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review

2009 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 Regulation enforcement actions and developments regarding broker-dealers during 2009.*

The economic crisis of 2008 and the Ponzi scheme of Bernard Madoff led government officials, the public and the media to call for an increase in securities enforcement activity. As a result, 2009 was a year of change at the SEC and FINRA.

The SEC installed new leadership who perceived a mandate to restore investor confidence by aggressively pursuing companies and individuals who engage in wrongdoing affecting the securities markets. The Commission's new leaders instituted a number of organizational and policy changes intended to make its Division of Enforcement more efficient and effective. Many of the metrics used to measure SEC enforcement activity reflect a significant increase compared to 2008.

With its own new CEO in place, FINRA also looked to make changes in its structure and enforcement processes. It did so last year, but perhaps in less noticeable and transformative ways. In 2009, FINRA's caseload increased; it also brought several actions with large fines, in stark contrast to the prior year.

Consistent with its more focused mandate, NYSE Regulation concentrated on trading and transaction reporting in its major cases and instituted fewer actions than the SEC and FINRA.

All of these developments are described in this Outline.

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The SEC

In 2009, the SEC went through enormous change. At the top of the list was the new leadership installed at the Commission. In January 2009, Mary L. Shapiro was appointed and confirmed as the new SEC Chairman. Among other senior personnel moves, Chairman Schapiro recruited Robert Khuzami, a former federal prosecutor, to head the Division of Enforcement. The Commission subsequently hired several other former criminal prosecutors to help Mr. Khuzami lead the SEC's enforcement efforts, including a new Deputy Director and the heads of the Commission's New York and Miami regional offices.

Organizationally, the Division of Enforcement announced plans to develop five specialized investigative units, streamline management by eliminating the position of Branch Chief, and create the Office of Market Intelligence. First, in an effort to create enhanced specialization, Enforcement is introducing five units dedicated to complex areas of the securities laws: (1) the Asset Management Unit; (2) the Market Abuse Unit; (3) the Structured and New Products Unit; (4) the Foreign Corrupt Practices Act Unit; and (5) the Municipal Securities and Public Pensions Unit. Second, the SEC is implementing measures to streamline management and internal processes to improve efficiency, including redeploying Division of Enforcement Branch Chiefs to conduct investigations. Third, the Commission is creating an Office of Market Intelligence, which is responsible for collecting, weighing, analyzing, and monitoring tips, complaints and referrals received by the SEC each year.

From a statistical perspective, the SEC's fiscal year 2009 was a busy time for enforcement.[1] Among the highlights, the Commission:

- Brought 664 cases, down slightly from its 671 actions in the prior year.
- Increased the number of cases brought against broker-dealers to 109 actions from FY 2008's 60 cases, a rise of 82%.
- Initiated 37 insider trading cases, a drop of 39% from 61 such actions in FY 2008.
- Filed 154 enforcement actions in FY 2009 in coordination with criminal actions brought by the Department of Justice ("DOJ"), representing more than a 30% increase over FY 2008.
- Started 944 investigations in FY 2009, up 6% from FY 2008, and issued 496 formal orders of investigation, an increase of more than 100% compared to the prior year.

[1] The SEC's fiscal year begins on October 1. References to FY 2009 refer to the year that began on October 1, 2008 and ended on September 30, 2009.

- Closed 716 investigations, down significantly from 1,355 actions closed in the prior year.

- Moved quickly to halt and punish misconduct by seeking 71 emergency orders in FY 2009 – an 82% increase from the prior year. The Commission also filed 70% of its first enforcement actions within two years of starting an investigation or inquiry. That figure represents an 8% increase from the prior year.

- Obtained a "favorable" outcome in 92% of its cases – the exact same percentage it had achieved in the two prior years.

- Obtained $345 million in civil money penalties (up 35%) and $2.09 billion in disgorgement orders (a 170% increase).

Keeping with the theme of change at the Commission, last year there were a number of new policy developments at the SEC. First, Chairman Schapiro ended the "penalty pilot" program in which staff attorneys had been required to obtain settlement ranges from the Commission before starting penalty negotiations with corporate respondents.

Second, the process for obtaining formal orders of investigation was made more efficient by allowing senior Division of Enforcement officials to issue such orders, which allow the staff to subpoena documents and demand testimony under oath.

Third, the SEC began work on several initiatives to foster cooperation by individuals, including developing a public policy statement describing how the Commission evaluates a person's cooperation in its investigations. In mid-January 2010, these efforts came to fruition with the publication of a formal statement concerning cooperation by individuals. The Division of Enforcement also added several sections to its Enforcement Manual concerning new "cooperation tools" relating to both individuals and corporations, such as Cooperation Agreements, Deferred Prosecution Agreements, and Non-Prosecution Agreements.

In November 2009, the SEC joined President Obama's interagency Financial Fraud Enforcement Task Force, which is designed to strengthen the country's efforts to combat financial crime. This initiative is yet another example of the Commission's efforts to coordinate its activities closely with criminal authorities.

Finally, in December 2009, the U.S. House of Representatives passed The Wall Street Reform and Consumer Protection Act of 2009. If approved by the Senate in its current form, the bill would enhance the SEC's enforcement powers by providing it with access to grand jury materials in certain instances, establishing a new whistleblower bounty program, and authorizing the Commission to obtain penalties in cease-and-desist administrative proceedings. The legislation would

also force the SEC to either commence an action or close an investigation within 180 days of a Wells notice in most cases.

The SEC's changes in personnel and structure, enforcement statistics, policy and legislative developments are described in this Outline on pages 7 – 14. Summaries of the Commission's key actions against broker-dealers and their employees can be found on pages 15 – 55 of this Outline.

Developments Relating to Bernard Madoff's Ponzi Scheme

Of course, Bernard Madoff's December 2008 arrest sparked many of the changes in the enforcement landscape discussed elsewhere in this Outline. That event also triggered a number of SEC and DOJ prosecutions targeted directly at Madoff's Ponzi scheme. The key Madoff-related actions, including those against his auditor, chief financial officer and computer programmers, and certain individuals and firms that provided their clients' money to Madoff are described on pages 56 – 62 of this Outline.

Auction Rate Securities

While the attention given to auction rate securities arguably was the enforcement story of the year in 2008, regulators continued to bring and/or finalize ARS cases in 2009. A list reflecting many significant ARS cases brought by the SEC, FINRA, and state regulators in 2008 and 2009 appears on pages 63 – 64 of this Outline.

FINRA

Last year marked the second full year since NASD Regulation and NYSE Regulation merged to form FINRA in July 2007. On February 24, 2009, the Board of Governors of FINRA announced that Richard G. Ketchum had been appointed FINRA's CEO, replacing Mary Schapiro. Prior to his appointment, Mr. Ketchum served as CEO of NYSE Regulation and as Chair of FINRA's Board of Governors, and he continues to hold the latter position.

Since becoming FINRA's CEO, Mr. Ketchum has, among other things, focused on the importance of restoring investors' trust in the financial markets and the regulatory system and promised that FINRA's Department of Enforcement will have the resources it needs to investigate and discipline firms or individuals that harm investors.

The changes at FINRA last year, while not as striking as at the SEC, are noteworthy. To begin, in March 2009, FINRA created the Office of the Whistleblower to accelerate the review and analysis by senior FINRA staff of

important tips and to assure a prompt response to meritorious investigative leads.

In October 2009, FINRA created the Office of Fraud Detection and Market Intelligence, which is responsible for analyzing allegations of fraud brought to the staff's attention either through its own internal processes or external sources. The new Office encompasses several existing groups within the Departments of Market Regulation and Enforcement, but fraud cases will generally continue to be investigated in the field by examiners and enforcement staff.

The Department of Enforcement also spent time last year reviewing its case identification, opening, and investigative processes with the aim of being more "nimble and quick." Of note, it is likely that FINRA will increase its use of "on-site" enforcement investigations based upon the success it had with this technique in its 2008 ARS investigations.

Last year FINRA significantly increased its use of sweeps, canvassing member firms on at least eight topics ranging from transactions with retail customers in various products to hedge fund advertising and sales literature to research and trading "huddles." This activity caused FINRA's Chief of Enforcement, Susan Merrill, to state that "sweeps are back in vogue."

FINRA resolved 1,103 cases last year, up 9.5% from the 1,007 such actions in 2008. It also appears that the fines imposed by FINRA in 2009 will exceed substantially the prior year's totals. Moreover, in 2009, FINRA announced six cases with fines of more than $1.5 million; there were no such actions publicized in 2008.

These developments are described in this Outline on pages 65 – 69. Summaries of the key FINRA disciplinary actions brought last year can be found on pages 70 – 120 of this Outline.

NYSE Regulation

Notwithstanding the creation of FINRA in 2007, NYSE Regulation retained independent oversight and enforcement responsibility for trading violations occurring on the NYSE's systems and facilities. Pursuant to a regulatory services agreement, NYSE Regulation also regulates the trading on NYSE Arca and NYSE Amex.

Not surprising, given its reduced mandate, the number of cases brought by NYSE Regulation in 2009 dropped substantially from prior years. NYSE Regulation released approximately 25 Hearing Board Decisions that have a 2009 case number (four of which relate to a single case involving four affiliates of one firm). In 2009, NYSE Regulation announced about 46 decisions relating to its oversight of NYSE Arca and NYSE Amex.

A discussion of selected NYSE Regulation and NYSE Arca enforcement actions in 2009 can be found on pages 121 – 131 of this Outline.

Enforcement Developments at the SEC in 2009

In 2009, there were many extraordinary enforcement developments at the SEC. These range from a new Chairman and senior enforcement personnel to significant increases in enforcement activity to a number of changes in the Division of Enforcement's structure and policies. These and other topics are described below.

Changes in Personnel and Division of Enforcement Structure

On January 20, 2009, President Barack Obama nominated Mary L. Schapiro, formerly an SEC Commissioner, Chair of the Commodities Futures Trading Commission, and CEO of FINRA, to serve as the 29th chair of the SEC; seven days later, the Senate unanimously confirmed her appointment. In her public comments, Chairman Schapiro has expressed her belief in vigorous enforcement of the securities laws. As an example, in testimony before the Senate Banking Committee during her confirmation hearings, Ms. Schapiro explained that she has "never been afraid to go after people who [she] thought violated the public trust" and vowed that "[o]ne of the first things [she would] do is take the handcuffs off the enforcement division."[2]

On the heels of the Madoff scandal, Chairman Schapiro set out to remake the Division of Enforcement. In terms of personnel, in 2009, the Commission recruited at least four former senior federal criminal prosecutors to run the Division of Enforcement. These appointments, along with several other developments described below, demonstrate the government's moves toward increasing the so-called "criminalization" of the federal securities laws.

In February 2009, Chairman Schapiro appointed Robert Khuzami to serve as Director of the SEC's Division of Enforcement. Mr. Khuzami previously served as General Counsel for the Americas at Deutsche Bank AG, and prior to that, spent 11 years working for the U.S. Attorney's Office for the Southern District of

[2] Neil Roland, Schapiro: "I'll 'Take the Handcuffs' Off Enforcement", Investment News, Jan. 15, 2009, http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20090115/REG/901159973.

New York, serving as chief of that office's Securities and Commodities Fraud Task Force for three of those years. Upon his appointment, Mr. Khuzami vowed to "relentlessly pursue and bring to justice those whose misconduct infects our markets, corrodes investor confidence and has caused so much financial suffering."[3] During the summer, the SEC appointed former federal prosecutors Lorin L. Reisner and George S. Canellos to serve as Deputy Director of the Division of Enforcement and Regional Director of the New York Regional Office, respectively.[4] Finally, in December 2009, the Commission announced that yet another former federal prosecutor had joined the SEC; Eric Bustillo was named the Regional Director of the SEC's Miami Regional Office.[5]

In addition to changes in personnel, the Division of Enforcement introduced several other organizational and management changes. Three new initiatives are worth noting. First, the SEC is in the process of creating five new national specialized enforcement groups. Second, the Commission made substantial changes to the Division of Enforcement's organizational structure. Third, the SEC announced the creation of an Office of Market Intelligence.

In August 2009, Mr. Khuzami formally announced the introduction of five specialized units dedicated to high-priority areas. The units, which will each be headed by a Unit Chief and staffed across the country, will focus on the following five areas: (1) Asset Management; (2) Market Abuse; (3) Structured and New Products; (4) Foreign Corrupt Practices Act; and (5) Municipal Securities and Public Pensions.[6] On January 13, 2010, the Enforcement Division announced the leaders of the specialized units.[7]

Last year, the Division of Enforcement began creating a flatter organizational structure by eliminating the role of Branch Chief. When implemented, Branch Chiefs will return to investigating cases rather than managing others, affording the SEC more – and more experienced – enforcers on the ground.[8]

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3 SEC Press Release, *Robert Khuzami Named SEC Director of Enforcement*, Feb. 19, 2009, http://www.sec.gov/news/press/2009/2009-31.htm.

4 SEC Press Release, *George S. Canellos Named Regional Director of SEC New York Regional Office*, June 2, 2009, http://www.sec.gov/news/press/2009/2009-125.htm; SEC Press Release, *Lorin L. Reisner to Join SEC Enforcement Division*, July 2, 2009, http://www.sec.gov/news/press/2009/2009-150.htm.

5 SEC Press Release, *Eric Bustillo Named Regional Director of SEC's Miami Regional Office*, Dec. 16, 2009, http://www.sec.gov/news/press/2009/2009-267.htm.

6 *See* Remarks by Robert Khuzami before the New York City Bar Association, Aug. 5, 2009, available at http://www.sec.gov/news/speech/2009/spch080509rk.htm.

7 See *SEC Names New Specialized Unit Chiefs and Head of New Office of Market Intelligence*, Jan. 13, 2010, available at www.sec.gov/news/press/2010/2010-5.

8 *See* Robert Khuzami, Testimony Concerning Mortgage Fraud, Securities Fraud, and the Financial Meltdown: Prosecuting Those Responsible, before the U.S. Senate Committee on the Judiciary, Dec. 9, 2009, available at http://www.sec.gov/news/testimony/2009/ts120909rk.htm.

Finally, in 2009, the Commission announced the establishment of an Office of Market Intelligence, which will be responsible for collecting, analyzing, monitoring and referring the large amount of tips and complaints annually received by the SEC.[9]

Enforcement Statistics

Many of the metrics used to measure enforcement activity at the SEC reflect a significant increase compared to FY 2008.[10]

Despite the major changes and initiatives undertaken last year, in the SEC's FY 2009, the Commission **brought 664 enforcement actions**, a slight decrease from the 671 cases initiated in FY 2008. The major categories of cases and the number of actions within each include:

Type of Case	Number of Actions	% of Total Cases
Issuer Reporting and Disclosure	143	22%
Securities Offering Cases	141	21%
Broker-Dealer	109	16%
Delinquent Filings	92	14%
Investment Advisers	76	11%
Market Manipulation	39	6%
Insider Trading	37	6%

Notably, in one of the SEC's core areas – **regulation of broker-dealers** – its case load was **up significantly to 109 cases** in FY 2009 from 60 actions in the prior year, an increase of approximately 82% and the highest number since FY 2004.

Despite the attention given to **insider trading cases** recently, the number of insider trading cases brought by the SEC in FY 2009 **dropped to 37** from 61 in FY 2008; those 37 actions made up 6% of the SEC's caseload last year.

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9 See Remarks by Robert Khuzami before the New York City Bar Association, Aug. 5, 2009.

10 As noted previously, the SEC's fiscal year begins on October 1st. References to FY 2009 refer to the year that began on October 1, 2008 and ended on September 30, 2009. The 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.

However, the SEC filed several high profile insider trading cases after its fiscal year closed in September 2009, which are not reflected in these statistics.

Last year a significant amount of attention was paid to the increasing "criminalization" of the federal securities laws. The evidence demonstrates that this was more than mere talk. The **SEC filed 154 actions** in FY 2009 in **coordination with criminal actions** (*i.e.*, indictments, informations, or contempt proceedings) brought by the DOJ. This represents more than a 30% increase over the 108 such actions filed in FY 2008.

The SEC **initiated 944 investigations in FY 2009**, up 6% from FY 2008 and up 22% from FY 2007. The SEC **issued 496 formal orders of investigation** – an increase of more than 100% compared to FY 2008.

According to the SEC, last year the Division of Enforcement continued its focus on **closing investigations**. In FY 2009, the staff closed **716** investigations. Although that number pales in comparison to the 1,355 cases closed by the Division of Enforcement in the prior year, it is commendable when compared with prior years.

One of the goals of the new SEC leadership is to move quickly to stop and punish misconduct affecting the securities markets. Again, this was not idle chatter by the Commission. As evidence of meeting this objective, in FY 2009 the SEC **sought 71 emergency orders** to stop ongoing misconduct – an 82% increase from the prior year. On a related note, last year the Commission **filed 70% of its first enforcement actions within two years** of starting an investigation or inquiry. That figure represents an 8% increase year-over-year. This rise results from the SEC's quickly moving in FY 2009 in response to a number of Ponzi schemes.

Last year the Commission continued its record of "successfully" resolving the vast majority of its cases. Specifically, in FY 2009 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.) This is the exact same percentage the Commission achieved in FY 2007 and FY 2008.

FY 2009 marked a reversal of the downward trend of the past several years in the **civil money penalties and disgorgement** paid by respondents in SEC enforcement actions. As shown in the table below, FY 2009 reflected an increase in both civil money penalties and disgorgement amounts over FY 2008 levels. Specifically, in FY 2009, the **SEC's penalties increased 35%** ($345 million versus $256 million), and the **Commission notched a 170% increase** ($2.09 billion versus $774 million) in disgorgement orders.

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

The average civil penalties paid by corporate respondents to settle SEC cases increased substantially as well. In FY 2009, SEC settlements with companies involved an average civil penalty of $10.7 million compared with an average civil penalty of $4.7 million in FY 2008.[11]

Policy Developments

As noted, last year was one of considerable change at the SEC. A number of key policy developments are described below.

In one of her first enforcement-related acts, Chairman Schapiro terminated the "penalty pilot" program initiated by former Chairman Christopher Cox in 2007 that required SEC Division of Enforcement staff attorneys to obtain settlement ranges from the Commission before commencing corporate penalty negotiations. Although the program was designed to increase the consistency and predictability of settlements, critics asserted that it "introduced significant delays into the process of bringing a corporate penalty case; discouraged staff from arguing for a penalty in a case that might deserve a penalty; and sometimes resulted in reductions in the size of penalties imposed."[12] In addition, early in 2009, Chairman Schapiro eliminated the requirement that all five Commissioners approve the issuance of a formal order of investigation, which is a predicate step for staff attorneys to issue subpoenas.[13] In a further streamlining of the process, the authority to issue formal orders of investigation was delegated to the Director of the Division of Enforcement, who in turn generally delegated such authority to

11. *See* Jan Larsen with Dr. Elaine Buckberg and Dr. Baruch Lev, *SEC Settlements Trends: 3Q09 Update*, Dec. 7, 2009 available at http://www.securitieslitigationtrends.com/pub_settlements_update_Q3_1209.pdf.

12 Mary L. Schapiro, Speech by SEC Chairman: Address to Practising Law Institute's "SEC Speaks in 2009" Program (Feb. 6, 2009), http://sec.gov/news/speech/2009/spch020609mls.htm.

13. *Id.*

senior officers throughout the Division.[14] This change will clearly permit the SEC's staff to move more quickly in investigating potential wrongdoing.

In 2009, the SEC's Division of Enforcement announced that it was working on several initiatives to foster cooperation by individuals.[15] First, it was working on a statement setting forth the standards by which the Commission would evaluate an individual's cooperation in an enforcement investigation. This report would be similar to the SEC's "Seaboard" policy statement pertaining to cooperation by corporations. Second, Enforcement was looking to create an expedited process that would allow the Director to submit immunity requests to the DOJ. Third, the Division of Enforcement was developing a cooperation agreement that would permit it to forego action against an individual under certain circumstances, including when the individual fully cooperates with the staff's investigation.

On January 13, 2010, the Commission formally released the policy statement and the Division of Enforcement issued a revised version of its Enforcement Manual, which contained a new section entitled "Fostering Cooperation." There, the Division of Enforcement provides its view concerning how it will evaluate cooperation by individuals and corporations and describes the "cooperation tools" now available to the staff and the SEC, including Cooperation Agreements, Deferred Prosecution Agreements, and Non-Prosecution Agreements.

