdaq whether a transaction was a buy, sell, sell short, or cross for thousands of transactions, failed to submit trade reports to Nasdaq, failed to display properly customer limit orders in Nasdaq securities in the firm's public quotation, and failed to adjust open customer limit orders to properly reflect a dividend, payment or distribution.

5. FINRA also alleged that the firm violated OATS rules by failing to transmit certain Reportable Order Events; transmitting hundreds of thousands of Route or Combined Order/Route Reports with inaccurate destination codes, representing 12% of such reports during the period; and submitting New Order Reports that could not be matched to related Route or Combined Order/Route Reports.

6. Citigroup consented to a censure and a fine of $400,000, of which $250,000 related to the TRACE violations. The firm also agreed to pay restitution of approximately $10,000.

Unregistered Securities

Unregistered securities offerings, particularly those regarding affiliated offerings, have attracted regulatory scrutiny. The cases below, instituted by both FINRA and the SEC, highlight this issue.

A. *FINRA Department of Enforcement v. McGinn, Smith & Co., Inc., et al.* (filed Apr. 5, 2010); *SEC v. McGinn, Smith & Co., Inc., et al.,* 10-Civ-457 (N.D.N.Y Apr. 20, 2010)

1. FINRA and the SEC brought separate actions against McGinn, Smith & Co. Inc. and related entities for conducting fraudulent unregistered securities offerings involving millions in income notes owed to investors.

2. FINRA alleged that, between September 2003 and November 2006, the firm and its affiliates relied on an exemption provided by Regulation D to issue offerings for four unregistered limited liability companies managed and

controlled by David Smith, a principal at the firm. However, the exemption was not available because the four offerings involved more than 35 nonaccredited investors. Further, both Smith and another principal, Timothy McGinn, misused the offering proceeds for their own personal needs or to benefit entities that they owned, controlled or in which they maintained a financial interest. Smith and McGinn did not disclose these transactions to investors and misrepresented to investors exactly the amount of the firm's underwriting/commission fees.

3. FINRA seeks disciplinary sanctions for misuse of proceeds, misrepresentations and omissions, sale of unregistered securities, supervisory violations, and providing false documents to FINRA. FINRA also seeks disgorgement of ill-gotten profits and restitution to investors.

4. The SEC's action relates to more than 20 unregistered debt offerings that raised approximately $136 million from investors, including the four fund offerings that FINRA cited and numerous trust entities.

5. The SEC alleges that, beginning in 2003, Smith and McGinn funneled investors' money to entities that they owned or controlled in order to provide liquidity to these entities as well as to support Smith's and McGinn's luxurious lifestyles. As of September 2009, investors were owed at least $84 million, and the four funds had less than $500,000 in cash on hand, while the trusts had a negative equity of approximately $18 million and never had the ability to pay the interest rates promised to investors. McGinn and Smith continued to drain the funds of cash into 2010.

6. The SEC obtained an emergency asset freeze and seeks sanctions related to antifraud violations, violations of public offering rules in accordance with the Investment Company Act, and violations of securities offerings rules in accordance with Regulation D. Further, the SEC seeks disgorgement of ill-gotten gains from the defendants as well as civil penalties, disgorgement from relief defendant Lynn A. Smith, and an order prohibiting McGinn from acting as an officer or director of any issuer of certain registered securities.

7. These actions are ongoing.

B. *Fagenson & Co., Inc.* ("Fagenson") (Apr. 9, 2010); *RBC Capital Markets Corporation* ("RBC") (Jan. 4. 2010); *Alpine Securities Corp.* ("Alpine") (Jan. 11, 2010); *Equity Station, Inc.* ("Equity Station") (Jan. 20, 2010); *Olympus Securities, LLC* ("Olympus") (Jan. 29. 2010)

1. FINRA settled actions against five broker-dealer firms in which it alleged that they unlawfully sold shares of unregistered stock into the market on behalf of clients.