In an effort to move investigations and cases along efficiently, Mr. Khuzami has also announced that going forward the Division of Enforcement could not enter into any tolling agreements on behalf of the SEC unless he personally reviewed and approved them.[16]

Finally, in light of the pressure being put on the SEC by Judge Jed Rakoff in the *Bank of America* case described below, there is speculation that the Commission will now seek to more aggressively pursue charges against individuals. However, in his December 11, 2009 Congressional testimony regarding the SEC's case against Bank of America, Mr. Khuzami addressed the issue of individual liability and stated that:

> The actions in this proposed settlement do not reflect a change in the Commission's approach to pursuing charges against individuals that violate the federal securities laws. The Commission has been and will continue to be aggressive in bringing actions against individual wrongdoers that violate the securities laws. Moreover, the Commission will continue to vigorously pursue penalties from culpable

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14 *See* Robert Khuzami Dec. 11, 2009 Congressional testimony.

15 *See* Remarks by Robert Khuzami before the New York City Bar Association, Aug. 5, 2009 and Mr. Khuzami's Dec. 11, 2009 Congressional testimony.

16 *See* Remarks by Robert Khuzami before the New York City Bar Association, Aug. 5, 2009.

individuals, including culpable corporate executives. Indeed, the Commission has a strong record of charging and seeking substantial penalties from individual executives in recent cases, and will continue to do so in the future.[17]

These policy developments have positioned the SEC to more efficiently pursue its enforcement mandate against firms and individuals in FY 2010 and beyond.

Financial Fraud Enforcement Task Force

In November 2009, President Obama established an interagency Financial Fraud Enforcement Task Force to strengthen the country's efforts to combat financial crime.[18] The DOJ will play the lead role on the Task Force and the SEC, the Treasury Department, and the Department of Housing and Urban Development will serve on its steering committee. The Task Force includes senior officials from more than two dozen U.S. governmental agencies. According to a press release announcing its creation, the Task Force "will build upon efforts already underway to combat mortgage, securities and corporate fraud by increasing coordination and fully utilizing the resources and expertise of the government's law enforcement and regulatory apparatus."[19] This initiative is yet another example of the SEC's coordination with criminal and other authorities. Notably, the Task Force does not include representatives from FINRA or NYSE Regulation.

Financial Crisis Inquiry Commission

In an enforcement-related development taking place away from the SEC, in 2009 Congress established a Financial Crisis Inquiry Commission ("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.[20]

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[17] *See Testimony of Robert Khuzami Concerning Events Surrounding Bank of America's Acquisition of Merrill Lynch*, Dec. 11, 2009 at www.sec.gov/news/testimony/2009/ts121109rk.htm. (Footnote omitted.)

[18] *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.

[19] *Id.*

[20] *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.

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. Witnesses included the CEOs of JPMorgan Chase, Goldman Sachs, and Morgan Stanley and several senior government regulators.

The FCIC's report to the President is due on or before December 15, 2010.

Legislative Developments

On December 11, 2009, the U.S. House of Representatives passed The Wall Street Reform and Consumer Protection Act of 2009. This draft legislation would significantly alter the legal and regulatory landscape for financial institutions.

Of particular interest for this Outline, Title V of the legislation is the Investor Protection Act of 2009, which has several provisions that affect the SEC's enforcement powers. Among other things, the bill would: (i) provide the SEC with access to grand jury materials in certain situations; (ii) establish a new whistleblower bounty program to reward individuals who provide information to the Commission in certain cases; (iii) quicken SEC investigations by requiring the Commission to either bring charges or close an investigation within 180 days after the filing of a Wells submission in certain matters; and (iv) authorize the SEC to obtain money penalties in cease-and-desist administrative proceedings.[21] Upon passage of the House legislation, SEC Chairman Schapiro "applaud[ed] the House for taking this historic step to bolster investor protections and fill gaps in our financial regulatory framework."[22]

The Senate has not yet passed legislation regarding financial regulatory reform.

Current SEC Enforcement Priorities

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:

- Insider trading on Wall Street

[21] An insightful summary of these provisions was written by Peter J. Henning for the New York Times DealBook. S*ee What the SEC Gains from the Financial Bill*, Dec. 15, 2009 at www.nytimes.com. This section of the Outline was drawn from Mr. Henning's work.

[22] See Press Release, *SEC Chairman Schapiro Statement on House-Passed Financial Regulatory Reform Legislation*, Dec. 11, 2009 at http://www.sec.gov/news/press/2009/2009-263.htm.

- Ponzi schemes
- Disclosure of the value of assets, including mortgage-backed securities and collateralized debt obligations
- Internet enforcement
- Microcap fraud
- Municipal securities fraud, including pay to play
- Short selling, particularly naked short selling
- Fraudulent registered representative sales practices
- The selection and use of pension consultants by broker-dealers
- Sales of collateralized mortgage obligations to retail customers

SEC Enforcement Actions[23]

Fraudulent Sales to Investors

Three fraud cases from last year are worth noting. In the first, the SEC and FINRA simultaneously charged 16 brokers with violations concerning collateralized mortgage obligation ("CMO") sales. A second case by the SEC also involves alleged fraudulent securities sales to investors. The third concerns sales of variable annuities.

A. *SEC v. William Betta, Jr., et al.*, 09-Civ-80803 (S.D. Fla. May 28, 2009); *SEC v. Brookstreet Securities Corp.* ("Brookstreet"), SACV 09-01431 (C.D. Cal. filed Dec. 8, 2009)

1. The SEC charged ten brokers with fraud related to their sales to customers of collateralized mortgage obligations, alleging that the brokers had misrepresented to customers that the CMOs were safe and suitable for retirees.

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[23] 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.

2. The SEC's complaint alleges that between 2004 and 2006, Brookstreet brokers defrauded more than 750 customers by telling them that CMOs were safe, secure, and liquid, leading customers to purchase more than $175 million in CMOs. The brokers earned commissions of more than $16 million in connection with the CMO sales.

3. According to the Commission, contrary to the brokers' representations, the CMOs were not all guaranteed by the U.S. government, put the customers' yield and principal at risk, were largely illiquid, and were only suitable for sophisticated investors with a high tolerance for risk. The brokers also traded heavily on margin in customers' accounts, despite assurances from some defendants that margin would be used sparingly.

4. When the CMO market began to fail in 2007, margin calls resulted, and customers lost over $36 million.

5. In September 2009, the SEC settled with one defendant, Barry Kornfeld. Kornfeld consented to an injunction, to disgorge ill-gotten gains, and to pay a civil penalty in an amount to be decided by the court upon motion by the SEC.

6. The SEC seeks permanent injunctions, civil penalties, and disgorgement in its action against the remaining defendants.

7. On December 8, 2009, the SEC filed an action in California federal district court against Brookstreet and Stanley Brooks (Brookstreet's president and CEO) related to the same allegedly fraudulent sales activity discussed above. The SEC alleged that Brooks created a program for its registered representatives to sell the risky CMOs to, among others, seniors and retired persons.

8. FINRA brought similar charges against six other Brookstreet brokers. FINRA alleges that the brokers did not have an adequate understanding of CMOs and that they misrepresented or failed to disclose information to customers relating to the risks of investing in CMOs. FINRA's complaint also charges the brokers with exercising discretionary authority in customer accounts without written authorization.

B. *SEC v. Aura Financial Services, Inc.* ("Aura"), *et al.*, 09-Civ-21592 (S.D. Fl. filed Jun. 11, 2009)

1. The SEC filed a complaint against Aura and six registered representatives for fraudulent sales practices.

2. The SEC alleged that between October 2005 and April 2009, Aura and its registered representatives employed fraudulent sales practices to induce fifteen customers to open Aura brokerage accounts. Defendants opened many of the accounts as margin accounts, despite the fact that they had not discussed with their clients the risks of margin. Defendants also allegedly engaged in excessive trading in (or churning) the accounts in order to increase commissions.

3. Defendants also allegedly traded in a manner that was inconsistent with their unsophisticated clients' investment objectives and risk tolerances. The customers did not understand the total transaction costs they were charged through their trading with Aura. During 2008, the churning generated total gross commissions of more than $1 million, while the accounts lost over $3.5 million.

4. The SEC alleged that Aura failed to take reasonable steps to prevent the churning practices by its registered representatives, although it was aware of high turnover in the accounts and several customer complaints about the representatives. Further, Aura allegedly was aware that FINRA had filed a disciplinary proceeding in May 2008 against one of the defendants (Ronald Hardy, Jr.) and his supervisor concerning the falsification of new account forms at a prior employer.[24]

5. In October 2009, Aura consented to an injunction, to disgorge ill-gotten gains and to pay a civil penalty in an amount to be set by the court upon motion by the SEC.

6. In July 2009, the court entered default judgments against defendants Raymond Rapaglia, Peter Dunne, and Hardy. In January 2010, the court entered a judgment against Hardy,

[24] In July 2009, a FINRA Hearing Panel Decision barred Hardy from associating with any FINRA member.

issuing an injunction and ordering Hardy to disgorge $228,362 and to pay a $130,000 civil penalty.

7. The SEC seeks injunctions, penalties, and disgorgement from the remaining defendants.

C. *In the Matter of Prime Capital Services, Inc.* ("PCS")*, et al.*, Admin. Proc. No. 3-13532 (Jun. 30, 2009)

1. The SEC filed an administrative proceeding against PCS, its president, one of its senior compliance employees, its parent company (Gilman Ciocia, Inc.), and several PCS registered representatives and their supervisors 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, the 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. The SEC also claimed that Gilman Ciocia, Inc. aided and abetted PCS's fraud by arranging free-lunch seminars in and around several senior citizen communities in Florida where the registered representatives would recruit senior citizens as customers and induce them into buying variable annuities.

4. Further, PCS, as well its president, compliance officer, and two supervisors allegedly failed to supervise and failed to set up a system to follow up on, among other topics, branch examinations, supervisory review of variable annuity transactions, and customer complaints.

5. In November 2009, respondent Christie Anderson, a PCS compliance officer settled with the SEC failure to supervise charges. Anderson consented to pay a $10,000 civil penalty, to a one-year suspension, and to cooperate with the SEC staff's investigation.

6. The matter is ongoing.

Gifts and Gratuities

As in recent years, in FY 2009, the SEC brought a gifts and gratuities action.

A. *In the Matter of RBC Capital Markets Corp.* ("RBC"), Admin. Proc. File No. 3-13379 (Feb. 24, 2009)

1. The SEC settled an action against RBC in which RBC allegedly violated the fair dealing, gifts and gratuities and supervisory rules of the Municipal Securities Board in connection with advances and reimbursements relating to an unnamed municipal client (the "City").

2. As part of its bond issuance process, the City obtained credit ratings for its bonds from credit rating agency analysts in New York. The SEC alleged that during trips to meet with the credit rating agencies in 2004 and 2005, City officials were accompanied by family members, ate at expensive restaurants, attended various entertainment events, including Broadway plays and a basketball game, and were afforded access to a private car service.

3. Before each trip, RBC coordinated with a City representative and organized the activities for the trips. RBC advanced the payment for almost all of the trips' expenses. RBC also reimbursed City officials for out-of-pocket costs during the trip. RBC then was reimbursed for the expenses related to the ratings trips from the bond proceeds as a cost of issuance.

4. RBC agreed to a censure, a cease-and-desist order, and a $125,000 civil penalty.

Insider Trading

As in the past several years, the SEC brought a number of insider trading cases in 2009, several of which involved allegations against Wall Street professionals employed by well-known investment banks. The SEC also initiated a substantial case involving a firm's failure to establish and maintain protocols to prevent insider trading and its first ever insider trading action relating to credit default swaps. The Galleon-related cases, which did not focus on broker-dealer employees and were brought after the end of the SEC's FY 2009, nevertheless are discussed below because of their high-profile nature.

A. *SEC v. Galleon Management* ("Galleon")*, Raj Rajaratnam, Rajiv Goel, Anil Kumar, Danielle Chiesi, Mark Kurland, Robert Moffat, New Castle Funds LLC, Roomy Khan, Deep Shah, Ali T. Far, Choo-Beng Lee, Far & Lee LLC, Spherix Captial LLC, Ali Hariri, Zvi Goffer, David Plate, Gautham Shankar, Shottenfeld Group LLC, Steven Fortuna, and S2 Capital Management, LP,* 09 Civ. 8811 (S.D.N.Y. Oct. 16, 2009 and Nov. 5, 2009)

1. In October 2009, 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 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, non-public 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 non-public 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. The SEC alleges that the insider trading ultimately resulted in more than $33 million in profits and losses avoided.

5. The SEC seeks injunctions, disgorgement, civil penalties, and an order barring certain defendants from acting as officers or directors of any registered public company.

6. To date, 21 individuals have been criminally charged in connection with the Galleon-related insider trading investigations, 7 of whom have pled guilty.[25]

B. *SEC v. Arthur J. Cutillo et al.,* 09 Civ. 9208, (S.D.N.Y. Nov. 5, 2009)

1. On the same day that the SEC amended its complaint in the Galleon case, the SEC filed a complaint against nine defendants, including four of the defendants in the Galleon case, in connection with an alleged insider trading ring of Wall Street traders, hedge funds and three attorneys who benefited by more than $20 million by trading ahead of acquisition announcements.

2. The complaint alleged that an attorney in private practice, Arthur Cutillo, misappropriated information concerning corporate acquisitions from his law firm. In return for kickbacks, Cutillo passed that information through another attorney, Jason Goldfarb, to Zvi Goffer, a Schottenfeld Group, LLC proprietary trader. Goffer allegedly then traded on this information and tipped numerous others, including two of his fellow proprietary traders at Schottenfeld, two traders at other broker-dealers, and two hedge fund advisors, who also traded on the information.

3. The SEC alleged that the insider trading ring used material, non public information regarding at least four acquisitions or bids – the 2007 acquisitions of Alliance Data Systems Corp., Avaya Inc., 3Com Corp., and Axcan Pharma Inc.

4. The SEC seeks injunctions, disgorgement and civil penalties from the defendants.

C. *SEC v. Nicos Achilleas Stephanou, Ramesh Chakrapani, Achilleas Stephanou, George Paparrizos, Konstantinos Paparrizos, Michael G. Koulouroudis, and Joseph Contorinis* (S.D.N.Y. Feb. 5, 2009)

1. The SEC filed a complaint against two mergers and acquisitions professionals Nicos Stephanou (an associate director of UBS Investment Bank) and Ramesh Chakrapani

[25] *See* C. Bray, "The Galleon Case: Kumar Says He Was Paid for Tips," The Wall Street Journal, p. C3 (Jan. 8, 2010).

(a managing director of Blackstone Advisory Services, L.P.), along with five individuals whom they allegedly tipped in an insider trading ring.

2. The SEC alleges that between November 2005 and December 2006, the two M&A professionals tipped friends and family members (including Joseph Contorinis, a Jefferies Group, Inc. hedge fund portfolio manager and managing director) concerning three separate M&A deals. Stephanou's and Chakrapani's employers served as financial advisors to the acquiring or target companies in the three deals. Prior to public announcement of the transactions, Stephanou and Chakrapani allegedly passed confidential information to their friends and family members by telephone, after which the tippees engaged in substantial trading.

3. The complaint further alleges that Stephanou either tipped his father (Achilleas Stephanou) or traded in his father's account to avoid detection.

4. The SEC alleges that the tipped investors made profits and avoided losses totaling more than $8 million. Most of the illegal profits were reaped by the Jefferies hedge fund managed by Contorinis, which allegedly netted $7.2 million in profits.

5. In September 2009, the SEC settled charges with Nicos Stephanou and George Paparrizos. Nicos Stephanou consented to an injunction, to disgorge $461,893, and to a bar from association with a broker or dealer. Paparrizos consented to an injunction, to disgorge $24,617, and to pay a civil penalty of $24,617.

6. In early 2009, related criminal charges were filed against Chakrapani, Nicos Stephanou, Koulourdis, George Paparrizos, and Contorinis. Nicos Stephanou, George Paparrizos, and Koulouroudis have pled guilty. In April 2009, federal prosecutors dropped charges without prejudice against Mr. Chakrapani without publicly providing an explanation.

7. In November 2009, the SEC moved to dismiss its charges against Chakrapani without prejudice on the grounds that a key witness (Nicos Stephanou) allegedly is unavailable to

the SEC because he would assert his Fifth Amendment privilege against self-incrimination until the criminal case against him has been completely resolved. Chakrapani has opposed the motion, which is scheduled for oral argument in February 2010. The SEC has also withdrawn its charges without prejudice against Achilleas Stephanou and Konstantinos Paparrizos.

8. The SEC seeks injunctive relief, disgorgement of illicit profits, and civil penalties against the remaining defendants.

D. *In the Matter of Merrill Lynch, Pierce, Fenner, & Smith Incorporated* ("Merrill Lynch") Admin. Proc. File No. 3-13407, Mar. 11, 2009.

1. The SEC settled an administrative proceeding against Merrill Lynch, alleging that the firm failed to establish and enforce policies and procedures reasonably designed to prevent the misuse of material, non-public information.

2. The SEC alleged that between 2002 and 2004, Merrill Lynch retail brokers positioned their telephone receivers in a way that provided A.B. Watley Group's day traders with real-time access to confidential Merrill Lynch institutional customer order information transmitted over the "squawk boxes." The SEC alleged that the day traders used this information to trade ahead of Merrill Lynch's customers and profited as a result of the market movement resulting from the subsequent trades by Merrill Lynch's institutional customers. In exchange for providing this access, the Merrill Lynch brokers allegedly received commissions and cash.

3. The SEC further alleged that Merrill Lynch did not have written policies or procedures reasonably designed to prevent misuse of customer order information because the firm did not limit access to the squawk box to its brokers who had a bona fide need for the information and because the firm did not track brokers' access to, or monitor their use of, the squawk box.

4. Merrill Lynch consented to a censure, and a cease-and-desist order, and agreed to pay a $7 million civil penalty. The firm also agreed to a number of undertakings, including an obligation to design and implement a program to enforce policies and procedures regarding the confidentiality of information sent through the squawk box

and a requirement that the firm audit the squawk box system every two years for the next six years and report the results and recommendations to the Enforcement staff.

5. Several A.B. Watley Group employees and one Merrill Lynch broker previously faced civil enforcement actions for their alleged misuse of material, non-public information in connection with their roles this activity.[26]

6. The squawk box abuses have also been the subject of criminal cases. After a mistrial was declared in a May 2007 criminal trial, federal prosecutors retried three brokers (one each from Merrill Lynch, Smith Barney and Lehman Brothers) and three A.B. Watley Group executives in April 2009. The jury convicted all six men on charges of conspiracy. In December 2009, a federal district court judge sentenced the defendants; they received sentences ranging from probation to 4 years in prison followed by 4 years of supervisory release and disgorgement of $242,000.

E. *SEC v. Maher F. Kara, et al.*, 09-Civ-1880 (N.D. Cal. Apr. 30, 2009); *SEC v. Joseph Azar*, 09-Civ-1881 (N.D. Cal. Apr. 30, 2009); *SEC v. Nassar Mardini*, 09-Civ-1882 (N.D. Cal. Apr. 30, 2009)

1. The SEC brought charges against brothers Maher Kara (a Citigroup investment banker) and Michael Kara and six of their friends and family members in connection with insider trading activity.

2. Maher Kara allegedly tipped his brother Michael Kara about upcoming deals involving health care industry clients. Maher learned non-public information about these clients from his work in the Citigroup Investment Banking Healthcare Group and allegedly shared that information despite explicit promises not to do so. Michael Kara then often spread the information to six friends and family members, who traded on the information before it became public.

3. Michael Kara traded in at least 20 companies with pending projects from 2004 to 2007, earning profits in excess of $1.2

[26] *See SEC v. Amore, et al.* (E.D.N.Y. Aug. 15, 2005); *SEC v. A.B. Watley Group, Inc., et al.* (E.D.N.Y. Mar. 21, 2006).

million, while the other tippees made nearly $4 million in total.

4. Three of the tippees, Joseph Azar, Nassar Mardini, and Zahi Haddad, agreed to settle the SEC's charges against them. Each consented to a permanent injunction and to disgorge profits. In addition, Azar agreed to pay a civil penalty.

5. The SEC recognized Citigroup's cooperation in its investigation.

F. *SEC v. Jon-Paul Rorech and Renato Negrin*, 09-Civ-4329 (S.D.N.Y. May 5, 2009)

1. The SEC filed an action in federal district court 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.

2. Deutsche Bank was serving as lead underwriter for a VNU bond offering. The SEC alleges 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. The SEC seeks permanent injunctions, civil penalties, and disgorgement.

4. Rorech and Negrin moved for judgment on the pleadings, based in part on their argument that the SEC did not have enforcement authority concerning CDS because they were not securities-based swap agreements. On December 10, 2009, the court denied the motion, explaining that in passing the Commodity Futures Modernization Act, Congress intended to prohibit in trading securities-based swap agreements what it prohibited in trading securities.

5. This is the first CDS insider trading case brought by the SEC.

G. *SEC v. Mitchel S. Guttenberg, et al.,* 07-Civ-1774 (S.D.N.Y. Jun. 2, 2009 and Sept. 29, 2009)

1. In our 2007 and 2008 Year-in-Review outlines, we reported on a case in which the SEC charged fourteen defendants in connection with two related insider trading schemes in which Wall Street professionals allegedly traded after receiving a series of tips from insiders at UBS Securities LLC ("UBS") and Morgan Stanley & Co., Inc. ("Morgan Stanley) in exchange for cash kickbacks. In 2007 and 2008, a number of defendants settled with the SEC and pled guilty to charges in related criminal actions.

2. In 2009, the SEC settled charges against Mitchel S. Guttenberg (an executive director in the UBS equity research department), DSJ International Resources Ltd. (d/b/a Chelsey Capital ("Chelsey Capital")), traders Erik R. Franklin and David M. Tavdy, and Q Capital Investment Partners ("Q Capital"), which is a hedge fund adviser affiliated with Franklin, related to the same insider trading allegations.

3. The SEC alleged, in part, that between 2001 and 2006, Guttenberg tipped material, non-public information regarding upcoming UBS analyst stock analysis to Franklin and Tavdy. In return, Guttenberg shared in the profits from the trading based on such information. Franklin passed the information on to Chelsey Capital, which also traded on the information.

4. Guttenberg consented to a permanent injunction and a permanent bar from association with a broker, dealer, or investment adviser. Guttenberg also agreed to disgorge about $15.8 million, which was deemed satisfied by a prior criminal forfeiture order in a related criminal case. Previously, Guttenberg pled guilty to securities fraud and conspiracy to commit securities fraud and was sentenced to 78 months in prison.

5. Chelsey Capital consented to a permanent injunction and agreed to pay a civil penalty of approximately $3.6 million and disgorgement of approximately $3.6 million.

6. Franklin and Q Capital consented to a permanent injunction and joint and several disgorgement of $5.4 million (all but $290,000 was waived due to an inability to pay). In an

administrative proceeding, Franklin was permanently barred from association with a broker, dealer, or investment adviser. Previously, Franklin pled guilty to securities fraud, conspiracy to commit securities fraud, and commercial bribery and is awaiting sentencing.

7. Tavdy consented to a permanent injunction and disgorgement of $10.3 million. In an administrative proceeding, Tavdy was barred from association with any broker or dealer. Previously, Tavdy pled guilty to securities fraud and conspiracy to commit securities fraud and was sentenced to more than five years in prison.

H. *SEC vs. Phillip Macdonald, Martin Gollan, and Michael Goodman*, 09-Civ-5352 (S.D.N.Y. filed Jun. 10, 2009)

1. The SEC filed a complaint against three Canadian citizens alleging that they engaged in insider trading in advance of public announcements of business deals based on information misappropriated from an investment bank.

2. The SEC alleges 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. Goodman settled with the SEC, consenting to a permanent injunction and liability for disgorgement of Macdonald's and Gollan's trading profits plus interest. Based on his statement of financial condition, however, the disgorgement was waived.

4. The SEC seeks disgorgement, civil penalties and an order enjoining Macdonald and Gollan from future violations of certain federal securities laws.

I. *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 (N.D. Cal. Dec. 16, 2009)

1. In December 2009, 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 alleges that between December 2006 and May 2007, Gowrish and Zaman obtained material, non-public 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 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, non-public information.

4. Zaman consented to an injunction, a bar from associating with a broker or dealer, and to disgorge $78,456. 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 Vaghar's inability to pay. Sameer Khoury consented to an injunction and disgorgement of $198,607; the disgorgement and a civil penalty were waived based on Sammer Khoury's inability to pay. Relief defendant Elias Khoury consented to disgorge $5,836.

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

6. Federal prosecutors filed criminal charges against Zaman, which have not yet been resolved.

Just and Equitable Principles of Trade

In 2009, both the SEC and a federal appeals court provided guidance to the industry concerning the standards applicable to proving SRO charges of violations of just and equitable principles of trade.

A. *In the Matter of the Application of Thomas W. Heath, III*, Admin. Proc. File No. 3-12890, Jan. 9, 2009; *Thomas W. Heath v. SEC*, Case No. 09-0825-ag, (2nd Cir. Nov. 4, 2009)

1. The SEC reviewed disciplinary action taken by the NYSE Division of Enforcement against Thomas W. Heath, III, a former investment banker and managing director at J.P. Morgan Securities Inc. ("JPMorgan"). Previously, in a litigated case, the Chief Hearing Officer of a NYSE Hearing Panel found that Heath engaged in conduct inconsistent with just and equitable principles of trade by disclosing material non-public information about a proposed acquisition of a JPMorgan client.

2. The NYSE had alleged that while JPMorgan was advising Hibernia Bank ("Hibernia") in connection with its proposed acquisition by Capital One Corp. ("Capital One"), Heath, who was in charge of the Hibernia account, orally accepted a position at Banc of America Securities LLC ("B of A Securities"). Prior to Heath's start at B of A Securities, he told Eric Corrigan, the head of B of A Securities's depository institutions group, about his ongoing Hibernia project in an effort to build a relationship with his future colleague. Heath allegedly told Corrigan that "[t]his is obviously confidential information. The deal is done, bankers have been hired, nothing is going to change. And you have to understand and respect that." Heath also claimed that he explained that Corrigan could not "act on this in any way." After Corrigan agreed to keep the information confidential, Heath described the Hibernia acquisition in detail.

3. Three days later, the Hibernia acquisition was publicly announced. That same day, the Chairman of JPMorgan's North American Mergers and Acquisitions group called Heath and told him that B of A Securities had called Capital One attempting to get hired with the "name, price, structure, and timing" of the transaction, and that Heath had been identified as the source of the leak. JPMorgan terminated

Heath, and B of A Securities rescinded its offer of employment.

4. The Chief Hearing Officer of the NYSE Hearing Panel held that Heath's disclosure violated NYSE Rule 476(a)(6), which prohibits conduct inconsistent with just and equitable principles of trade. The NYSE Hearing Panel imposed a censure and $100,000 fine. The NYSE Board of Directors affirmed the order and sanctions.

5. Heath appealed, arguing that his conduct did not violate just and equitable principles of trade because the Hearing Panel did not find that he acted in bad faith. The SEC disagreed, concluding that just and equitable principles of trade could be violated through bad faith or unethical conduct, and that Heath's disclosure constituted unethical conduct. Accordingly, the SEC sustained the order and sanctions. Of note, the Commission made clear that scienter is not a necessary element of a violation of just and equitable principles of trade if the respondent engaged in unethical conduct.

6. Heath appealed the SEC's decision to the Second Circuit, arguing that bad faith, and not mere unethical conduct, was required to sustain a violation of the Rule. The Second Circuit denied Heath's petition and held that Rule 476(a)(6) is "concerned with enforcing ethical standards of practice in the securities industry and is violated by a breach of confidence if such breach amounts to unethical conduct."

Market Manipulation and Provision of Information to the Marketplace

Market manipulation is a mainstay of the SEC's enforcement program. Below is an example of one such case. A second case, against an inter-dealer broker, involving information provided to the market is described in this section.

A. *SEC v. Anthony Fareri*, *et al.,* 09-Civ-80360 (S.D. Fla. Mar. 3, 2009)

1. The SEC brought a civil action against Fareri, a former Florida stockbroker, his firm, Fareri Financial Services, Inc. d/b/a Amerifinancial ("FFS"), and Anthony Fareri & Associates, Inc. (as a relief defendant) for defrauding

customers of more than $4.7 million in an alleged market manipulation and kickback scheme.

2. The complaint alleges that in 2004 and 2005, Fareri collaborated with Florida investor Paul Harary to perpetrate the fraud by creating demand for worthless shares of stocks of two companies that were quoted on the Pink Sheets. Fareri created an artificial market for the stocks by purchasing the shares for FFS customers, and Harary controlled the supply and sold the shares.

3. Fareri and Harary used pre-arranged matched orders to manipulate the price of the stocks upward, thereby creating the illusion of demand. In connection with this alleged fraud, Fareri received more than $1 million in kickbacks and commissions/mark-ups of more than $160,000.

4. Among the defrauded customers were retirees with little investment experience who had trusted Fareri to invest their money conservatively and who ended up with worthless shares of stock.

5. The SEC seeks a permanent injunction, disgorgement with interest, and civil penalties in its case against Fareri and FFS.

6. In a separate case that settled in September 2007, Harary consented to a final judgment ordering disgorgement and interest of $4 million and a permanent injunction. In a criminal action brought in the U.S. District Court for the District of Columbia, Harary pleaded guilty to conspiracy to commit mail and wire fraud.

B. *In the Matter of ICAP Securities USA LLC* ("ICAP"), *Ronald A. Purpora*, *Gregory F. Murphy*, *Peter M. Agola*, *Ronald Boccio*, *Kevin Cunningham*), *Donald E. Hoffman, Jr.*, *and Anthony Parisi*, Admin. Proc. File No. 3-13726 (Dec. 18, 2009)

1. The SEC settled an administrative proceeding against ICAP, an inter-dealer broker, alleging that it employed deceptive practices by showing "flash" trades in U.S. Treasury securities on its screens viewed by firm customers, who used that information when making trading decisions, and

that it misrepresented its trading activities on its mortgage-backed securities ("MBS") desk.

2. The SEC contemporaneously settled charges against ICAP U.S. Treasury brokers Agola, Boccio, Cunningham, Hoffman, and Parisi, who allegedly aided and abetted the firm's violations as to the US Treasury trading activity. The SEC also contemporaneously settled charges against Purpora and Murphy for allegedly failing reasonably to supervise the U.S. Treasury brokers with a view to preventing and detecting their alleged violations.

3. The SEC alleged that between December 2004 and December 2005, ICAP, through certain U.S. Treasury brokers, displayed thousands of "flash" trades, to its customers via the firm's trading screens. According to the SEC, "flash" trades were fictitious trades effected at what the brokers believed to be market prices between two ICAP house accounts that flashed on the ICAP screens visible to customers, which subsequently would be cancelled before processing. The SEC alleged that the purpose of the flash trades was to attract customer attention to the ICAP's screens and encourage customer trading.

4. Additionally, ICAP allegedly represented to customers during the same period that its electronic trading system for US Treasuries would follow certain protocols in its handling of customer orders. The SEC alleged that ICAP did not follow its order-handling protocols when it posted certain bids and offers using manual tickets or liquidated certain positions obtained in error trades.

5. The SEC further alleged that the MBS desk violated the firm's policy and contradicted representations in regulatory filings by engaging in proprietary trading.

6. In addition, ICAP allegedly failed to retain cancelled order tickets and documents concerning unfilled or changed customer orders.

7. ICAP and the respondent brokers consented to cease-and-desist orders. ICAP also consented to a censure, a $24 million civil penalty, disgorgement of $1 million, and an undertaking to retain an independent consultant to review the firm's controls and compliance processes, trading

activities on all ICAP's desks, and ICAP's books and records regarding trading records. The respondent brokers were suspended from association with any broker or dealer for 3 months, and each consented to a $100,000 civil penalty, except for Hoffman who consented to a $50,000 civil penalty.[27] Purpora and Murphy were suspended from association in a supervisory capacity with any broker or dealer for three months, and each consented to a $100,000 civil penalty.

8. The settlement order noted that in determining an appropriate remedy, the Commission considered the respondents' cooperation and prompt remediation.

Pay to Play

The SEC is currently focusing on many aspects of the municipal securities markets, including so-called "pay to play" arrangements.

A. *In the matter of J. P. Morgan Securities Inc.* ("JPMS"), Admin. Proc. No. 3-13673 (Nov. 4, 2009); *SEC v. Charles E. LeCroy and Douglas W. MacFaddin*, Case No. cv-09 U/B 2238-S (N.D. Ala. Nov. 4, 2009)

1. The SEC settled a matter against JPMS and filed a civil complaint against two former JPMS managing directors, Charles LeCroy and Douglas MacFaddin, in connection with an alleged scheme to pay millions of dollars to local broker-dealers with ties to Jefferson County, Alabama officials in exchange for the selection of JPMS to underwrite municipal bond offerings and participate in swap agreement transactions.

2. LeCroy and MacFaddin allegedly made more than $8 million in undisclosed payments to close friends of certain Jefferson County commissioners, who were close friends with affiliates of local broker-dealer firms. In return, the County officials helped choose JPMS as the underwriter and its affiliated commercial bank as a swap counterparty, on certain transactions.

[27] The settlement order in this case does not explain why Hoffman received a lower civil penalty, but it does note that he retired during the middle of the relevant period.

3. According to the SEC, the payments were falsely designated as work on the transactions, even though the broker-dealers provided few or no services on the deals. The SEC further alleged that the payments and the attendant conflicts of interest were not disclosed and that JPMS charged higher swap interest rates to recoup the costs of some of payments, which increased the cost of the transactions.

4. JPMS consented to a censure, disgorgement of $1, and a $25 penalty. In addition, JPMS agreed to pay $50 million to Jefferson County and forfeit more than $647 million in claimed termination fees.

5. The SEC initiated a case in federal district court against LeCroy and MacFaddin for securities fraud and for breaches of municipal securities laws. The SEC seeks permanent injunctions and disgorgement.

6. As we reported in our 2008 outline, the SEC brought an action against three individuals, including Larry Langford, the mayor of Birmingham, Alabama and formerly the president of the Jefferson County commission, stemming from allegations that Landford received bribes from a local broker-dealer in exchange for the right to participate in municipal bond offerings and security-based swap transactions. This matter has not yet been resolved.

Ponzi Schemes

The largest alleged Ponzi scheme of 2009 concerns Allen Stanford and his companies. This matter is described below.

A. *SEC v. Stanford International Bank, Ltd.* (“SIB”), *Stanford Group Company* (“SGC”), *Stanford Capital Management, LLC* (“SCM”), *Allen Stanford*, *James M. Davis*, *Laura Pendergest-Holt*, *Gilberto Lopez*, *Mark Kuhrt and Leroy King* (Defendants), *and Stanford Financial Group Company and The Stanford Financial Group Bldg Inc.* (Relief Defendants), Case No. 3-09cv0298-L (N.D.Tx. 2009)

1. In February 2009, the SEC brought a civil case against SIB, SGC, SCM, Stanford, Davis, Pendergest-Holt, and Lopez, alleging that the defendants participated in an $8 billion Ponzi scheme.

2. The SEC alleged that between 2005 and 2008, SIB, an Antiguan private bank controlled by Stanford, sold certificates of deposits to investors as safe and stable investments with high rates of return. In truth, Stanford misappropriated billions in investors' money and diverted the majority of the portfolio into private equity real estate investments. Stanford allegedly used the investors' funds to finance hundreds of millions of dollars in personal real estate deals and event sponsorships.

3. The SEC alleged that to cover up the theft of investor money, Stanford and Davis, SIB's CFO, fabricated the portfolio's performance and signed falsified financial statements. In addition, some of the fraudulent transfers allegedly were documented as personal loans, which were tracked in spreadsheets maintained by Lopez and Kuhrt, that were not disclosed to investors. In other efforts to conceal the misappropriations, some of the defendants allegedly fabricated financial statements, lied to investors about fund performance, burned paper SIB files, and deleted information from computer servers.

4. In May 2009, the SEC amended its complaint to charge Kuhrt and Lopez, accounting executives at companies affiliated with Stanford, who allegedly falsified financial statements, and King, the chief executive officer of Antigua's Financial Services Regulatory Commission ("FSRC") who allegedly accepted thousands of dollars in bribes to ignore the Ponzi scheme and ensure that FSRC did not audit SIB. King also allegedly provided Stanford with access to FSRC's regulatory files, which contained information about the SEC's inquiry into SIB, and withheld information from the Commission.

5. In February 2009, the court entered a temporary restraining order against Stanford, Davis, Pendergest-Holt, SIB, SGC and SCM and froze the assets of those defendants. The case is ongoing.

6. Federal prosecutors have brought criminal fraud charges against Stanford, Davis, Pendergest-Holt, King, Kuhrt, and Lopez for their above-described conduct and against King, Kuhrt, Lopez and Pendergest-Holt for obstructing the SEC's investigation.

Proxy Disclosures

One of the cases that received a lot of media attention last year was the SEC's action against Bank of America. Although not a broker-dealer case, the legal and enforcement program issues are worth briefly describing below.

A. *SEC v. Bank of America Corporation* ("B of A"), 09 Civ. 6829 (S.D.N.Y., Aug. 3, 2009)

1. Southern District of New York Judge Jed Rakoff rejected the SEC's settlement with B of A regarding the firm's disclosure of bonuses that it paid to Merrill Lynch executives prior to the merger of both companies.

2. The SEC had filed a complaint in the matter in August 2009, alleging that B of A had made material misrepresentations to its shareholders in a proxy statement concerning the firm's acquisition of Merrill Lynch. According to the complaint, B of A had represented that Merrill Lynch had agreed not to pay bonuses to its executives without B of A's consent prior to the closing of the merger. The SEC alleged that, in fact, B of A had agreed that Merrill Lynch could pay up to $5.8 billion for such bonuses.

3. B of A agreed to settle with the SEC for making false statements in proxy solicitations and pay a civil penalty of $33 million. Judge Rakoff rejected the settlement because the proposed penalty would be imposed on B of A's shareholders, rather than executives who "would now settle the legal consequences of their lying by paying the SEC $33 million more of their shareholders money." The court called the agreement "neither fair, nor reasonable, nor adequate" and asserted that it "does not comport with the most elementary notions of justice and morality . . ." and referred to it as "a contrivance designed to provide the SEC with the façade of enforcement and the management of the Bank with a quick resolution of an embarrassing inquiry – all at the expense of the sole alleged victim, the shareholders."

4. In response to such criticism, the SEC asserted that while its standard policy is to pursue charges against executives who allegedly lie, instead of the blameless shareholders, it could not do so in this case because decisions were made and drafting was performed by attorneys. Judge Rakoff rejected

that explanation, questioning why the SEC had not sought penalties from lawyers.

5. Judge Rakoff described the proposed consent judgment as unreasonable for other reasons, including that the proposed $33 million penalty is trivial for an alleged misstatement that "infected a multi-billion merger." At the same time, Judge Rakoff also questioned why B of A would agree to pay $33 million to settle charges that it believed were unwarranted and why its decision to settle was made by the same executives whose conduct formed the basis of the charge against the company.

6. The case is scheduled for trial in March 2010.

7. As we went to press with this Outline, the SEC filed a second complaint against B of A alleging that certain losses at Merrill Lynch were not disclosed to B of A shareholders prior to the merger vote. At the same time, the Commission publicly stated that it would not charge any individuals in these matters.

Registration Requirements

Although not a broker-dealer case, the SEC's action relating to UBS AG is noteworthy for its discussion of certain registration issues.

A. *SEC vs. UBS AG*, 09-Civ-00316 (D.D.C. Feb. 18, 2009)

1. The SEC filed an action in district court against UBS AG, a global financial services company, charging that between 1999 and 2008, UBS AG acted as an unregistered broker-dealer and investment adviser to thousands of U.S. cross-border clients by maintaining offshore undisclosed accounts in Switzerland, which permitted the clients to avoid paying taxes with respect to assets in those accounts. UBS AG allegedly earned $120-$140 million in annual revenues from its cross-border business.

2. UBS AG allegedly conducted this business through client advisers located primarily in Switzerland who were not associated with a registered broker-dealer or investment adviser. However, these client advisers allegedly traveled to

the U.S. multiple times per year and attended several events aimed at soliciting U.S. cross-border clients. Further, UBS AG used telephones, facsimiles, mail, and e-mail to provide securities services to its U.S. cross-border clients. These activities allowed the client advisers to engage in a cross-border business of soliciting, establishing and maintaining brokerage accounts, executing securities transactions, and providing investment advice.