2. FINRA alleged that the firms permitted their customers to deposit millions or billions of shares of USXP securities in certificate form and immediately liquidate those positions. The firms failed to conduct proper inquiries, and four of the firms (all except Equity Station) failed to maintain an adequate supervisory system, to determine the registration status of securities of Universal Express, Inc. (USXP) before permitting the shares to be sold into the market. Instead of conducting their own inquiries, the firms relied on transfer agents, clearing brokers, or customer questionnaires to satisfy their obligation to perform a reasonable inquiry. As a result, the firms allegedly missed red flags indicating that their clients' sales constituted illegal distributions.

3. FINRA alleged that an appropriate inquiry would have revealed that, prior to these sales, the SEC brought an injunctive action against USXP and certain of its executives relating to their issuance and promotion of hundreds of millions of shares of unregistered stock for public distribution, which led USXP to disgorge approximately $12 million in gains and pay a civil penalty of approximately $10 million.

4. The actions filed against Alpine, Equity Station, and Olympus solely involved USXP securities. FINRA alleged that Fagenson and RBC permitted their customers to sell shares of unregistered stock of nine and seven other issuers besides USXP, respectively.

5. FINRA also alleged that Fagenson failed to establish adequate anti-money laundering policies and failed to comply with its then-existing anti-money laundering policy by missing red flag alerts referenced in the policy and by failing to file suspicious activity reports required by the Bank Secrecy Act.

6. Each of the firms consented to a censure and to pay the following fine:

Firm	Fine
Fagenson	$165,000
RBC	$135,000
Alpine	$40,000
Equity Station	$25,000
Olympus	$20,000

C. *Department of Enforcement v. Pinnacle Partners Financial Corporation and Brian K. Alfaro* (Dec. 3, 2010)

1. In November 2010, FINRA filed a complaint in a contested matter against Pinnacle Partners Financial Corporation and its President, Brian K. Alfaro concerning the respondents' allegedly fraudulent sale of unregistered securities in eight private placement offerings.

2. According to FINRA, the respondents operated a boiler room in which registered representatives placed cold calls to solicit investments in oil and gas drilling joint ventures, leading clients to pay more than $10 million to invest in unregistered securities.

3. FINRA alleged that the offering documents for the ventures include numerous misrepresentations and omissions and that Alfaro deleted negative information from reports and inflated projections before providing materials to investors.

4. FINRA further alleged that Alfaro admitted that he misused investment funds to meet obligations for previous offerings and for unrelated business and personal expenses.

5. FINRA also alleged that the respondents destroyed documents, maintained inaccurate books and records, failed to report customer complaints and update Forms U-4, and failed to maintain procedures reasonably designed to comply with e-mail retention requirements.

6. FINRA alleged that Respondents were selling a new offering despite assurances to FINRA that sales had been discontinued. Accordingly, on December 3, 2010, in a rare move, FINRA's Department of Enforcement filed a notice

seeking a Temporary Cease and Desist Order ("TCDO") by the Hearing Panel to avoid customer harm and the depletion of customer assets before the completion of the disciplinary proceeding.

7. FINRA is seeking fines, disgorgement, and restitution in the underlying matter.

Unit Investment Trusts and Closed-End Funds

For years, regulators have had concerns about the breakpoints provided on certain packaged products and the suitability of such investments. Below are two cases brought last year by FINRA in this area.

A. *Merrill Lynch, Pierce, Fenner & Smith, Incorporated* ("Merrill Lynch") (Aug. 18, 2010)

1. In 2010, FINRA settled a matter with Merrill Lynch in which FINRA alleged that the firm failed to provide breakpoints and rollover and exchange discounts (collectively, "sales charge discounts") to customers on eligible purchases of Unit Investment Trusts ("UITs") and approved the use of UIT sales literature that was inaccurate and misleading.

2. FINRA alleged that from September 2006 through June 2008, Merrill Lynch failed to establish, maintain, and enforce a supervisory system and written supervisory procedures reasonably designed to provide customers with appropriate sales charge discounts on eligible UIT purchases. According to FINRA, prior to May 2008, Merrill Lynch's written supervisory procedures had little or no information or guidance regarding UIT sales charge discounts; once such procedures were established, they were inaccurate and conflicting, *e.g.*, stating that sales charge discounts would not apply when a client liquidated an existing UIT position and used the proceeds to purchase a different UIT.

3. FINRA alleged that Merrill Lynch's procedures lacked substantive guidelines for brokers or their supervisors to follow to determine if a UIT purchase should receive a sales charge discount. FINRA found this problematic because firm and broker compensation was reduced if a customer received a sales charge discount, which created a financial disincentive to the broker to confirm the customer received the appropriate sales charge discount.

4. According to FINRA, a review of a sample of customer UIT purchases revealed that 5.7% of the transactions in top selling UITs overcharged customers approximately $123,000. Following FINRA's publication of a settlement with another firm concerning UIT transactions and independent of FINRA's pending inquiry, Merrill Lynch analyzed UIT sales charge discounts back to January 2006. As a result of its review, Merrill Lynch identified customers who were overcharged more than $2 million.

5. Merrill Lynch consented to a censure and fine of $500,000 and undertook to provide remediation to the customers identified in the firm's review who were overcharged as noted above.

B. *SunTrust Investment Services, Inc.* ("SunTrust") (Jul. 22, 2010)

1. In 2010, FINRA settled a matter with SunTrust concerning allegedly unsuitable short-term Unit Investment Trust ("UIT"), closed-end fund ("CEF") and mutual fund transactions.

2. FINRA alleged that between February 2004 and November 2006, two SunTrust brokers recommended 294 unsuitable UIT, CEF and mutual fund transactions in 17 customer accounts and recommended unsuitable securities purchases on margin to 10 of the 17 customers. These trades caused approximately $540,000 in losses to the customers during that period, while earning approximately $630,000 in revenue for the firm. FINRA alleged that most of the customers were elderly and unsophisticated with moderate investment objectives and limited investment experience.

3. According to FINRA, the firm and the brokers' supervisor failed to respond adequately to red flags surrounding these transactions, and the firm had inadequate systems and procedures to supervise UIT, CEF, and margin transactions.

4. FINRA further alleged that before September 2006, SunTrust failed to provide all customers with the maximum sales charge discounts. FINRA asserted that SunTrust had notice of the requirement to provide applicable discounts because it had entered into a settlement with the SEC in May 2005 in which the SEC alleged that SunTrust had failed to give certain mutual fund customers breakpoint discounts.

5. SunTrust consented to a censure and a $900,000 fine that included $223,997 in disgorgement of commissions. The firm also undertook to provide restitution to the 17 affected customers and to provide remediation to customers who purchased UITs and qualified for, but did not receive, the applicable discounts during the relevant period. The supervisor of the brokers consented to a six-month suspension from acting in a principal capacity and a fine of $10,000.

6. In separate actions, FINRA permanently barred one of the brokers, who had been previously sanctioned in another FINRA matter, and filed a complaint against the second broker.

On June 14, 2010, FINRA and NYSE Euronext announced that they had completed the previously announced agreement under which FINRA assumed responsibility for performing the market surveillance and enforcement functions previously conducted by NYSE Regulation. Under the agreement, FINRA assumed regulatory functions for the New York Stock Exchange LLC ("NYSE"), NYSE Arca, Inc. ("NYSE Arca") and NYSE Amex LLC ("NYSE Amex") (collectively "NYSE Exchanges"). Most of the approximately 225 staff members that performed these functions for NYSE Exchanges were transferred to FINRA.