3. The SEC further alleged that UBS AG knew that it needed to register with the Commission and attempted to hide its activities by, among other steps, providing training to client advisers on how to avoid detection by U.S. authorities.

4. UBS AG consented to an injunction and to disgorge $200 million and included a permanent injunction.

5. In a related criminal investigation, UBS AG entered into a deferred prosecution agreement with the DOJ that required the firm to pay an additional $180 million in disgorgement and $400 million in tax-related payments.

Regulation SHO

In August 2009, the SEC brought its first Regulation SHO enforcement actions; both were brought along with SRO charges. These cases are described below.

A. *SEC v. TJM Proprietary Trading LLC* ("TJM"), *Michael R. Benson and John T. Burke*, Admin. Proc. No. 3-13569 (Aug. 5, 2009)

1. The SEC settled a matter involving Regulation SHO against TJM and one of its traders, Michael R. Benson. The SEC also settled charges against John T. Burke, TJM's chief operating officer, for failing to supervise.

2. Between January 2007 and July 2007, TJM engaged in certain transactions known as "reverse conversions" in hard-to-borrow threshold securities. In connection with these transactions, TJM improperly used the market-maker exception to Regulation SHO and failed to locate or arrange to borrow shares before executing the short sale trades.

3. The short sales resulted in "fail to deliver" positions at TJM's clearing firm, which transferred the close-out requirement for

these positions to TJM. In order to avoid an expensive close-out, Benson and TJM engaged in a series of complex transactions involving short-term FLEX options to give the appearance that TJM was closing out its short position, but which did not satisfy Regulation SHO.

4. Burke, who was responsible for overseeing all aspects of the firm's operations, including trading, allegedly failed to supervise Benson reasonably because he permitted Benson to engage in the FLEX options trading despite being warned by another firm employee that Benson's trading might violate Regulation SHO.

5. TJM consented to a cease-and-desist order and a censure and agreed to disgorge $541,000. Benson consented to a cease-and-desist order and a three-month suspension from associating with a broker or dealer. Burke consented to a nine-month suspension from supervisory responsibility with any broker or dealer. In addition, the respondents were required to pay a $250,000 fine to the Chicago Board of Options Exchange ("CBOE") as a result of the CBOE's findings in a related matter.

B. *SEC v. Hazan Capital Management* ("HCM") *and Steven M. Hazan*, Admin. Proc. File No. 3-13570 (Aug. 5, 2009)

1. The SEC settled with HCM for alleged Regulation SHO violations and with its majority owner and principal trader, Steven Hazan, for aiding and abetting HCM's violations.

2. The SEC alleged that between January 2005 and October 2007, HCM engaged in certain transactions (reverse conversions and resets) that involved short selling. HCM did not locate or arrange to borrow shares before effecting the short sales. HCM improperly claimed the market maker exception to Regulation SHO that eliminates the need to find a locate before placing a short sale.

3. The short sales resulted in "fail to deliver" positions; HCM's clearing broker allocated to it the obligation to close out the positions. In order to avoid costly close-outs, HCM effected sham reset transactions that gave the appearance that the position had been closed out, but did not satisfy Regulation SHO's requirements.

4. HCM and Hazan consented to cease-and-desist orders and to disgorge $3 million ($1.5 million to each of NYSE Amex, LLC and NYSE Arca, Inc). Hazan also agreed to a five-year bar from associating with a broker or dealer. In addition, the respondents were required to pay a $500,000 fine to NYSE Amex, LLC and a $500,000 fine to NYSE Arca, Inc. as a result of findings in related matters brought by those regulators.

Regulation S-P

In 2008, the SEC and FINRA brought several Regulation S-P cases. Below is a Regulation S-P case commenced by the Commission in 2009.

A. *In re Commonwealth Equity Services, LLP d/b/a Commonwealth Financial Network* ("Commonwealth"), Admin Proc. File No. 60733 (Sep. 29, 2009)

1. The SEC settled charges against Commonwealth in which it alleged that Commonwealth failed to require that its registered representatives maintain antivirus software on their computers, thus opening up customer information to unauthorized access.

2. The SEC alleged that an intruder accessed Commonwealth customer data after acquiring a registered representative's login credentials using a computer virus. The intruder then infiltrated Commonwealth's intranet and accessed customer-identifying information associated with 368 accounts and placed or attempted to place unauthorized purchase orders involving more than $500,000 in eight customer accounts.

3. Commonwealth's clearing broker became aware of these trades within ten minutes and blocked their execution. Commonwealth promptly cancelled the unauthorized trades and transferred them to its error account, taking $8,000 in losses. Commonwealth also notified the SEC and the customers associated with the 368 affected accounts.

4. The SEC alleged that Commonwealth's policies and procedures were inadequate to safeguard customer data and assets. Although Commonwealth distributed written best practices to its representatives requiring that they maintain the security of customer information, the firm

suggested, but did not require, that its representatives employ antivirus software. Further, the SEC alleged that Commonwealth did not have adequate IT procedures to follow up on potential antivirus security issues.

5. Commonwealth consented to a cease-and-desist order and a censure and agreed to pay a $100,000 civil penalty.

6. In determining an appropriate resolution to this matter, the Commission considered Commonwealth's cooperation with the SEC staff and its prompt remediation.

Revenue Sharing

Regulators had been particularly active in the revenue sharing space in the mid-2000's. Here is another case in that arena.

A. *In re Ameriprise Financial Services, Inc.* ("Ameriprise"), Admin. Proc. File No. 3-13544 (Jul. 10, 2009)

1. The SEC settled an enforcement action against broker-dealer Ameriprise in which the Commission alleged that between 2000 and May 2004, Ameriprise received more than $30 million in undisclosed compensation in connection with offering and selling REITs to its brokerage customers.

2. The SEC determined that Ameriprise demanded and received "revenue sharing" payments from REIT companies in return for offering and selling their REITs. Neither Ameriprise nor the REITs disclosed to investors the additional payments or the conflicts of interest that they allegedly created. Ameriprise allegedly only offered to sell certain types of REITs offered by companies that agreed to pay revenue sharing compensation.

3. To help obtain those payments, Ameriprise allegedly issued to the REIT companies misleading invoices characterizing the revenue sharing payments as *bona fide* expenses.

4. Ameriprise consented to a censure and a cease-and-desist order and to pay a civil money penalty of $8.65 million and disgorgement of the same amount.

Selection of Money Managers

In 2009, the SEC brought cases against two financial institutions regarding their recommendations of money managers.

A. *In the Matter of Merrill Lynch, Pierce, Fenner & Smith, Inc.*, Admin. Proc. File No. 3-13357 (Jan. 30, 2009); *In the Matter of Jeffrey Swanson*, Admin. Proc. File No. 3-13358 (Jan. 30, 2009); *In the Matter of Michael Callaway*, Admin. Proc. File No. 3-13356 (Jun. 8, 2009)

1. The SEC settled an administrative proceeding against Merrill Lynch alleging that the firm violated its fiduciary duties to certain pension fund clients when it failed to disclose, and misrepresented, material information concerning its money manager selections for clients. The SEC contemporaneously settled a related administrative proceeding against Jeffrey Swanson, a Merrill Lynch investment adviser representative in the firm's Ponte Vedra South office, who allegedly aided and abetted Merrill Lynch's violations.

2. The SEC alleged that between 2002 and 2005, Merrill Lynch misrepresented its process for selecting money managers for clients of its Ponte Vedra South office. Merrill Lynch's disclosures described a complex and extensive search process through which its Consulting Services program would identify the most suitable money managers for each client based on the client's objectives and risk tolerance. The SEC alleged, however, that Merrill Lynch's Ponte Vedra South office, not the Consulting Services office, selected managers for its clients from a much smaller universe of potential money managers, some of whom were not approved by Consulting Services.

3. Merrill Lynch also offered its clients an option to pay the fixed fee associated with use of its Consulting Services in cash or through directed brokerage. Merrill Lynch allegedly failed to disclose to clients that the firm received far greater revenues when clients opted to pay with directed brokerage than when they paid in cash. Similarly, Merrill Lynch allegedly failed to disclose that it had a direct financial incentive to recommend that clients use Merrill Lynch for services related to transitioning funds from one money manager to another.

4. The SEC also charged Merrill Lynch with failing to supervise the Ponte Vedra South branch office's provision of these services and failing to maintain adequate records.

5. Merrill Lynch and Swanson each agreed to a censure and to cease and desist from further violations, and the firm consented to paying a civil penalty of $1 million.

6. The SEC also brought related charges against Michael Callaway, another Merrill Lynch investment adviser representative in the relevant office. After initially contesting the charges, Callaway consented to a censure and a cease-and-desist order and agreed to pay a $20,000 civil penalty.

B. *In the Matter of Morgan Stanley & Co., Inc.* Admin. Proc. File No. 3-13558 (Jul. 20, 2009); *In the Matter of William Keith Phillips*, Admin. Proc. File No. 3-13550 (Jan. 4, 2010)

1. The SEC settled administrative proceedings against Morgan Stanley and Phillips (a Morgan Stanley registered representative and investment adviser), alleging that the firm breached its fiduciary duty to advisory clients when it misrepresented material information concerning its recommendations of money managers and that Phillips aided and abetted and caused Morgan Stanley's violation.

2. The SEC alleged that between 2000 and April 2006, Morgan Stanley misrepresented to clients its process for selecting money managers at its Nashville, Tennessee office. Morgan Stanley's disclosures described an extensive due diligence process whereby financial advisers would select from an approved list money managers who would be suitable based on the client's risk tolerance and investment objectives. The SEC alleged, however, that Phillips recommended money managers who were not on the approved list and who had not been subject to the due diligence review.

3. The SEC further alleged that Morgan Stanley and Phillips failed to disclose to clients the conflict of interest that resulted from the fact that they received or could receive considerable fees and/or brokerage commissions from the money managers.

4. The SEC also charged Morgan Stanley with failing to supervise adequately Phillips' brokerage and advisory activities because it did not monitor specifically for conflicts of interest inherent in Phillips' dual brokerage and advisory business and because it failed to establish a clear chain of responsibility for supervising Phillips. In addition, the firm failed to follow up after Phillips refused to sign an acknowledgement that he would abide by the firm's code of conduct and refused to be placed under heightened supervision.

5. Morgan Stanley also allegedly failed to maintain certain required records, including client questionnaires employed to select suitable money managers and communications relating to money manager recommendations.

6. Morgan Stanley and Phillips each consented to a censure and a cease-and-desist order and to pay civil penalties of $500,000 and $80,000, respectively. In addition, Phillips was barred from associating with any investment adviser, broker or dealer for four months.

Specialists

Specialist activity has drawn regulatory scrutiny in the past, and this year was no exception. Thirteen firms were sanctioned by the SEC in two separate actions in March 2009. We also describe a litigated specialist case below.

A. *In the Matter of Botta Capital, L.L.C.*, Admin. Proc. File No. 3-13390 (Mar. 4, 2009); *In the Matter of Equitec Proprietary Markets, LLC*, Admin. Proc. File No. 3-13391 (Mar. 4, 2009); *In the Matter of Group One Trading, L.P.*, Admin. Proc. File No. 3-13392 (Mar. 4, 2009); *In the Matter of Knight Financial Products, LLC*, Admin. Proc. File No. 3-13393 (Mar. 4, 2009*); In the Matter of Goldman Sachs Execution & Clearing, L.P. et al.*, Admin. Proc. File No. 3-13394 (Mar. 4, 2009); *In the Matter of Susquehanna Investment Group*, Admin. Proc. File No. 3-13395 (Mar. 4, 2009); *In the Matter of TD Options, Inc.*, Admin. Proc. File No. 3-13396 (Mar. 4, 2009)

1. The SEC settled administrative actions against seven specialist firms on the American Stock Exchange, the Chicago Board Options Exchange, and the Philadelphia Stock Exchange, alleging that the firms failed to meet their

duties to customers by favoring their own proprietary interests.

2. The SEC's charges alleged that, over the course of six years, the specialist firms caused over $35 million in customer harm by filling customers' orders from their proprietary accounts, despite the presence of matchable customer orders on the other side, interpositioning themselves between customers' buy and sell orders, and trading ahead of cancelled orders.

3. The firms each consented to censures and cease-and-desist orders and collectively agreed to pay the civil penalties and disgorgement of approximately $4.4 million and $24.5 million, respectively.

B. *SEC v. Automated Trading Desk Specialists, LLC*, 09-Civ-1977 (S.D.N.Y. Mar. 11, 2009); *SEC v. E*Trade Capital Markets LLC*, 09-Civ-1976 (S.D.N.Y. Mar. 11, 2009); *SEC v. Melvin Securities, LLC et al.*, 09-Civ-1978 (S.D.N.Y. Mar. 11, 2009); *SEC v. Sydan, LP*, 09-Civ-1975 (S.D.N.Y. Mar. 11, 2009); *SEC v. TradeLink, LLC*, 09-Civ-1973 (S.D.N.Y. Mar. 11, 2009)

1. The SEC settled civil injunctive cases that it brought in district court against six specialist firms operating on the Chicago Stock Exchange, alleging that the firms failed to meet their duties to customers by favoring their own proprietary interests.

2. The SEC's civil charges alleged that, over the course of five or six years, the specialist firms caused more than $35 million in customer harm by filling customers' orders from their proprietary accounts, despite the presence of matchable customer orders on the other side, interpositioning themselves between customers' buy and sell orders, and trading ahead of cancelled orders.

3. The SEC further alleged that the specialists failed to keep current blotters recording their daily proprietary trading on other exchanges in dual-listed securities.

4. The defendant firms consented to permanent injunctions and collectively agreed to pay civil penalties and disgorgement of more than $6.7 million and $35.7 million, respectively.

C. *In re David A. Finnerty, et al.,* Admin Proc. File No. 3-11893 (May 28, 2009)

1. In 2005, the SEC commenced an administrative proceeding against twenty specialists, including David Finnerty, a former Fleet specialist, alleging fraudulent and improper trading. In 2007, the SEC settled charges against five of the specialists. In 2008, the SEC settled charges against several respondents and dropped the charges against another respondent.

2. In May 2009, the SEC settled charges against Finnerty, who was a specialist for the stock of PE Biosystems, Applera Corp. Celera Genomics Group, and General Electric. The SEC alleged that between 1999 and 2003, Finnerty improperly filled orders through proprietary trading, rather than through available customer orders, earning riskless profits for Fleet of $4.5 million and causing $5 million in harm to customers.

3. Finnerty consented to a cease-and-desist order, a permanent bar, and a $150,000 civil penalty. In 2005, Finnerty was convicted on related criminal charges, but the judge set aside the conviction.

4. On July 13, 2009, an ALJ issued an initial decision as to the remaining eight respondents – Foley, Hunt, Delaney, Parolisi, Luckow, Johnson, Volpe, and Scavone, Jr. The ALJ concluded that these eight respondents violated NYSE rules relating to specialist conduct but that the SEC failed to prove other charges, including violations of the federal antifraud laws.

5. The eight respondents were barred from associating with any broker or dealer. The ALJ rejected the Enforcement staff's request for cease-and-desist orders, among other reasons, because of the low likelihood of repeated offenses. The decision also ordered that the Division of Enforcement request that the Commission order the NYSE to discipline Foley, Hunt, Delaney, Johnson, Volpe and Scavone, Jr., unless the NYSE had already done so.

Supervision

Several of last year's SEC supervision cases are noteworthy because the Commission not only sued a firm, but also various individual supervisors.

A. *In the Matter of Ferris, Baker Watts, Inc.* ("Ferris"), SEC Admin. Proc. File No. 3-13364 (Feb. 10, 2009); *In the Matter of Patrick J. Vaughan*, SEC Admin. Proc. File No. 3-13367 (Feb. 10, 2009); *In the Matter of Louis J. Akers*, Admin. Proc. No. 3-13612 (Sept. 4, 2009); In *the Matter of Theodore W. Urban,* Admin. Proc. No. 3-13655 (Oct. 19, 2009)

1. The SEC settled matters against Ferris and three of its employees for failing 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").

2. Between August 2002 and November 2005, Stephen Glantz, a registered representative employed by Ferris, participated in a scheme to manipulate the market for the stock of Innotrac Corp. ("Innotrac"), a NASDAQ security in which Ferris made a market.

3. With respect to Innotrac, Glantz and non-Ferris employees allegedly employed a variety of devices (*e.g.*, marking the closing price of the stock, engaging in matched and wash trades, and attempting to artificially create down bids to suppress short selling of Innotrac) to manipulate the price of the stock. Glantz also made unauthorized and unsuitable trades in Innotrac and certain other securities. In September 2007, Glantz pled guilty to securities fraud and subsequently was sentenced to, among other sanctions, 33 months in prison. In February 2009, Glantz was barred from associating with any broker, dealer, or investment adviser.

4. Despite warnings about Glantz's history of customer complaints and "questionable reputation" before joining Ferris, the firm's senior executives permitted Glantz to work under a special arrangement, allowing him greater freedom and less supervision than other Ferris registered representatives. For example, Glantz was assigned to one branch office but was permitted to work at a different branch several days each week, which enabled him to evade Ferris' supervision.

5. Red flags regarding Glantz's conduct were raised orally by the compliance department on numerous occasions and in writing on two occasions during the relevant time period. Despite these warnings, the firm's senior executives opted not to take action.

6. The SEC also alleged that information available to Ferris concerning the alleged market manipulation of Innotrac should have prompted Ferris to file SARs. By failing to do so, the firm allegedly violated the Bank Secrecy Act.

7. Ferris consented to a censure and agreed to pay a civil penalty of $500,000 and to disgorge approximately $222,000.

8. The SEC also settled an action against Patrick Vaughan, Ferris's director of retail sales, for failing to reasonably supervise Glantz to detect and prevent violations of the securities laws and reasonably respond to red flags regarding Glantz's misconduct and special working arrangement. Vaughn consented to a six-month suspension from acting in any supervisory or investment advisory capacity, a civil penalty of $50,000, and disgorgement of more than $12,000.

9. In September 2009, the SEC settled charges against Louis Akers, Ferris's former CEO and vice chairman, alleging that Akers failed to respond reasonably to red flags regarding Glantz's misconduct. Akers was barred from acting in a supervisory capacity for one year, ordered to pay approximately $20,000 in disgorgement, and was assessed a $75,000 penalty.

10. In October 2009, the SEC instituted a proceeding against Theodore Urban, Ferris' general counsel and supervisor of its compliance department, for failing to supervise. The SEC alleged that Urban ignored and/or failed to adequately follow-up on numerous red flags concerning Glantz's trading in Innotrac, including several issues to which he was alerted by the Compliance Department. The charges against Urban have not yet been resolved.

B. *In the Matter of Oppenheimer & Co., Inc.,* (“Oppenheimer”) Admin. Proc. File No. 3-13378 (Feb. 24, 2009); *In the Matter of Leumi Investment Services, Inc.* (“LISI”), Admin. Proc. File No. 3-13377 (Feb. 24, 2009)

1. The SEC settled an administrative proceeding against Oppenheimer in which the Commission alleged that Oppenheimer failed to reasonably supervise a former salesperson in order to prevent and detect the salesperson’s violations of the federal securities laws.

2. The SEC alleged that between May 2003 and August 2004, an Oppenheimer salesperson, Frank Lu, and Victor Machado, a trader at Leumi Investment Services Inc. and Bank of Leumi USA (collectively, “Leumi”), participated in a fraudulent scheme that increased order flow from Leumi to Oppenheimer. Lu gave Machado gratuities and entertainment, and Machado sent orders to Oppenheimer at prices that benefited Oppenheimer and harmed Leumi’s customers.

3. Lu and Machado traded and generally communicated by Bloomberg messaging. The SEC alleged that a number of the Bloomberg messages raised “red flags” and demonstrated that Machado was directing order flow to Oppenheimer in return for gifts and entertainment. As the result of an inadequacy in Oppenheimer’s Bloomberg message collection procedures, none of Lu’s Bloomberg messages were gathered or reviewed during the relevant time period. The SEC asserted that Lu’s misconduct could have been prevented or detected earlier if Lu’s Bloomberg messages had been reviewed.

4. Oppenheimer agreed to a censure and an $850,000 civil penalty. The firm also consented to an undertaking to review its policies, procedures and systems regarding the collection and review of electronic communications.

5. The SEC also settled an administrative proceeding against LISI, in which it alleged that LISI failed to reasonably supervise Machado by not having adequate procedures to prevent and detect improper changes to trade tickets. LISI consented to an undertaking to review its policies, procedures, and systems concerning trade tickets, monitoring the trade blotter and the review of electronic

communications. LISI was censured, but no money penalty was imposed. In the settlement release, the SEC acknowledged Leumi's remediation (*e.g.*, reimbursing customers) and cooperation with the SEC staff during the investigation.

C. *In the Matter of Grant Bettingen, Inc.* ("GBI"), SEC Admin. Proc. File No. 3-1403 (Mar. 6, 2009); *In the Matter of M. Grant Bettingen* ("Bettingen"), SEC Admin. Proc. File No. 3-13402 (Mar. 6, 2009)

1. The SEC settled a matter against registered broker-dealer GBI for failing to supervise reasonably a registered representative because the firm did not have a supervisory policy in place regarding its sale of distressed debt securities in private placement offerings until almost one year after the registered representative began selling private placement securities.

2. The SEC alleged that from January 2004 to December 2005, Christopher J. Johndrow, a GBI registered representative, made misrepresentations to investors about profits that they would earn (1% monthly) from private placement offerings despite the fact that a review of the issuer's financial statements would have revealed that the issuer was not making a profit. Johndrow also allegedly instructed sales agents that he supervised to make similar misrepresentations to investors.

3. GBI consented to a censure and to disgorge $88,675.

4. The SEC settled a related action against Bettingen (GBI's president, compliance manager, and indirect owner of GBI) for failing to supervise Johndrow. In addition to his failure to implement written policies concerning private placement offerings, Bettingen did not follow existing firm procedures, including inspecting Johndrow's office, which could have led to the discovery of Johndrow's violations. Further, the SEC alleged that Bettingen failed to put Johndrow on heightened supervision (required by firm policy), even though Bettingen was aware that Johndrow had been discharged by a former broker-dealer for failing to adequately supervise his branch and for "selling away" violations.

5. Bettingen consented to a civil penalty of $35,000 and a bar from associating in a supervisory capacity with any broker or dealer for three years.

D. *In re Royal Alliance Associates, Inc.* ("Royal"), Admin. Proc. File No. 3-13456 (Apr. 28, 2009); *In re Brad E. Parish*, Admin. Proc. File No. 3-13457 (Apr. 28, 2009)

1. The SEC settled charges against Royal and one of its supervisors, Brad Parish, alleging that Royal and Parish failed to supervise David L. McMillan, a Royal broker who ran a Ponzi scheme that defrauded 28 investors.

2. McMillan ran a one-person satellite office for Royal. Between 1994 and 2004, McMillan misrepresented to customers that he was investing at least $3 million of their funds in securities and loans to a real estate developer, when he was in fact using the funds for personal use or to repay other customers.

3. Prior to 2000, Royal did not have written supervisory policies that required supervisors to review bank records. A review of McMillan's account in 1999 would have uncovered that he was depositing clients' money into his operating account. Royal's procedures for examinations of its satellite offices also were allegedly deficient in that they did not require supervisors to confirm that all sections of the examination workbook were completed. Royal also allegedly did not catch other red flags, including that McMillan kept his branch in business despite a sizeable drop in his commissions (from $149,000 in 2000 to $13,000 in 2004).

4. Additionally, Royal allegedly did not adequately implement its own procedures that made supervisors responsible for responding to surveillance inquiries concerning their direct reports. Instead, the subject of the inquiry typically was responsible for responding to the inquiry.

5. The SEC also alleged that Royal did not adequately implement its procedure that required transaction reports to contain all customer transactions; McMillan manually entered his own trades on the transaction report and omitted trades related to his fraudulent activity, which enabled his conduct to evade detection.

6. The SEC alleged that Parish, who was McMillan's supervisor despite working approximately 200 miles away from McMillan, failed to supervise him adequately. For example, Parish falsely claimed that he had reviewed McMillan's business banking account in 2001, despite the fact that the account that he claimed to have reviewed wasn't opened until after the examination occurred.

7. Royal consented to a censure, to disgorge $1, and to pay a $500,000 civil penalty, and to certify to the Commission staff when it implemented improvements recommended by an independent consultant. Parish consented to disgorge $1 and to pay a $30,000 civil penalty. He also consented to a one-year bar from associating with any broker-dealer in a supervisory capacity.

8. In the settlement release, the SEC noted Royal's enhancements to its supervisory system and its cooperation with the Commission staff.

E. *In the Matter of Banc of America Investment Securities, Inc.* ("BAI") *and Virginia Holliday*, Admin. Proc. File No. 3-13664 (Oct. 22, 2009)

1. The SEC settled a matter against BAI and Virginia Holliday, in which it alleged that BAI and Holliday failed to reasonably supervise a former registered representative who misappropriated customer assets.

2. In early 2005, after Brent Steven Lemons began working as a BAI registered representative, his former firm disclosed four customer complaints against him, including for possible fraud related to variable annuity sales. BAI investigated the allegations solely by speaking with Lemons, who denied wrongdoing. Nevertheless, BAI placed Lemons on heightened supervision.

3. The SEC alleged that Holliday, who was Lemon's supervisor, failed to comply with BAI's correspondence review procedures and did not discover that she had only received some of Lemons' outgoing correspondence. The SEC alleged that if she had reviewed all of his outgoing correspondence, she would have learned that Lemons admitted wrongdoing in connection with the complaints from his prior firm and that he misappropriated over $1.3 million

from BAI customers' accounts by liquidating their variable annuities. The SEC also alleged that Holliday failed to investigate adequately complaints by two BAI customers against Lemons, which were also red flags.

4. BAI allegedly failed to establish and maintain adequate written supervisory procedures regarding the review of customer accounts. BAI also failed to adequately implement its written supervisory procedures regarding branch office compliance inspections in order to ensure that supervisors followed up on any reported deficiencies.

5. BAI consented to a censure and $150,000 civil penalty. The firm also agreed to an undertaking to review its policies, procedures, and systems regarding review of customer accounts and securities transactions and periodic compliance inspections.

6. Holliday was barred from associating with any broker or dealer in a supervisory capacity with a right to reapply after one year. The SEC declined to impose a civil money penalty against Holliday based on her sworn inability to pay.

F. *In the Matter of Merriman Curhan Ford & Co.* ("Merriman Curhan")*, D. Jonathan Merriman* ("Merriman") *and Christopher Aguilar*, Admin. Proceeding, File No. 3-13681 (Nov. 10, 2009)

1. The SEC settled charges against Merriman Curhan (a broker-dealer), Merriman (the firm's founder and CEO), and Christopher Aguilar (the firm's general counsel) for failing to supervise reasonably a registered representative who engaged in fraudulent schemes involving unauthorized trading in customer accounts and aiding a friend with the fraudulent pledging of customer securities to obtain personal loans.

2. The SEC alleged that between August 2007 and May 2008, D. Scott Cacchione, a Merriman Curhan registered representative and managing director of the firm's Client Services Group, provided account statements containing customer-identifying information to a friend, William Del Biaggio III. With Cacchione's knowledge, Del Biaggio then altered the statements to appear as though he owned the securities reflected in the account statements, so that he could fraudulently pledge them to obtain more than $45

million in personal loans. In addition, between March 2006 and October 2007, Cacchione allegedly engaged in unauthorized risky trading in customer accounts, for which he received commissions.

3. The SEC alleged that Merriman Curhan, Merriman, and Aguilar failed to supervise Caccione, who previously had been disciplined by the NASD. Although Merriman delegated some of his responsibility for supervising Cacchione to Aguilar, the SEC alleged that the delegation was unreasonable because Merriman did not follow up to make sure that the supervision was being adequately performed. Aguilar placed Cacchione on heightened supervision for his prior disciplinary history but delegated responsibility for reviewing on a daily basis Cacchione's e-mails and trading to a compliance manager who was responsible for most of the firm's daily compliance functions. Aguilar never followed up to ensure that the daily reviews were taking place and failed to inform the compliance manager's successor about Caccione's heightened supervision.

4. The SEC also alleged that Merriman and Aguilar failed to respond to red flags concerning Cacchione's unauthorized trading, permitted Cacchione to supervise five registered representatives without the necessary license, and permitted Cacchione to recommend securities that were prohibited by the firm's written supervisory procedures

5. Finally, although Merriman Curhan historically provided services to institutional investors, Cacchione brought approximately one hundred retail clients with him when he joined the firm. The SEC alleged that despite this change, the firm did not hire additional compliance personnel or provide additional training and that Aguilar had no experience with supervising retail brokerage activities.

6. Merriman Curhan consented to a censure, a $100,000 civil penalty, and an undertaking to hire an independent consultant to to review the firm's policies and procedures concerning supervision. Merriman and Aguilar consented to civil penalties of $75,000 and $40,000, respectively, and each was suspended for one year from acting in a supervisory role for any broker or dealer.

7. In connection with the settlement, the SEC considered the respondents' cooperation and the prompt remedial actions taken by Merriman Curhan, which included undertaking an internal investigation, promptly suspending and firing Cacchione, reviewing the firm's compliance procedures, agreeing to hire an outside compliance consultant and monitor, hiring a former FINRA examiner as the chief compliance officer, and reorganizing the firm's management structure.

8. In related district court and administrative actions against Cacchione, the SEC settled charges against Cacchione, who consented to a permanent injunction and a permanent bar from associating with any broker or dealer. Separately, Cacchione pled guilty to criminal securities fraud charges in connection with the pledging of customer securities.

As we reported in our 2008 outline, Bernard Madoff was arrested on December 11, 2008 and charged with securities fraud after admitting that he carried out a $50 billion Ponzi scheme at least in part through a registered broker-dealer that he controlled named Bernard L. Madoff Investment Securities LLC ("BMIS"). Madoff misrepresented to investors that they were receiving gains on their investments when in fact the "gains" consisted of new principal deposits from other investors.

On March 12, 2009, Madoff pled guilty to all charges against him. In his allocution, Madoff admitted to, among other things, running a Ponzi scheme, securities fraud, investment advisor fraud, and filing false financial statements with the SEC. He was sentenced to the maximum allowable term, 150 years in prison, on June 29, 2009.

In a parallel SEC civil proceeding, Madoff consented to a partial judgment on February 9, 2009, which imposed a permanent injunction from violating certain securities laws. On June 16, 2009, Madoff consented to entry of an order by the SEC barring him from associating with any broker, dealer or investment adviser.

Some of the key Madoff-related actions are described below.

A. *SEC v. David G. Friehling and Friehling & Horowitz* ("F&H") 09-Civ-2467 (S.D.N.Y. Mar. 18, 2009)

1. In March 2009, the SEC brought a civil action against Madoff's certified public accountant and auditor, F&H, and David Friehling, F&H's sole shareholder, alleging that the defendants enabled Madoff to operate a Ponzi scheme by making false statements concerning its audits of BMIS.

2. Specifically, the SEC alleged, in part, that between 1991 and 2008, defendants falsely stated that F&H audited BMIS in accordance with GAAS, that BMIS' financial statements were presented in accordance with GAAP, and that F&H reviewed BMIS' internal controls and found no material inadequacies.

3. In November 2009, Friehling and F&H consented to a proposed partial judgment imposing permanent injunctions against them. The court will consider whether to impose financial penalties after Friehling is sentenced in February 2010 in a related criminal case in which Friehling pleaded guilty to nine criminal counts, including securities fraud.

B. *SEC v. Cohmad Securities Corp.* ("Cohmad") *et al.,* 09-Civ-5680 (S.D.N.Y. Jun. 22, 2009)

1. The SEC brought a civil action against Cohmad, Maurice J. Cohn (the firm's owner and chairman), Marcia B. Cohn (the firm's president and chief operating officer), and Robert M. Jaffe (the firm's vice president for marketing), alleging that the broker-dealer firm and the named officers solicited investors and funneled billions of dollars to BMIS.

2. The SEC alleged that for more than twenty years, defendants operated as BMIS's in-house marketing arm and cultivated an aura of privilege in order to bring investors to BMIS. Madoff and his brother owned 24% of Cohmad (a contraction of "Cohn" and "Madoff"), which had offices located within BMIS' offices.

3. In return for referring billions of dollars in investments and approximately 800 accounts to BMIS, defendants earned hundreds of millions of dollars. The percentage of Cohmad's revenue derived from BMIS ranged between approximately 80% and 90% per year.

4. The complaint also alleges 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.

5. The SEC alleged that Jaffe was aware that BMIS employees prepared false confirmations and statements. Madoff allegedly compensated Jaffe through Jaffe's personal BMIS account, rather than through Cohmad. While the investors that Jaffe brought to BMIS received returns of 12-18%, he received returns of up to 42%, and he withdrew at least $150 million from his BMIS accounts.

6. The SEC seeks permanent injunctions, disgorgement, and civil penalties.

C. *SEC v. Stanley Chais*, 09-Civ-5681 (S.D.N.Y. Jun. 22, 2009)

1. The SEC brought a civil action against Stanley Chais, an investment adviser to three funds that invested all or most of their assets with BMIS.

2. The complaint alleges that Chais misrepresented to fund investors that he was managing their investments. In reality, Chais simply turned over all or virtually all fund assets to BMIS without disclosing this fact to fund investors.

3. As a general partner in these funds, Chais received almost $270 million in fees from his funds between 1995 and 2008. During this same period, Chais, his family members, and his affiliated entities withdrew approximately $545 million more than they invested with BMIS.

4. The complaint also alleges that Chais provided false returns to fund investors. Specifically, Chais asked BMIS to ensure that none of the funds' trades resulted in losses (despite the fact that BMIS did report losing trades to other clients). BMIS complied with Chais's instructions. Accordingly, between 1998 and 2008, none of the thousands of trades executed on Chais' funds' behalf reflected losses.

5. The SEC seeks a permanent injunction, disgorgement, and civil penalties.

D. *SEC v. Frank DiPascali, Jr.*, 09-CIV-7085 (S.D.N.Y. Aug. 11, 2009)

1. The SEC brought a civil action against DiPascali, BMIS's former chief financial officer and "key Madoff lieutenant," alleging that he assisted Madoff in structuring fictitious trades and creating fictitious books and records in order to help conceal the Ponzi scheme from investors and regulators.

2. The SEC alleged that beginning as early as the 1980s, DiPascali manufactured BMIS trading data and kept multiple sets of books and records to shield from regulators that the

firm had thousands of advisory clients, which would have required the firm to register as an investment adviser.

3. In addition, DiPascali concealed the fraud by creating false account balances and records that were sent to customers to evidence trading that did not actually occur and by presenting false information to BMIS clients and regulators.

4. The SEC also alleged that DiPascali misappropriated investors' funds for his own personal benefit. Specifically, he withdrew more than $5 million between 2002 and 2008 from a BMIS account despite never making capital contributions to the account. DiPascali also received more than $2 million annually in salary and bonus from BMIS that was funded by investors' money.

5. DiPascali consented to a proposed partial judgment that would impose permanent injunctions against him but that left open the financial penalties that will be imposed against him. In October 2009, in a related SEC matter, DiPascali consented to a bar from associating with any broker, dealer or investment adviser.

6. On August 11, 2009, in a related criminal action in the U.S. District Court for the Southern District of New York, DiPascali pleaded guilty to ten criminal counts, including securities fraud. He currently awaits sentencing in May 2010.

E. *SEC v. Jerome O'Hara and George Perez*, 09-Civ-9425 (S.D.N.Y. Nov. 19, 2009)

1. The SEC brought a civil action against O'Hara and Perez, BMIS computer programmers, for assisting in the perpetration and concealment of the Ponzi scheme.

2. The SEC alleged that since the early 1990s, O'Hara and Perez were responsible for programming and operating some of the BMIS computer systems. Specifically, the SEC alleged that O'Hara and Perez wrote the programs that were used to create false trading records, account statements, and other records that were used to mislead investors, auditors, and regulators.

3. In or around April 2006, the defendants attempted to conceal their involvement in the scheme by deleting most of the computer programs used to create the false records. They also confronted Madoff later in the year about the use of these programs and stated that they would no longer generate false records. However, in exchange for an approximately 25% increase in salary and the payment of a special bonus, both men agreed to remain with BMIS and subsequently modified the computer programs so that other BMIS employees could continue to generate false records.

4. The SEC also alleged that O'Hara and Perez withdrew hundreds of thousands of dollars from their personal BMIS accounts.

5. The SEC seeks permanent injunctions, disgorgement with interest, and civil penalties.

6. In a related criminal action in the Southern District of New York, O'Hara and Perez have been charged with conspiracy and falsifying book and records.

Report of Investigation, U.S. Securities and Exchange Commission Office of Inspector General, Case No. OIG – 509, Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme (Aug. 31, 2009)

In December 2008, then-SEC Chairman Cox asked the SEC Office of Inspector General ("OIG") to investigate the allegations regarding Madoff that were brought to the SEC staff's attention and the SEC's policies regarding when fraud allegations should be escalated to the Commission. On August 31, 2009, OIG issued a public version of a report of its investigation, which included the following findings:

- OIG did not find evidence that any SEC personnel who were assigned to examine or investigate Madoff had any inappropriate connection to him and did not find that senior SEC personnel attempted to influence or interfere with any examination or investigation of Madoff or his firm.

- The SEC received six separate complaints regarding Madoff and BMIS, which provided detailed allegations and information regarding Madoff's activities. Several of the complaints made overlapping allegations, including that: (i) Madoff's investment strategy could not be duplicated; (ii) the secrecy surrounding Madoff's strategy and firm was suspicious; and (iii) the consistency of Madoff's returns was improbable. The SEC, however, did not follow up or investigate these complaints adequately. In

addition, the SEC was aware of two industry journal articles that raised serious questions regarding Madoff's activities, but did not follow up on concerns raised in the articles.

- When the SEC investigated the complaints and conducted examinations, it assigned inexperienced personnel to perform the inquiries and failed to follow up on obvious red flags such as: inconsistencies in Madoff's statements to them, Madoff's failure to provide requests documents, and his inability to credibly explain the consistency of his returns.

- In its examinations and investigations, the SEC failed to obtain verification of Madoff's trading, which would have led to the discovery of his Ponzi scheme. For example, if the SEC had contacted DTC, it would have discovered that Madoff's trading volume did not match the amounts shown on customer statements.

- The OIG concluded that despite numerous complaints regarding Madoff's hedge fund activities and several SEC examinations and investigations, the SEC did not take the "necessary and basic steps to determine if Madoff was misrepresenting his trading." If it had, the SEC could have discovered the Ponzi scheme at a much earlier point in time.

U.S. Securities and Exchange Commission OIG, Program Improvements Needed Within the SEC's Division of Enforcement (Sept. 29, 2009)

As part of OIG's review of past complaints concerning Madoff, the OIG distributed a survey questionnaire to the SEC Division of Enforcement staff and reviewed related issues, such as case management, allocation of resources, and communication. Based on its review, the OIG made 21 recommendations for improvements in Enforcement. Among its 21 recommendations, the OIG suggested that Enforcement:

- Establish formal guidance and training for reviewing and evaluating complaints.

- Require that at least two experienced people review tips and complaints before determining not to pursue further action.

- Establish and implement procedures to ensure that at least one staff member on an investigation team has specific expertise and knowledge regarding the relevant subject and that the team has access to at least one other individual with such knowledge.

- Require that planning memoranda be created during an investigation that identifies what assistance will be needed, which would be reviewed and approved by senior Enforcement staff.

- Provide sufficient supervisory and support resources for investigations.

- Direct working groups to review the staff's concerns reflected in the OIG survey information concerning communication of program priorities, case handling procedures, and working relationships and then make recommendations for improvement to the Director of Enforcement.

FINRA's Special Review Committee Report

On April 13, 2009, FINRA's Board of Governors established a Special Review Committee (the "Special Committee") to review FINRA's examination program as it relates to examinations of BMIS and the brokerage firm affiliated with R. Allen Stanford. In its report, the Special Committee did not find that FINRA was aware of any information regarding Madoff's Ponzi scheme. Specifically, the Special Committee determined that the records provided to FINRA did not contain any evidence that Madoff operated an investment advisory business through BMIS, the business through which the Ponzi scheme was effected. However, the Special Committee noted that FINRA examiners identified information during the course of examinations that should have been investigated further. This information included records that BMIS received unusual "commissions" (which were in fact the result of round-trip transactions from off-the-book accounts), and that BMIS paid "brokerage fees" to Cohmad Securities Corporation, an entity that referred investors to BMIS and the Ponzi scheme.