According to NYSE Euronext and FINRA executives, consolidating surveillance and enforcement functions for the NYSE Exchanges with FINRA will help to create a consistent and integrated approach to regulation and address the fragmented trading environment that erodes regulators' ability to get a more complete picture of market activity across multiple markets and financial products.

NYSE Euronext, through its subsidiary NYSE Regulation, remains ultimately responsible for overseeing FINRA's performance of regulatory services for the NYSE Exchanges and retains its staff associated with rule interpretations and oversight of listed issuers' compliance with the NYSE Exchanges financial and corporate governance standards.

In addition to the NYSE Exchanges, FINRA also provides regulatory services to six other exchanges: the NASDAQ Stock Market, NASDAQ Options Market, NASDAQ OMX Philadelphia, NASDAQ OMX Boston, The BATS Exchange and The International Securities Exchange.

Set forth below are six cases settled by the NYSE Exchanges in 2010 for $200,000 or more.

A. *Israel A. Englander & Co., Inc.* ("Englander") (Feb. 22, 2010)

1. NYSE Amex settled a case against Englander in which it alleged that Englander engaged in certain trading, supervisory and other violations. Englander's primary business provided floor executions for the accounts of other

broker-dealers and financial institutions (a/k/a a two dollar broker).

2. Specifically, NYSE Amex alleged that between December 2002 and September 2004, Englander failed to: (i) identify and disclose certain orders and other pertinent information accurately in the trading crowd on the Amex floor on at least five trade dates, (ii) know essential facts regarding its customers, (iii) use due diligence in executing a customer's order at the best available price, and (iv) complete order tickets properly.

3. NYSE Amex also alleged that in connection with an investigation involving another firm, Englander produced an inaccurate trade ticket.

4. NYSE Amex alleged that between September 2007 and September 2008, Englander failed to prevent and detect inaccurate information from being reported to FINRA's Central Registration Depository and Englander's website regarding the title of an employee position, who was identified as managing partner. However, the employee was a clerk who performed no management functions. NYSE Amex also alleged that the employee also performed duties on the Amex floor normally performed by a registered representative, even though the employee was not registered.

5. From April 2008 through February 2009, NYSE Amex further alleged that Englander improperly entered option orders into the Booth Automated Routing System "BARS" after their execution on at least 10 separate occasions.

6. NYSE Amex alleged that on or about March 25, 2008, Englander represented to NYSE Amex that pursuant to a February 25, 2008 disciplinary decision, it updated and would continue to monitor the effectiveness of its WSPs, but it did not do so during the period from April 2008 to February 2009.

7. Englander consented to a censure and a $200,000 fine.

B. *UBS Securities LLC* (“UBS”), HBD 10-7 (Mar. 15, 2010)

1. NYSE Regulation settled a case with UBS in which it alleged that UBS failed to adhere to various rules related to order entry and execution of proprietary trades, and order entry and cancellation requirements for MOC/LOC orders.

2. NYSE Regulation alleged that, during the first relevant period (January 1, 2005 - December 31, 2008), UBS:

   (a) entered orders to buy (sell) an NYSE-listed security while knowingly in possession of a customer order to buy (sell) such a security, which could have been executed at the same price, on 21 occasions;

   (b) traded along with or ahead of customer orders without consent on eight occasions;

   (c) obtained consent to trade along with the customer’s order, but allocated certain executions between the firms’ proprietary account and the customer’s account in amounts outside of the consent granted on seven occasions;

   (d) failed to yield priority, parity and precedence to public orders with respect to the firm’s “G” order on six occasions in which UBS traded along with the customer’s order without consent;

   (e) failed to adequately document whether it obtained a customer’s permission to trade along with, or ahead of, customer orders on 11 occasions by failing to mark certain proprietary orders with the required “G” notation;

   (f) failed to submit accurate account type indicators; and

   (g) failed to maintain accurate books and records.

3. NYSE Regulation further alleged that, during the second relevant period (January 19, 2007 - December 24, 2008), UBS failed to comply with order entry and cancellation requirements for 1,231 Market-On-Close/Limit-On-Close

orders and failed to report transactions in NYSE-listed securities that were not otherwise reported to the Consolidated Tape on three occasions.

4. NYSE Regulation alleged that, during both relevant periods, UBS failed to provide appropriate supervision and control procedures designed to prevent the foregoing alleged violations. In connection with this issue, NYSE Regulation stated that "in instances where the Firm's algorithmic trading system executed transactions involving orders subject to NYSE Rule 92, the Firm failed to have in place any supervisory review of such transactions to determine whether the algorithmic trading system was operating as designed."

5. UBS consented to a censure and a penalty of $350,000.

C. *Cantor Fitzgerald & Co.* ("Cantor Fitzgerald"), (Apr. 16, 2010)

1. NYSE Arca settled a case with Cantor Fitzgerald in which it alleged that the firm failed to supervise the proprietary and personal trading accounts of the chief executive officer of the firm's Debt Capital Markets business unit ("DCM CEO") from January to December 2006.

2. NYSE Arca alleged that in October 2005, the DCM CEO began day trading a stock, FMTI, in his personal accounts held outside the firm. Beginning in January 2006, the DCM CEO also built a large position in FMTI in a firm proprietary account. Around February 2006, the firm became aware of the DCM CEO's personal trading in FMTI. By April 2006, the DCM CEO exceeded the 10% ownership threshold, which required filing of a Schedule 13G with the SEC. On many days during the relevant period, the DCM CEO placed dozens of orders throughout the day for both the firm's account and his personal accounts, often placing trades for both accounts within minutes of each other.

3. From April through December 2006, the DCM CEO accumulated, actively traded and maintained a position in a stock, IMMC, in the firm's account. From August through November 2006, he actively traded IMMC in his personal accounts. On certain days throughout the relevant period, the DCM CEO placed dozens of orders in IMMC for both the

firm's account and his personal accounts, often within minutes of each other.

4. Cantor Fitzgerald had policies that prohibited traders from trading the same stocks in their personal accounts and the firm's accounts and mandated a 10-day holding period for all personal trades, but NYSE Arca alleged that the firm did not enforce these policies with respect to the DCM CEO.

5. NYSE Arca further alleged that Cantor Fitzgerald failed to reasonably supervise the DCM CEO's proprietary trading in that the firm did not subject the DCM CEO's trading to surveillance reviews designed to prevent front-running, wash-trading and marking the close, although NYSE Arca noted that it did not find any such substantive violations. Nonetheless, NYSE Arca found that Cantor Fitzgerald allowed the DCM CEO's investment decisions to be potentially affected by an inappropriate conflict of interest (*i.e.*, effecting trades for his personal benefit).

6. NYSE Arca found that, between August 2003 and November 2006, Cantor Fitzgerald failed to retain and review the DCM CEO's trade confirmations and monthly account statements.

7. Cantor Fitzgerald consented to a censure and a fine of $250,000.

D. *Fortis Clearing Americas LLC* ("Fortis") (Apr. 22, 2010)

1. NYSE settled a case against Fortis involving Electronic Blue Sheet, books and records, odd-lot trading, and supervision violations.

2. NYSE alleged that Fortis received a 2007 request for Electronic Blue Sheet data. In response, Fortis submitted data that was incomplete (for 14 trade dates) and inaccurate (for 17 trade dates) because they were missing customer name information or had incorrect share numbers or prices. The errors resulted, in part, because the firm's internal systems did not capture this information accurately, which led NYSE to charge the firm with failing to maintain accurate books and records. The firm corrected the system glitches that caused these issues.