The Special Committee also noted that FINRA has limited jurisdiction to investigate or regulate financial institutions. The Special Committee recommended that FINRA undertake, with the approval of the SEC and Congress as necessary, to implement the following: (i) seek jurisdiction to regulate activities under the Investment Advisers Act; (ii) clarify that it has jurisdiction over affiliates of member firms; (iii) strengthen its examination program; (iv) coordinate its activities better with the SEC and other regulators; and (v) enhance its training program.

In 2008, the SEC, FINRA and more than a dozen state securities regulators launched inquiries and/or brought cases concerning auction rate securities. In 2009, regulators continued to bring cases in this area and finalize settlements that had been preliminarily announced in 2008. The following list reflects selected SEC, FINRA, and state regulatory ARS enforcement announced in 2008 or 2009. For further details on many of these cases, please refer to our 2008 and mid-year 2009 Outlines.

Firm	Regulator(s)	Date	Civil Penalty/Fine
Banc of America Securities LLC and Banc of America Investment Services, Inc.	SEC	6/3/2009	See footnote 28 below.[28]
	NASAA; New York	10/8/2008	$50 million
BNY Mellon Capital Markets, LLC	FINRA	4/13/2009	$250,000
Citigroup Global Markets, Inc.	SEC	12/11/2008	See footnote 28 below.
	NASAA; New York	8/7/2008	$50 million to NASAA; $50 million to New York
City National Securities	FINRA	2/4/2009	$315,000
City Services Corporation	FINRA	9/1/2009	$250,000
Comerica Securities, Inc.	FINRA	3/2009	$750,000
Credit Suisse Securities (USA) LLC	NASAA; New York	9/16/2009	$15 million
Deutsche Bank Securities, Inc. and Deutsche Bank AG	SEC	6/3/2009	See footnote 28 below.
	NASAA; New York	8/21/2008	$15 million
Fifth Third Securities, Inc.	FINRA	9/1/2009	$150,000
First Southwest Company	FINRA	12/16/2008	$300,000
Goldman Sachs, Inc.	NASAA; New York	8/21/2008	$22.5 million

[28] In all of its ARS settlements, the SEC reserved the right to seek a financial penalty.

Firm	Regulator(s)	Date	Civil Penalty/Fine
Harris Investor Services, Inc.	FINRA	1/8/2009	$150,000
Janney Montgomery Scott LLC	FINRA	5/1/2009	$200,000
JP Morgan (including Bear Stearns & Co.)	NASAA; New York	8/14/2008	$25 million
M&I Financial Advisors, Inc.	FINRA	5/6/2009	$150,000
M&T Securities, Inc.	FINRA	5/7/2009	$200,000
Merrill Lynch, Pierce Fenner & Smith, Inc.	SEC (agreement in principle)	8/22/08	See footnote 28 below.
	NASAA; New York	8/21/2008	$125 million
Morgan Keegan & Co., Inc.	SEC	7/21/2009	Currently being litigated
Morgan Stanley	NASAA; New York	8/14/2008	$35 million
NatCity Investments, Inc.	FINRA	3/19/2009	$300,000
Northwestern Mutual Investment Services, LLC	FINRA	7/15/2009	$200,000
RBC Capital Markets Corp.	SEC	6/3/2009	See footnote 28 below.
	NASAA; New York	10/8/2008	$9.8 million
Stifel, Nicolaus & Co., Inc.	NASAA	12/29/2009	$525,000
TD Ameritrade	SEC	7/20/2009	See footnote 28 below.
	NASAA	7/20/2009	No fine
UBS Securities LLC and UBS Financial Services, Inc.	SEC	12/11/2008	See footnote 28 below.
	NASAA; New York	8/11/2008	$75 million to NASAA; $75 million to New York
Wachovia Securities, LLC and Wachovia Capital Markets, LLC	SEC	2/5/2009	See footnote 28 below.
	NASAA; New York	8/15/2008	$50 million
WaMu Investments Inc.	FINRA	12/16/2008	$250,000
Wells Fargo Investments LLC	NASAA	11/18/2009	$1.9 million

Changing of the Guard in 2009

As with the SEC, there was a change in FINRA's leadership in 2009. In February 2009, the Board of Governors of FINRA announced that Richard G. Ketchum had been appointed as FINRA's CEO, effective March 16, 2009. Mr. Ketchum replaced Mary L. Schapiro, who resigned her position as CEO after her confirmation as Chairman of the SEC. Mr. Ketchum, one of the lead architects of the consolidation of NASD and NYSE Regulation, has had a long career in securities regulation. Prior to being appointed CEO of FINRA, Mr. Ketchum served as CEO of NYSE Regulation and Chairman of FINRA's Board, and continues to serve in his role as Chairman. He has also served as the first Chief Regulatory Officer of the NYSE, President of NASD and President of the Nasdaq Stock Market, Inc. At the outset of his FINRA tenure, Mr. Ketchum stressed the urgent need to restore investors' trust in both the financial markets and the regulatory system and stated that FINRA's staff will attempt to "triage" the information it receives and have the resources that it needs to investigate and discipline any firm or individual that harms investors.[29]

Structural Changes Regarding FINRA's Enforcement Efforts

In October 2009, FINRA announced the creation of a new Office of Fraud Detection and Market Intelligence.[30] It appears that the Office will include the existing fraud and insider trading group previously in the Market Regulation Department, FINRA's recently created Office of the Whistleblower, and the Central Review Group. The new Office is responsible for examining allegations of fraud brought to FINRA's attention either through its own internal processes or external sources. Finally, the new Office will act more like a clearing house; although the Office will "triage" the information it receives, cases will generally

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[29] *See FINRA Taps Ketchum as CEO*, Wall Street Journal at C7, Feb. 25, 2009.

[30] *See Statement from FINRA Chairman and CEO Richard G. Ketchum on the Report of the Special Review Committee of the FINRA Board of Governors*, Oct. 2, 2009.

continue to be investigated by examination and enforcement teams located in the field.[31]

Changes in the FINRA Enforcement Program

At the SIFMA seminar noted above, FINRA leadership discussed certain "philosophical" changes being considered in its enforcement program. First, FINRA is looking at how it identifies cases for investigation, ways to streamline the case opening process, and its investigative process. As to the investigative process, the staff has been encouraged to move away from its traditional methods when appropriate, including taking testimony early in a case to get the facts on the record. Second, harking back to comments that she made earlier in 2009, Head of Enforcement, Susan Merrill, noted that, like Jack in the nursery rhyme, she wanted her staff to "be nimble and be quick." In this regard, the staff is looking for ways to obtain quicker results on important matters so that FINRA could make a statement in an effort to change the industry's behavior. Third, sending enforcement teams to visit firms at their offices was particularly successful in the ARS investigations. This on-site investigative technique saved FINRA months of time and effort and purportedly did not result in any complaints from member firms. Based upon this success, FINRA expects that announced on-site investigations will become more prevalent in the future. Surprise on-site visits by enforcement will continue to be rare; they will be used only where potential fraud at a firm is onsgoing.[32]

An Overview of FINRA's Enforcement Process: Regulatory Notice 09-17

In March 2009, FINRA published Regulatory Notice 09-17, in which it provided guidance to the industry concerning its enforcement process. Although it did not break new ground, the Regulatory Notice provides a useful high-level description of various FINRA enforcement protocols, including information regarding managerial oversight of investigations, reviews of the sufficiency of evidence, the Wells process, FINRA's Disciplinary Advisory Committee, and the Office of Disciplinary Affairs.

Cooperation with Foreign Regulators

In the summer of 2009, FINRA signed a memorandum of understanding concerning information sharing and cooperation with the Investment Industry Regulatory Organization of Canada. On October 29, 2009, FINRA and the French Autorité des Marches Financiers signed a similar agreement.

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[31] This information is based upon Morgan Lewis' notes of a presentation by Susan Merrill at the November 18, 2009 SIFMA Compliance and Legal Division conference in New York City.

[32] *Id.*

Creation of the Office of the Whistleblower

Growing out of the scandals of 2008, in March 2009, FINRA established an Office of the Whistleblower to "expedite the review of high-risk tips by FINRA senior staff and ensure a rapid response for tips that may have merit."[33] To make submission of tips easy, FINRA announced that it had created a toll free number and a dedicated web page for individuals to provide information to the staff. Where whistleblower leads fall outside of FINRA's jurisdiction, the staff will refer the tip to an appropriate regulator or law enforcement agency.

Enforcement Statistics

By way of background, in 2008, FINRA resolved 1,007 formal disciplinary cases, expelled 19 member firms, barred 363 individuals from membership, and suspended 321 individuals.[34] In 2008, FINRA collected more than $28.1 million in fines. FINRA also reached agreements involving a total of $1.2 billion in restitution or reimbursement in 2008, including agreements in principle relating to "buy backs" of auction rate securities by certain member firms.[35] Finally, in 2008, there were two FINRA settlements with fines greater than $1 million.

Turning to 2009, FINRA resolved 1,103 formal actions, an increase of 9.5% from the prior year. Last year, FINRA expelled 20 firms, barred 383 individuals, and suspended 363 individuals. The fines in the 73 cases that FINRA announced in 2009 with penalties greater than $100,000 alone totaled more than $40 million, which is substantially larger than the $28.1 million that FINRA collected in all of its cases in 2008.[36] The following table reflects our analysis of the fine amounts in FINRA's cases during the past two years, which includes a breakdown of those 73 cases.

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[33] Testimony of Richard G. Ketchum, FINRA Chairman & Chief Executive Officer, Remarks from the SIFMA Compliance and Legal Division's Annual Seminar, Mar. 23, 2009. See also *FINRA Announces Creation of "Office of the Whistleblower*," Mar. 5, 2009, available at www.finra.org.

[34] *See* FINRA's 2008 Year in Review and Annual Financial Report available at www.finra.org.

[35] *Id.* at p. 9.

[36] FINRA's statistics are apparently based on the collection, not assessment, of fines. Our analysis is based on announced fine amounts rather than FINRA's collection for 2009, which have not yet been released.

Fine Range	2008	2009
$100,001 to $250,000	45	34
$250,001 to $500,000	10	20
$500,001 to $750,000	4	6
$750,001 to $1,000,000	2	3
$1,000,001 to $1,500,000	2	4
$1,500,001 or more	0	6

The above table reflects that in 2009 FINRA released cases involving fines of more than $1.5 million in six cases, as compared with zero such cases in 2008.[37] Each of these six cases is summarized in this Outline.

Sweep Examinations

In the last year, FINRA stepped up its use of sweeps, canvassing member firms on the following topics:

1. Hedge fund advertising and sales literature (January 2009);

2. Sales and promotion of non-traded REITs (March 2009);

3. Exchange traded funds (May 2009);

4. Municipal underwritings and municipal derivative instruments (May 2009);

5. Retail sale of “gas bonds” (May 2009);

6. Retail municipal securities transactions (June 2009);

7. Retail Forex trading (November 2009);[38] and

8. Research and trading “huddles” (December 2009).[39]

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37. 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 2009. We note that of the six cases released in 2009 imposing fines of $1.5 million or more, one (against Mutual Services Corp.) was a Hearing Panel Decision dated December 16, 2008 (but not publicly released until March 19, 2009).

38 The first seven sweep topics are reflected on the *Targeted Examination Letters* section of FINRA’s website.

39 *See* Suzanne Craig, *FINRA Probes Wall Street’s Trade Huddles*, the Wall Street Journal, Dec. 18, 2009.

In addition to the sweeps listed above, after the Madoff Ponzi scheme came to light in late 2008, FINRA undertook two separate reviews of member firms on the topics of: (1) custody of assets for investments with joint broker-dealers/investment advisers, and (2) broker-dealers that serve or served as feeders to asset managers, including but not limited to, Madoff's firm.

Simply put, as FINRA's Chief of Enforcement, Susan Merrill, remarked in mid-2009, "sweeps are back in vogue."[40]

Current FINRA Enforcement Priorities

Based on our review of currently available information, we believe the following list reflects several of FINRA's top enforcement priorities:

- Ponzi schemes, including an emphasis on understanding brokers' outside business activities
- Securities lending activities with retail customers
- Anti-money laundering policies, procedures and systems
- Sales to senior investors
- Auction rate securities
- Variable annuities
- Supervision of registered representatives
- Mutual fund sales practices
- Sales of municipal securities to retail investors
- Municipal derivatives
- Hedge fund advertising and sales literature
- Sales of collateralized mortgage obligations to retail investors
- Life settlement transactions
- Reverse exchange notes or reverse convertibles
- Private placements and Regulation D offerings

[40] *See* FINRA Ramps Up Sweep Program, Compliance Reporter, Jul. 6, 2009.

FINRA Enforcement Actions

Anti-Money Laundering ("AML")

AML cases continue to be a significant part of FINRA's enforcement program. In 2009, FINRA settled significant enforcement actions against E*Trade, Park Financial Group, J.P. Turner & Co., Legent Clearing and Scottrade. In two of the cases, FINRA sanctioned not only a firm but its AML Compliance Officer as well.

A. *E*Trade Securities, LLC and E*Trade Clearing, LLC* (collectively "E*Trade"), FINRA Case No. 2006004297301 (Jan. 2, 2009)

1. FINRA settled a matter with E*Trade for failing to implement anti-money laundering policies and procedures that were reasonably designed to detect suspicious securities transactions that did not involve money movements.

2. Between January 2003 and May 2007, E*Trade used an automated system to detect suspicious activity, which filtered transactions based on five triggers and flagged transactions as "alerts" for further review by the firm's AML Department. E*Trade relied on employees to manually monitor the alerts to detect suspicious trading activity in accounts.

3. The five triggers employed by the automated system identified patterns of abnormal money movement activity in brokerage accounts. Two of the triggers were designed to flag suspicious patterns of money movement into and out of accounts. Two additional triggers were designed to flag activity based on the number or dollar value of trades executed. The last trigger was designed to monitor trading activity in employee accounts. Because the alerts were triggered only by money movements, employees reviewing the alerts did not typically review for suspicious trading activity.

4. FINRA alleged that E*Trade's AML procedures were insufficient because they were not tailored to the firm's business, which included permitting clients to have direct on-line access to trade in the securities markets. E*Trade's surveillance filters would not have detected, for example, manipulative matched or wash trades.

5. E*Trade consented to a censure and a $1 million fine.

B. *Park Financial Group, Inc.* ("Park"), *Gordon Charles Cantley and David Farber* (Jun. 4, 2009)

1. FINRA settled a matter with Park, Gordon Charles Cantley (Park's owner, CEO, President, Chief Compliance Officer, and AML Compliance Officer) and David Farber (a Park trader), in which it alleged that Park failed to establish effective AML policies and procedures.

2. FINRA alleged that between September 2004 and April 2008, Park's AML program was not specifically tailored to the firm's business. For example, Park's AML policies did not specifically address penny-stock trading despite the fact that many of Park's customers, some of whom had committed securities-related violations, traded penny stocks. In addition, Park failed to enforce adequately its AML policies by not identifying or investigating red flags and failing to file SARs.

3. FINRA also alleged that between August 2004 and April 2008, Park failed to retain instant messages sent or received by certain of its registered representatives. Furthermore, Park did not implement supervisory procedures regarding instant message retention or review until April 2006.

4. Park, acting through Farber, also allegedly participated in the sale of unregistered securities of two issuers. Farber opened issuer-affiliated accounts and unlawfully sold millions of shares of restricted stock. Farber also engaged in front-running by trading for his personal or relatives' accounts after learning of impending block trades in the same securities. FINRA alleged that Park's supervisory systems were not reasonably designed to detect sales of unregistered stock or front-running.

5. Finally, Park allegedly failed to maintain the minimum required net capital on three days in December 2007 and failed to file notices that its net capital had fallen below certain required thresholds.

6. Park consented to a censure and a fine of $400,000 and agreed to hire a consultant to review its AML program. Cantley consented to a permanent bar from associating with any FINRA member. Farber consented to a fine of $25,000 and a 30-day suspension.

7. As we described in our 2007 Year in Review Outline, on April 11, 2007, the SEC announced a settled action in which it alleged that Park and Cantley aided and abetted a "pump-and-dump" scheme and failed to file SARs. In that matter, Park consented to a censure, a cease-and-desist order, disgorgement of approximately $30,000, and a fine of $50,000, while Cantley consented to a cease-and-desist order, a bar from association with any broker or dealer (with a right to reapply after two years), and a fine and disgorgement totaling approximately $33,000.

C. *J.P. Turner & Co., LLC* ("JPT"), *S. Cheryl Bauman, John McFarland, and Robert S. Meyer* (Jun. 4, 2009)

1. FINRA settled a matter with JPT, S. Cheryl Bauman (JPT's chief compliance officer and AML compliance officer), Robert S. Meyer (a JPT branch manager), and John McFarland (a JPT equity trader) in which it alleged that between March 2005 and September 2006, JPT failed to establish effective AML policies and procedures.

2. FINRA alleged that JPT, acting through Bauman, failed to design and implement reasonable AML procedures. As a result, JPT allegedly failed to detect red flags involving suspicious conduct by its customers and a former JPT principal and failed to file SARs on numerous occasions when red flags were present. FINRA also alleged that AML tests performed in 2005 and 2006 by an independent consultant were inadequate because they failed to address JPT's monitoring of suspicious transactions.

3. Apart from AML violations, FINRA alleged that JPT paid transaction-based referral fees to an unregistered individual in exchange for institutional orders and failed to:

(a) report customer complaints timely and accurately and failed to maintain records of such complaints;

(b) maintain required customer information, including financial status, tax status, investment objectives, customer age, required signatures, tax IDs or SSNs, employment information, broker-dealer associations, telephone numbers, dates of birth, income and net worth;

(c) amend or timely amend Forms U-4 or U-5 to report disclosable events;

(d) honor clients' requests to join the firm's Do Not Call ("DNC") list and permitted brokers to call individuals on the firm's and/or the national DNC list; and

(e) adequately supervise the verification of orders and cancellation of trades at branch offices, including failing to enforce a "Special Supervisory Agreement" in 2004 and 2005 with a branch office with a high number of trade cancellations.

4. FINRA alleged that between March 2005 and September 2006, McFarland failed to report numerous instances of suspicious activity in his customers' accounts as required by the firm's AML procedures. FINRA further alleged that McFarland disclosed personal customer information to non-affiliated parties and took instructions for transactions from non-account holders in the absence of written authorization to do so.

5. JPT consented to a $525,000 fine ($25,000 of which was joint and several with Bauman and $5,000 of which was joint and several with Bauman and Meyer) and agreed that its Chief Compliance Officer would review trades for suspicious activity on a daily basis for an eighteen-month period. Bauman and Meyer also consented to 18-month and one-month suspensions, respectively, from acting in any principal capacity. McFarland consented to a permanent bar from associating with FINRA members.

D. *Legent Clearing LLC* ("Legent") (Jun. 4, 2009)

1. FINRA settled a matter with Legent, a clearing broker-dealer, in which it alleged that between February 2004 and November 2006, the firm failed to establish effective written AML policies and procedures tailored to Legent's business of providing clearing services to introducing firms.

2. Some introducing firms serviced by Legent engaged in activities such as penny-stock transactions, liquidations of proceeds, and journaling between accounts that created the risk of AML violations. In addition, some of the introducing

firms were the subject of prior disciplinary proceedings by the SEC, FINRA, and/or state regulators for a variety of issues, including AML violations. However, in many instances involving suspicious circumstances or red flags, Legent failed to investigate and/or failed to file SARs.

3. FINRA further alleged that to the extent that Legent did investigate suspicious activity, it failed to document its investigation or its decision not the file a SAR. In addition, in several cases in which Legent filed a SAR, such filing was untimely. In one instance, the suspicious activity in question began sixteen months before Legent filed a SAR.

4. FINRA also found that Legent's AML program was not specifically tailored to its business and instead was copied from FINRA's Small Firm Template. For example, Legent's AML program failed to identify red flags for money laundering or address the firm's rapid growth during the relevant time period when the number of introducing firms serviced by Legent grew from nine to fifty. In addition, the firm's AML procedures did not contain specific information that identified how and where reviews were to be memorialized and which employees were responsible for which tasks. Legent also allegedly did not have adequate controls in place to ensure that its employees received AML training.