3. NYSE also alleged that in 2006 and 2007, Fortis permitted a non-member broker-dealer customer to have direct market access to the NYSE via Fortis. The customer executed approximately 8,800 odd-lot trades in a pattern of day trading that was prohibited by NYSE policies. Throughout most of 2007, Fortis did not have a supervisory system in place to monitor for odd-lot activity on the order entry system used by the customer, and a Fortis odd-lot surveillance system established in October 2007 did not detect it due to certain system limitations.

4. NYSE further alleged that Fortis failed reasonably to supervise the accurate submission of Blue Sheet data and odd-lot trades.

5. Fortis consented to a censure and a $225,000 fine.

E. *E*Trade Clearing LLC* (Nov. 3, 2010)

1. FINRA, on behalf of NYSE Regulation, settled a matter with E*Trade in which it alleged that the firm failed to submit accurate electronic blue sheets to NYSE Regulation on 178 occasions and failed to establish and maintain an appropriate system of follow-up and review to reasonably ensure compliance with NYSE Rules relating to electronic blue sheets.

2. FINRA alleged that between January 2007 and April 2009, E*Trade submitted approximately 220 electronic blue sheets to NYSE Regulation; approximately 178 of them omitted trades effected by two of E*Trade's affiliated entities, E*Trade Capital Markets and E*Trade Canada, due to a misunderstanding by firm personnel that such trades were required to be reported.

3. In January 2006, E*Trade settled a matter with NYSE Regulation concerning inaccurate electronic blue sheets, in which it paid a $150,000 fine. Under the terms of that settlement, E*Trade was required to validate its blue sheet data elements, which FINRA alleged should have provided notice to the firm that it was not reporting all required trades in its blue sheet submissions.

4. FINRA further alleged that E*Trade's failure to determine accurately which trades were required to be disclosed in its electronic blue sheet reporting constituted a failure to reasonably supervise.

5. E*Trade consented to a censure and a $225,000 fine.

F. *Merrill Lynch, Pierce, Fenner & Smith Incorporated* (Sept. 13, 2010)

1. FINRA, on behalf of NYSE Regulation, settled a matter with Merrill Lynch in which it alleged that the firm entered orders to purchase and sell approximately 3.1 million shares of two NYSE-listed stocks without any change in beneficial ownership.

2. In January 2008, Merrill Lynch entered into a single stock swap in a notional amount of 1,605,000 shares for an NYSE-listed stock with a hedge fund client. In July 2008, Merrill Lynch entered into an identical swap with the same client on 1,880,577 shares of a second NYSE-listed stock. In both swaps, Merrill Lynch held the long position and hedged its positions by establishing proprietary short positions in the market.

3. FINRA alleged that on September 16, 2008, a day during which the markets were extremely volatile, Merrill Lynch violated NYSE's market-on-close rule.

   (a) Late in the trading day, the hedge fund client notified Merrill Lynch that it wished to unwind a portion of one swap and the entire amount of the other swap. As part of unwinding the swaps, Merrill Lynch needed to cover its short position in the swaps. Shortly before 3:40 p.m., Merrill Lynch entered market-on-close buy orders to cover the firm's short positions. Market-on-close orders cannot be canceled after 3:50 p.m.

   (b) Shortly after 3:40 p.m., Merrill Lynch alerted the hedge fund client of what appeared to be an error by the client in entering the orders, and the client informed Merrill Lynch that it no longer wanted to unwind the positions that day.

(c) At 3:50 p.m., the specialist in the stocks published buy-side imbalances for the securities. Merrill Lynch then entered sell orders to offset its previously entered buy orders, causing the buy-side imbalances to become a sell-side imbalance. FINRA alleged that Merrill Lynch's sell orders had an effect on the closing price of the stock.

4. Merrill Lynch consented to a censure and a fine of $200,000. In resolving the matter, FINRA considered that Merrill Lynch had self-reported the trades the same day to NYSE Regulation Market Surveillance and that Merrill Lynch's offsetting orders were not entered to manipulate the market, but as a result of an erroneous market-on-close order by its client on the wrong side of the market.

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