5. FINRA further alleged that on numerous occasions between June 2004 and October 2006, Legent violated Regulation T by: (i) permitting customers to sell securities in cash accounts before making full cash payment for these securities, and (ii) failing to ensure that full cash payment was made within two days of the settlement date. Finally, FINRA alleged that on two occasions, Legent failed to make an accurate reserve computation.

6. Legent consented to a censure and a fine of $350,000.

E. *Scottrade Inc.* ("Scottrade") (Oct. 26, 2009)

1. FINRA settled a matter with Scottrade in which it alleged that the firm failed to implement AML policies and procedures reasonably designed to comply with the Bank Secrecy Act.

2. FINRA alleged that between April 2003 and February 2005, Scottrade's AML policies and procedures were not tailored to the firm's business, which was comprised primarily of high-volume on-line trading. During this period, the firm had no automated processes to detect potentially suspicious activity and instead relied on manual monitoring based on internal and external referrals. In addition, until June 2004, only one firm employee investigated referrals regarding suspicious money movements.

3. In February 2005, Scottrade implemented an automated monitoring system, but the system was inadequate to monitor properly suspicious activity. For example, the automated system's alerts were weighted and reviewed based on the weighting priority, and not every alert was reviewed. In addition, between February 2005 and April 2008, the system's policies, procedures, and systems were designed to detect suspicious money movement only, not suspicious securities trading or movement.

4. FINRA further alleged that the firm's AML analysts were not provided adequate written guidance describing when and how they should review accounts for suspicious trading activity.

5. Scottrade consented to a censure, a fine of $600,000, and an undertaking to certify within 60 days that it had implemented effective AML policies, procedures and internal controls.

Anti-Reciprocal Rule

A. *Bear Stearns & Co., Inc., n.k.a. J.P. Morgan Securities, Inc.* ("Bear Stearns") *and Renee Fourcade* (Aug. 5, 2009)

1. FINRA settled a matter with Bear Stearns and Renee Fourcade, one of the firm's registered representatives, in which it alleged that Bear Stearns shared impermissibly with Fourcade portfolio trading commissions and failed to supervise such payments.

2. Fourcade and her partner (now deceased) were brokers of record for a client's retirement plan. A mutual fund company provided all investment options and recordkeeping for the

plan. Initially, the fund company expected to pay to Fourcade and her partner 12b-1 fees in the amount of 25 basis points but later advised that such fees would be 15 basis points. To compensate for the lower fees, the fund company decided to direct trades to Bear Stearns for the benefit of Fourcade and her partner.

3. FINRA alleged that between February 2001 and November 2003, the fund company identified specific trades as being for the benefit of Fourcade and her partner, and the commissions for these trades totaled over $1 million. Bear Stearns retained approximately $544,000 and paid to Fourcade and her partner approximately $241,000 each.

4. FINRA alleged that these payments violated the NASD's Anti-Reciprocal Rule, which "protects against the potential that brokers might be subject to a conflict of interest by prohibiting a member from granting sales personnel participation in directed commissions generated by the sale of mutual fund shares." FINRA alleged further that Bear Stearns failed to maintain and enforce an adequate supervisory system, was unable to identify whether any employee had approved this commission arrangement, and was unable to provide records reflecting its analysis as to whether this arrangement was permissible under NASD rules.

5. Bear Stearns consented to a censure and a fine of $225,000. Fourcade consented to a censure and a fine of $15,000.

Breakpoint Pricing Self-Assessment

In March 2009, FINRA settled matters with 25 firms arising from the NASD's 2003 request to approximately 2,000 broker-dealers that sold front-end load mutual funds to conduct a self-assessment of their 2001 and 2002 mutual fund breakpoint discount practices.[41] This self-assessment was instituted after the SEC, the NASD and the NYSE found that almost one-third of mutual fund

[41] See *FINRA Fines 25 Firms More than $2.1 Million for Failures in Connection Mutual Fund Breakpoint Review, Other Violations*, Mar. 23, 2009.

transactions that appeared to be eligible for a breakpoint discount failed to receive it.[42]

In the cases concluded last year, FINRA alleged that: (i) fourteen firms failed to accurately and/or completely fill out their self-assessments; (ii) six firms failed to provide timely refunds of fees to customers; (iii) six firms failed to accurately complete a trade-by-trade review of transactions as required by the remediation process following their self-assessments; (iv) five firms failed to notify or timely notify their customers of potential refunds of fees; (v) three firms failed to provide breakpoint discounts during a later period; and (vi) two firms failed to respond timely to questions from their customers concerning breakpoint discounts.

The firms consented to a total of $2.145 million in fines, as follows:

Firm	Fine
J.J.B. Hilliard, W.L. Lyons Inc.	$500,000
New England Securities	$500,000 [43]
SunAmerica Securities, Inc.	$300,000
Multi-Financial Securities Corporation	$150,000
H. Beck, Inc.	$140,000 [44]
SWS Financial Services	$70,000
Leonard & Company	$60,000
Securities America, Inc.	$55,000
SIGMA Financial Corporation	$50,000
Intersecurities, Inc.	$50,000
Fox & Company Investments Inc.	$45,000
Chase Investment Services Corp.	$32,500
vFinance Investments, Inc.	$27,500
Investors Capital Corp.	$25,000
ProEquities, Inc.	$25,000
National Securities Corporation	$25,000
Gary Goldberg & Co., Inc.	$19,500
FSC Securities Corporation	$15,000

42 In February 2004, the SEC and NASD announced disciplinary actions against 15 firms based upon their self-assessment reports. These firms paid over $21.5 million to settle these cases.

43 Includes fines for alleged AML, customer complaint, reporting, and supervisory violations.

44 Includes fines for alleged fee-based brokerage violations.

Lincoln Investment Planning, Inc.	$15,000
Spelman & Co.	$10,000
Stephen L. Falk & Associates, Inc.	$7,500
First Midwest Securities, Inc.	$7,000
GunnAllen Financial, Inc.	$6,000
Advantage Capital Corporation	$5,000
Financial West Group	$5,000

In 2007, FINRA settled a breakpoint assessment action with Oppenheimer & Co, Inc. for $1 million, alleging that the firm knowingly or recklessly submitted a deficient self-assessment.

Credit Default Swaps

A product that has been under increased regulatory scrutiny recently is the credit default swap ("CDS"), which was the subject of a FINRA matter against ICAP and a desk manager at the firm.

A. *ICAP Corporates LLC* ("ICAP Corporates") *and Jennifer Joan James* (Jun. 30, 2009)

1. FINRA settled a matter with ICAP Corporates in which it alleged that the firm, acting through its CDS desk manager, Jennifer James, 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 James repeatedly communicated with other interdealer brokerage firms in connection with setting brokerage fees. These discussions typically took place after an individual firm received a customer request to renegotiate the brokerage fee. James and others discussed, among other things, actual or proposed reactions to such requests, including the preparation of similar responses to customers.

3. FINRA further alleged that this conduct violated NASD Rule 2110 and IM-2110-5 because it "attempts improperly to influence another member or person associated with a member."

4. ICAP Corporates consented to a fine of $2.8 million, which included a $1.8 million fine for supervisory failures and a $1 million fine for violations of NASD Rule 2110 and IM-2110-5 for improperly influencing other firms. In a separate proceeding, Ms. James consented to a fine of $350,000 and a six-month suspension from acting in all capacities.

5. According to FINRA, its investigation into the conduct of other interdealer brokerage firms and individuals was continuing at the time it released these cases in mid-2009.

Excessive Mark-Ups and Commissions

FINRA examiners routinely focus on high mark-ups in examinations. The case below demonstrates enforcement activity in this area.

A. *Department of Enforcement v. RD Capital Group, Inc.* ("RD Capital") *and Ramon Luis Dominguez* (May 11, 2009)

1. After initially commencing litigation, FINRA settled a case with RD Capital and its president, Ramon Luis Dominguez, in which it alleged that RD Capital charged undisclosed and excessive mark-ups on the sale of U.S. Treasury Separate Trading of Registered Interest and Principal Securities ("STRIPS").[45]

2. FINRA alleged that between August 2005 and October 2005, RD Capital sold more than $34 million worth of STRIPS to three customers with undisclosed mark-ups, ranging from 3.5% to 6.2%, which totaled $1,289,727. FINRA alleged that these mark-ups were excessive in light of market conditions, execution costs, and the value provided by RD Capital to its customers.

3. RD Capital and Dominguez consented to a joint and several fine of $50,000. In addition, Dominguez consented to a 30-day suspension from acting as a principal and a five-day suspension from acting in all capacities (to be served concurrently) and agreed to pay restitution of $950,000 to the three affected customers.

[45] As explained in FINRA's press release dated May 11, 2009, announcing the settlement, STRIPS are "zero-coupon U.S. Treasury fixed-income securities generally sold at a significant discount to face value."

Failure to Cooperate – Rule 8210

FINRA (and its predecessor, NASD) has aggressively pursued cases in which it believes that a firm or an individual has not cooperated with requests for information or documents made under Rule 8210. Here is a litigated case from last year.

A. *Department of Enforcement v. Legacy Trading Co., LLC* ("Legacy") *and Mark Uselton* (Mar. 12, 2009)

1. FINRA brought a contested action against Legacy and Mark Uselton, Legacy's President, CEO, and Chief Compliance Officer, in which it alleged that respondents violated rules regarding the locate and delivery of securities being sold short and failed to cooperate with FINRA's investigation.

2. The Hearing Panel found that between May 2004 and August 2005, Legacy failed to satisfy the locate and delivery requirements of NASD Conduct Rule 3370 and subsequently Regulation SHO 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 facts concerning, among other topics, the source of a $300,000 capital contribution and firm employees' use of e-mail for business purposes.

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. 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.[46] 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 have appealed the ruling to FINRA's National Adjudicatory Council ("NAC").

Fee-Based Brokerage

Since 2004, SROs have been very active in the fee-based brokerage arena. Below is yet another case.

A. *Robert W. Baird & Co. Inc.* ("Baird") (Feb. 18, 2009)

1. FINRA settled a matter with Baird in which it alleged that Baird failed to supervise adequately its fee-based brokerage program (the "360/One" program).

2. FINRA alleged that Baird implemented its 360/One program in June 2001 but failed to establish supervisory procedures tailored to accounts in the program until March 2004.

3. FINRA also alleged that between January 1, 2002 and December 31, 2005, Baird failed to monitor and reassess whether fee-based brokerage accounts remained suitable for 360/One customers. Prior to March 2004, Baird did not prepare exception reports or procedures for representatives to determine suitability of the program for its customers. Subsequently, the firm established a supervisory system and procedures but failed to create automated surveillance to verify that the program was suitable for customers and a system for following up when exception reports raised red flags.

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[46] 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.

4. Approximately 100 customers remained in the 360/One program despite the fact that they had not traded at all for at least two years. During that period, these customers paid $269,317 in fees.

5. FINRA also alleged that through September 2007, Baird failed to identify how specific fees were calculated for each 360/One customer and failed to award automatically breakpoint discounts to customers who traded above certain breakpoint levels. As a result of the latter, 53 customers paid $165,193 in excess fees.

6. Baird consented to a censure, a $500,000 fine, and payment of restitution to its customers in the amount of $434,510.

Foreign Currency Exchange Business

In 2009, FINRA brought a case relating to retail foreign currency trading.

A. *Maximum Financial Investment Group, Inc.* ("Maximum") *and Christopher T. Paganes* (Aug. 13, 2009)

1. FINRA expelled Maximum for violations arising out of its retail foreign currency business ("forex"), as well as violations of FINRA registration and related rules.

2. Maximum, acting through its CEO and CCO, Christopher Paganes, entered into an agreement with a non-registered entity to engage in a retail foreign exchange business, whereby Maximum agreed to act as a counterparty for retail forex transactions. Between January and May 2008, more than $15 million in customer funds to be used for retail forex transactions were deposited in Maximum's bank accounts, which Maximum failed to record as assets and liabilities. Maximum's failure to record the funds received for its retail forex business led to the firm's failure to maintain required minimum net capital and accurate books and records.

3. FINRA also found that the firm failed to calculate the amount it had to deposit on behalf of the retail forex customers in a reserve bank account to safeguard the funds, as well as failed to establish AML procedures for its retail foreign exchange business.

4. FINRA also found that Paganes, acting for Maximum, failed to timely file an application for approval of a material change in business on three occasions, including notifying FINRA of its intent to engage in the foreign exchange business.

5. In its AWC, Maximum consented to its expulsion from FINRA; Paganes consented to a supervisory bar and a nine month suspension from association with any FINRA member.

Global Research Analyst Settlement

In 2003, regulators brought landmark cases against a number of firms in the research area. Here is a follow-up case to those settlements.

A. *Credit Suisse Securities* (USA), LLC ("Credit Suisse") (May 21, 2009)

1. FINRA settled a matter with Credit Suisse in which it alleged that the firm violated the provisions of the 2003 Global Research Analyst settlement with the SEC, NYSE, NASD, and state regulators that required Credit Suisse, among other undertakings, to update its policies and procedures concerning equity research and make independent research ("IR") available to customers.

2. Under the terms of the 2003 settlement, Credit Suisse agreed to contract with at least three independent research providers selected by an independent consultant and make IR available to its customers for five years. The IR was to be disseminated in the same manner as the firm's proprietary research. Credit Suisse retained outside vendors to provide IR and to maintain a website that made the IR available to the firm's customers.

3. FINRA alleged that the firm became aware of problems with the posting of IR but failed to take prompt steps to correct the problems effectively, leading to three separate failures to provide IR between August 2004 and July 2008.

(a) Between April 2007 and September 2007, Credit Suisse failed to post to the website 32,500 IR reports due to a software coding change.

(b) Between December 2004 and October 2007, Credit Suisse failed to post certain IR for 224 out of 1,400 covered companies due to a failure by the website vendor to update its records.

(c) Between September 2006 and July 2008, Credit Suisse failed to post IR for 35 covered companies due to a filtering error that excluded these companies from the website.

4. Credit Suisse consented to a censure and a fine of $275,000.

Market Manipulation

In the case below, a member firm was expelled from FINRA after a contested hearing and appeal to the NAC. A second case concerns a settlement with a firm and two principals.

A. *In the Matter of Department of Enforcement v. Kirlin Securities, Inc.* (“Kirlin”), *Anthony J. Kirincic, David O. Lindner and Andrew J. Israel* (May 18, 2009)

1. The NAC affirmed the findings of a Hearing Panel that: (i) Kirlin, Anthony J. Kirincic (Kirlin’s co-CEO), and Andrew J. Israel (Kirlin’s head trader) manipulated the market for the shares of Kirlin’s parent company, Kirlin Holding Corp. (“Kirlin Holding”); (ii) Kirincic falsified customer signatures on stock certificates and letters of authorization, and (iii) Kirlin, David O. Lindner (Kirlin’s co-CEO), and Israel failed to comply with their best execution obligations.

2. On February 20, 2002, Nasdaq notified Kirlin Holding of a possible delisting of its stock from the Nasdaq National Market unless its share price exceeded $1 for at least ten consecutive trading days by May 21, 2002.

3. Between March 5 and March 17, 2002, Kirincic effected cross trades and open market purchases of Kirlin Holding in his parents’ accounts. However, Kirlin Holding’s share price failed to increase as a result of these transactions. Accordingly, beginning on March 18, 2002, Kirincic began purchasing shares of Kirlin Holding using his sister’s

account. For many of these purchases, Kirincic cancelled the order before it was completely filled and replaced it with a higher-priced bid.

4. As a result of these transactions and stock repurchases authorized by Kirlin Holding's board of directors, the stock price closed above $1 beginning on April 2, 2002; two weeks later, Nasdaq orally informed Kirincic that Kirlin Holding's share price had met the pricing requirement and that Nasdaq would issue a formal notice of compliance. During the five-week period beginning on March 18, 2002, more than 90% of the total volume of Kirlin Holding shares traded was executed in connection with orders from Kirincic's relatives or other Kirlin customers.

5. Kirincic continued to purchase shares of Kirlin Holding for his sister's account after April 22, 2002 but at greatly reduced volume. In addition, between April 2002 and June 2002, Kirincic forged his parents' signatures on Kirlin Holding stock certificates representing more than 465,000 shares and letters of authorization that enabled him to transfer $200,000 from his parents' account to his sister's account.

6. The NAC also found that Kirlin, through Lindner and Israel, failed to seek best execution for a customer selling Kirlin Holding shares. On April 22, 2002, Kirlin Holding's share price opened with an inside bid price of $1.04/share and an inside ask price of $1.18/share. That afternoon, Kirlin received an order directing it to liquidate a customer's 114,000 shares of Kirlin Holding. Lindner ordered Israel to repurchase the shares for the company for $.80/share, a price lower than the inside bid and lower than two executions minutes earlier for Kirincic's sister's account.

7. The Hearing Panel: (i) expelled Kirlin from FINRA membership, (ii) barred Kirincic, Lindner, and Israel in all capacities, and (iii) ordered Kirlin, Lindner, and Israel jointly and severally to pay $26,163 in restitution for the best execution violation.

8. The NAC affirmed all of the Hearing Panel's sanctions, except it concluded that the sanctions for the best execution violations were "unnecessarily harsh." As a result, the NAC reduced Lindner's bar to a one-year suspension and ordered

that Lindner requalify in all capacities (other respondents had been barred for other violations as well).

9. The respondents appealed the decision to the SEC. In December 2009, the Commission sustained FINRA's finding of violation but modified the sanctions. The Commission sustained the expulsion of Kirlin. The Commission set aside a bar against Kirincic for improperly signing customers' names to transactional documents but sustained a bar against him for fraudulent market manipulation. The Commission set aside a permanent bar against Israel for fraudulent market manipulation and instead imposed a bar with a right to apply for re-entry after five years because the Commission found the permanent bar to be excessive. The Commission set aside the order of restitution because it believed the facts did not support the order.

B. *Department of Enforcement v. Meeting Street Brokerage, LLC* ("Meeting Street") *Vincent Esposito and Lisa Esposito* (Dec. 8, 2009)

1. FINRA's Department of Enforcement accepted an offer of settlement to resolve disciplinary charges that it brought against Meeting Street, Vincent Esposito (the firm's owner, principal, chief compliance officer and AML compliance officer), and Lisa Esposito, who was in charge of the firm's margin department, in which it alleged that the respondents manipulated the market for the stock of Relay Capital Corporation ("Relay"), violated Regulation T and AML rules, failed to retain instant messages, and failed to adhere to registration and net capital requirements.

2. In 2005, the respondents prearranged approximately 100 matched orders for its customers in Relay stock in order to artificially increase the trading volume and price of the security. The respondents also facilitated journals in Relay stock between the firm's customers and effected agency cross trades at prices above the market price for the same purpose.

3. As a result of these activities, Meeting Street collected $289,000 in commissions on trades in Relay stock. The Espositos, their immediate family members, and an affiliated entity realized a collective gain on their Relay stock transactions of almost $120,000.

4. To further the scheme, the respondents allowed certain customers to purchase the stock without sufficient funds to complete the purchase, or without a good faith belief that the stock would be paid for before the customers sold the stock, in violation of Regulation T. The respondents also violated Regulation T in 2005 and 2006 when the firm did not sell stock or cancel a purchase order after customers failed to pay for the purchase within the time required by Regulation T. The respondents also improperly allowed stock purchases to be funded by the sale of the same stock and failed to impose Regulation T's 90-day freeze when required.

5. The Department of Enforcement also alleged that between 2005 and 2007, the firm, through Vincent Esposito, was aware or should have been aware of numerous AML red flags but did not investigate its customers' activities, file SARs in connection with such activity, or document the firm's actions.

6. Finally, the Department of Enforcement alleged that, at various times between 2004 and 2006, the firm failed to preserve instant messages, permitted Lisa Esposito to execute equity transactions even though she was not registered, failed to maintain records regarding its discretionary power over three customer accounts, and, on five occasions, failed to maintain its minimum required net capital.

7. Meeting Street consented to expulsion from FINRA membership. Lisa Esposito consented to a bar in all capacities. Vincent Esposito consented to a 90-day suspension in all capacities, a two-year suspension as a principal, and a $15,000 fine.

Mutual Fund Sales Practices

In 2008, FINRA brought several significant cases involving mutual fund sales practices. In early 2009, FINRA imposed substantial sanctions on two affiliated firms for alleged mutual fund sales practice violations. These two cases add to a long line of B/C share and NAV transfer cases brought by FINRA and its predecessor, NASD. In mid-2009, FINRA brought two cases related to closed-end funds.

A. *Wachovia Securities, LLC* ("Wachovia Securities") *and Wachovia Securities Financial Network, LLC* ("Wachovia Financial") (Feb. 12, 2009)

1. FINRA settled a matter with Wachovia Securities and Wachovia Financial in which it alleged that: (i) they sold mutual fund shares without determining whether such investments were suitable for their customers, and (ii) Wachovia Securities sold Unit Investment Trust ("UIT") shares without properly applying relevant discounts.

2. FINRA alleged that between January 1, 2003 and June 30, 2004, Wachovia Securities and Wachovia Financial recommended that their customers purchase Class B and/or Class C shares of mutual funds without taking into consideration whether purchases of Class A shares would have been more suitable investments. In certain instances, Wachovia Securities and Wachovia Financial received greater commissions than they would have if they had sold Class A shares: Wachovia Securities received an additional $3.86 million, and Wachovia Financial received an additional $150,500.

3. FINRA also alleged that between January 1, 2002 and December 31, 2004, Wachovia Securities failed to implement systems and procedures designed to ensure that customers eligible for NAV Transfer Programs were able to purchase Class A shares without paying the sales charges and/or higher fees associated with new mutual fund purchases.

4. In addition, FINRA alleged that Wachovia Securities applied incorrectly a "rollover" discount (available when investors purchase a new UIT with proceeds from a maturing UIT) associated with customers' purchases of UITs between January 1, 2001 and June 30, 2005. FINRA also alleged that Wachovia Securities applied insufficient "breakpoint" discounts (available for increasingly large UIT purchases) to customers between January 1, 2001 and May 31, 2006. As a result, customers paid approximately $2.7 million in excess sales charges.

5. Wachovia Securities consented to a censure and a fine of $4.41 million and agreed to refund initial sales charges to those customers who purchased Class A shares. Wachovia

Financial consented to a censure and a fine of $150,500. Both Wachovia units also agreed to refund various fees and expenses to customers who purchased Class B and Class C shares; qualifying customers had the option of converting their Class B or Class C shares to Class A shares. By the time the matter settled, Wachovia Securities had already conducted a remediation program with respect to UIT sales.

B. *UBS Financial Services, Inc.* ("UBS FS") (June 26, 2009) and *Merrill Lynch, Pierce, Fenner & Smith, Inc.* (Jul. 28, 2009)

1. FINRA settled matters with UBS FS and Merrill Lynch in which it alleged that the firms did not have systems or procedures reasonably designed to prevent unsuitable trading of closed-end funds ("CEFs").

2. CEFs are investment companies that sell a fixed number of shares in an IPO. After the offering, CEF shares may trade in the secondary market. Because sales charges are built in to the offering price, the shares' market price generally decline after the IPO. According to FINRA, for these reasons, among others, CEFs are most suitable as long-term investments.

3. Between January 2004 and December 2005, UBS FS participated in 34 CEF offerings; between March 2003 and August 2006, Merrill Lynch participated in 114 CEF offerings.

4. FINRA alleged that the firms failed to maintain policies and procedures to detect and prevent unsuitable short-term trading of shares of CEFs purchased in the IPO. In total, FINRA alleged that UBS FS' customers lost more than $2 million, while Merrill Lynch's customers lost more than $3 million.

5. The firms each consented to censures, and UBS FS and Merrill Lynch agreed to pay fines of $100,000 and $150,000, respectively.

6. In determining these sanctions, FINRA took into consideration that the firms undertook internal reviews, identified the causes of the violations, and corrected their systems and procedures. The firms also made "extraordinary remediation" to their customers in the full

amount of their losses. Finally, the firms sanctioned those representatives found to have made unsuitable CEF recommendations.

7. Separately, FINRA suspended five Merrill Lynch representatives for 15 days and fined them $10,000 for making unsuitable recommendations regarding CEF shares. At the time of the issuance of these cases, FINRA stated that its investigation into the activities of former UBS FS representatives was ongoing.

Offering Documents and Marketing Materials

The cases below demonstrate FINRA's focus on hedge fund and private placement marketing materials.

A. *Bear Stearns & Co., Inc., n/k/a J.P. Morgan Securities, Inc.* (Aug. 6, 2009)

1. FINRA settled a matter with Bear Stearns in which it alleged that the firm failed to supervise adequately investments in a hedge fund of funds by its retail customers, failed to supervise certain private securities transactions, and distributed misleading marketing materials.

2. Between July 2000 and early 2007, Bear Stearns offered its retail customers the opportunity to invest in a hedge fund of funds ("Mosaique"). The Fund's adviser ("MCM") was 25% owned by the firm and operated under its supervision. In total, 34 of the firm's registered representatives sold Mosaique to Bear Stearns retail customers.

3. FINRA alleged that referral fees to the firm's representatives were paid by Mosaique investors, notwithstanding the fact that the offering documents stated that MCM would pay such fees. FINRA alleged further that, despite receiving financial statements indicating that high administrative expenses were being charged to investors, the firm failed to detect this activity. FINRA noted that when the firm became aware of these fees, it voluntarily reimbursed the investors.

4. FINRA also alleged that the firm failed to supervise adequately the activities of a registered investment advisor formed to enable a firm representative to recommend

outside investment managers. Although the agreement between the firm and the representative stated that Bear Stearns would be responsible for "regulatory compliance oversight," the firm failed to supervise adequately the activities of the adviser, including failing to review and record certain private securities transactions on its books and records.

5. Finally, FINRA alleged that, in connection with sales of Mosaique, the firm distributed marketing materials that contained inaccurate information because they relied upon hypothetical performance figures and failed to adequately disclose the risks of hedge fund investments.

6. Bear Stearns consented to a censure and a $500,000 fine.

7. This matter was initiated following a referral from the SEC staff based on information gathered during a Commission staff examination of hedge funds relating to hedge funds' use of broker-dealers as a source of new investors.

B. *Pacific Cornerstone Capital, Inc.* ("PCCI") *and Terry Roussel*, (Nov. 23, 2009)

1. FINRA settled a matter with PCCI and Terry Roussel (the firm's president, principal, director, CEO and CCO), in which it alleged that PCCI made material misstatements and omissions in connection with private placement offerings and distributed inaccurate marketing materials.

2. Between January 2004 and May 30, 2009, PCCI conducted private placement offerings for two of its parent company's affiliates, Cornerstone Industrial Properties, LLC ("CIP") and CIP Leveraged Fund Advisors, LLC ("CLFA"). In total, during the relevant period, 950 investors purchased $50.4 million in private placement units in CIP and CLFA.

3. FINRA alleged that PCCI and Roussel made material misstatements or omissions in connection with these private placements. Specifically, PCCI and Roussel distributed private placement memoranda and sales literature that contained unreasonable targets for distributions and yields, contained inadequate risk disclosures, and were not updated

to reflect the investments' performance over time, which lagged behind stated targets.

4. FINRA also alleged that PCCI and Roussel made misstatements or omissions in periodic update letters to CIP and CLFA investors. These letters, among other things, failed to disclose that CIP was unable to pay its expenses, failed to disclose adequately the risks associated with such investments, and contained prohibited statements predicting future performance.

5. Finally, FINRA alleged that PCCI and Roussel failed to supervise adequately the CIP and CLFA private placement offerings and failed to conduct adequate due diligence prior to conducting the offerings.

6. PCCI consented to a censure, a fine of $700,000, and undertakings to: (i) distribute corrective disclosures to existing investors in CIP and CLFA within sixty days, and (ii) file with FINRA's Advertising Regulation Department for a period of one year all sales literature and advertisements at least ten days prior to publication. Roussel consented to a fine of $50,000, a 20-day suspension in all capacities, and a three-month suspension as a principal.

Operational Issues

Over the last several years, SROs have brought disciplinary actions against firms that highlight the need to pay close attention to operational matters. Two significant cases in 2009 again raise this issue.

A. *Wachovia Securities, LLC and First Clearing, LLC* ("First Clearing") (Mar. 24, 2009)

1. FINRA settled a matter with Wachovia and its affiliate First Clearing in which it alleged that they failed to send numerous required notifications to customers.

2. FINRA alleged that between June 2003 and October 2008, Wachovia and First Clearing did not send to customers a wide variety of mandatory notifications as a result of a number of computer programming and system errors. In total, approximately 800,000 required notifications were not sent.

3. FINRA alleged that during the relevant period, due to computer programming and system update errors, Wachovia failed to send certain confirmation of changes in investment objectives and confirmation of address changes.

4. FINRA alleged that due primarily to programming errors, First Clearing failed to send in certain instances: (i) clearing agreement notifications; (ii) confirmation of address changes; (iii) confirmation of changes in investment objectives; (iv) notification of partial calls; and (v) margin disclosure statements. First Clearing also allegedly provided incorrect bond ratings on trade confirmations for transactions in certain bonds and incorrect fee statements in certain mailings.

5. FINRA also alleged that both Wachovia and First Clearing failed to send to customers asset transfer notifications and customer profile information forms due to operations and computer coding issues.

6. FINRA also alleged that the above issues went undetected because Wachovia and First Clearing failed to adequately supervise the process of mailing required notifications and failed to have written supervisory procedures regarding such mailings.

7. Wachovia and First Clearing consented to a censure, a fine of $1.1 million, and retention of an independent compliance consultant.

B. *Edward D. Jones & Co., L.P.* (“Edward Jones”) (Apr. 9, 2009)

1. FINRA settled a matter with Edward Jones in which it alleged that the firm failed to provide timely official statements to certain customers who purchased “new issue” municipal securities.

2. FINRA alleged that between 2002 and September 2008, Edward Jones “systemically” failed to provide official statements on or before the settlement date to customers who purchased municipal securities, as required by MSRB Rule G-32, despite learning “repeatedly” that it was not complying with the rule.

3. FINRA alleged specifically that: (i) between August 2002 and May 2003, Edward Jones failed to timely provide official statements in over 1,200 transactions; (ii) between February 2004 and May 2006, Edward Jones did not mail timely official statements for a significant number of its approximately 100,000 new issue municipal security transactions; and (iii) in September 2008, Edward Jones did not mail timely official statements for more than 6,200 transactions.

4. FINRA alleged that these failures occurred due to, among other reasons, inadequate procedures and employee training, resource constraints, and employee error, including failures by supervisors to provide proper guidance to mail room personnel regarding the regulatory requirements.

5. FINRA also alleged that Edward Jones failed to maintain adequate written supervisory procedures and accurate books and records. Edward Jones's procedures did not address MSRB Rule G-32 requirements until May 2006, and the firm failed to maintain detailed information about deliveries of official statements for new issues required by MSRB Rule G-8.

6. Edward Jones consented to a censure, a $900,000 fine, and an undertaking to adopt systems and procedures to achieve compliance with MSRB rules relating to new issue transactions and official statement deliveries.

Prospectus Delivery

In prior years, SROs brought several substantial prospectus delivery cases against member firms. The case below is another in that line.

A. *Wachovia Securities, LLC* (Jun. 25, 2009)

1. FINRA settled a matter with Wachovia Securities in which it alleged that the firm failed to deliver certain prospectuses to customers.

2. FINRA alleged that between July 2003 and December 2004, Wachovia failed to deliver prospectuses in connection with customer purchases of several different classes of securities, including, among others, exchange-traded funds,

collateralized mortgage obligations, auction rate market preferred securities, debt securities, preferred stocks, and mutual funds. In total, the firm failed to deliver prospectuses in connection with 6,000 transactions out of approximately 22,000 transactions effected during this time period.

3. The firm's failure to deliver prospectuses stemmed from coding errors, internal failures to notify the firm's operations department that a prospectus must be delivered, and failures to supervise the activities of an outside vendor that had contracted to deliver prospectuses.

4. FINRA also alleged that the firm lacked adequate supervisory procedures regarding prospectus delivery.

5. Wachovia Securities consented to a fine of $1.4 million.

Regulation S-P

The SEC and FINRA have been active in the Regulation S-P area in recent years. The case below is another example of FINRA's efforts.

A. *Centaurus Financial, Inc.* ("CFI") (Apr. 28, 2009)

1. FINRA settled a matter with CFI in which it alleged that the firm failed to protect adequately confidential customer information and failed to provide accurate notices to customers after unauthorized individuals gained access to such information.

2. FINRA alleged that between April 2006 and July 2007, CFI failed to safeguard a server containing images of faxes reflecting confidential customer information, such as account numbers, social security numbers, and account balances. This failure occurred because the firm's firewall was improperly configured in a way that permitted unauthorized users to access the firm's server and because CFI set the username as "Administrator" and the password as "password."

3. FINRA alleged that an individual accessed the server to load a "phishing" program designed to bring internet users to a simulated eBay website. The next day, "John Doe," a third

party who monitors phishing scams, contacted CFI and informed the firm that its server had been compromised. CFI allegedly failed to take prompt action.

4. When John Doe subsequently discovered that the server had not been secured, he downloaded 1,800 fax images containing confidential customer information for approximately 1,400 customers and used this information to contact two CFI customers. Only after these customers contacted CFI did the firm shut down the server.

5. FINRA further alleged that when CFI investigated the incident, the firm limited its review to July 2007 computer logs. As a result, CFI failed to discover that between April 2006 and July 2007, CFI's server was improperly accessed approximately 73 times by 64 unique IP addresses. In total, 119 files were downloaded by unauthorized users besides the phishing incident described above.

6. FINRA also alleged that when CFI subsequently sent letters to the 1,400 affected customers and its registered representatives informing them of a security breach, the firm inaccurately stated that unauthorized access was limited to one "benevolent" person and failed to disclose that CFI's inadequate security procedures permitted the breach. Finally, FINRA found that CFI's supervisory procedures were not reasonably designed to protect confidential customer information.

7. CFI consented to a censure and a fine of $175,000 as well as an undertaking to distribute to affected customers corrected and accurate notices of the security breach, and offer at least one year of credit monitoring services to these customers.

Research Disclosures

FINRA, and its predecessor, NASD, have a long history of instituting actions relating to research report disclosures. The case below is another example in this area.

A. *Ladenburg, Thalmann & Co., Inc.* ("Ladenburg") (Mar. 24, 2009)

1. FINRA settled a matter with Ladenburg in which it alleged that the firm failed to document approval of research reports or properly disclose its securities holdings in such reports.

2. FINRA alleged that between November 1, 2005 and December 31, 2006, Ladenburg published 72 research reports but was only able to demonstrate that it had approved adequately six of those reports. In addition, in 65 of these reports, Ladenburg failed to "clearly, comprehensively, and unconditionally" disclose ownership of the subject securities by the firm and/or analyst who authored the reports.

3. FINRA also found that Ladenburg failed to adequately supervise the activities of associated persons in several respects. Specifically, the firm allegedly failed to:

   (a) enforce its procedures regarding approval of research reports between 2005 and 2006, which required review by a designated supervisor and retention of the final report for three years;

   (b) review or have policies and procedures for reviewing electronic mail before July 2005 and instant messages and Bloomberg messages before September 2005;

   (c) evidence its request for, or receipt of, duplicate account statements between 2005 and 2006 for three research analysts who held securities away from the firm;

   (d) evidence requests or approvals for two employees to have dual employment during 2006; and

   (e) evidence that it had conducted annual inspections of two of its five branch offices during 2005.

4. FINRA also alleged that Ladenburg failed to satisfy various reporting requirements related to, among other topics, annual compliance reports, customer complaints, and Forms U-5.

5. FINRA further alleged that Ladenburg miscalculated its net capital computation by improperly classifying as cash a $3.5 million collateralized mortgage obligation. This investment should have been classified as inventory, which would have resulted in a haircut and undue concentration charges of $325,000.

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

Retention of Electronic Communications

For years, regulators have imposed harsh sanctions on firms for failure to retain electronic communications. The action below continues that trend. Here, the firm was credited with self-reporting and remedying the matter.

A. *AXA Advisors, LLC* ("AXA") (Feb. 2009)

1. FINRA settled a matter with AXA in which it alleged that AXA failed to retain business-related electronic communications and failed to implement adequate systems to detect failures in its e-mail archive system.

2. FINRA alleged that between January 2002 and August 2004, AXA failed to ensure that all business-related e-mails were retained. For example, representatives could change e-mail retention settings on their computers, delete e-mails before daily backups were performed, and use public instant messaging that the firm did not retain. In addition, between January 2002 and September 2003, AXA's e-mail system overwrote e-mail back-up tapes every three to four weeks.

3. Although a new system was purchased in August 2004, it did not work properly until November 2006 and failed to capture e-mails promptly and transfer them to an archive. Of these, approximately 1.1 million e-mails became corrupted and could not be recovered.

4. AXA consented to a censure and a fine of $350,000.

5. In setting the sanction, FINRA considered that AXA self-reported the violation and took remedial steps to rectify it.

Sales of Restricted Securities

Early in 2009, FINRA issued a release announcing its settlement with Leonard & Company concerning the firm's alleged sale of restricted securities.

A. *Leonard & Company* ("Leonard") *and Robert J. Cole* (Jan. 13, 2009)

1. FINRA settled a matter with Leonard alleging several violations, including that the firm sold unregistered shares into public markets and violated anti-money laundering rules.

2. FINRA alleged that Leonard participated in an illegal distribution of 2.2 million unregistered shares of Shallbetter Industries ("Shallbetter") while it knew or could have known through reasonable inquiry that the Shallbetter shares were restricted and that trading of the shares held at Leonard was being conducted by a control person of Shallbetter. Although Leonard received a legal opinion that the shares were freely tradable, the firm had information in its files and e-mails that contradicted the opinion. The sales yielded proceeds of more than $3.1 million.

3. Robert Cole, a Leonard registered representative, was aware that Shallbetter had issued releases, and a third party had engaged in a spam e-mail campaign, touting the stock. Cole arranged for the removal of restrictive legends that appeared on the stock certificates, allowing the shares to be sold to the public. Also, FINRA alleged that while in possession of material, non-public information, Cole purchased shares of Shallbetter for his own account and solicited purchases of 10,000 shares for two customers.

4. FINRA also alleged other violations by Leonard, including that the firm: (i) failed to adequately research a stock not listed on a national exchange or NASDAQ before recommending it to a client; (ii) failed to adequately review and preserve e-mail; (iii) failed to implement and enforce its AML program by following up on red flags and to file SARs in response to the red flags; (iv) permitted an employee to serve as a principal in violation of the terms of a prior AWC; and (v) failed to supervise.

5. Leonard consented to a censure and a $225,000 fine and agreed to retain an independent compliance consultant to

review its supervisory systems and procedures. Cole consented to an industry bar.

6. FINRA's release of this settlement coincided with its issuance of Regulatory Notice 09-05, Unregistered Resales of Restricted Securities, in which it reminded firms of their obligation to conduct reasonable reviews to determine whether securities are eligible for public sale to avoid participation in illegal distributions. In the notice, FINRA also provided examples of satisfactory supervisory procedures.

Soft Dollar Payments

A. *Terra Nova Financial, LLC* ("Terra Nova"), *Cleovan E. Jordan, Joshua D. Teuber, and David P. Persenaire* (Nov. 23, 2009)

1. FINRA settled a matter with Terra Nova, Cleovan E. Jordan (the firm's soft dollar administrator), Joshua D. Teuber (the firm's soft dollar operations supervisor), and David P. Persenaire (the firm's chief compliance officer) in which it alleged that the firm made more than $1 million in improper soft dollar payments and failed to supervise its soft dollar program.

2. FINRA alleged that in 2004 and 2005, Terra Nova made more than $1 million in soft dollar payments to, or on behalf of, five hedge funds for inappropriate expenses that were either not allowed under the funds' offering documents or that lacked the requisite documentary support to confirm that the payments were for authorized expenses.

3. FINRA alleged that soft dollars were used improperly to pay for such expenses as accounting and administrative expenses, clothing, automobile repairs, parking tickets, meals, entertainment, and salaries and benefits. Terra Nova made such payments in reliance on representations from fund managers without verifying that the expenses were proper or addressing adequately certain red flags regarding such expenses. For example, shortly after implementing its soft dollar program, Terra Nova learned that the SEC had sued a manager of one of its clients for misusing soft dollar payments.

4. FINRA also alleged that the firm failed to have adequate systems and procedures in place to supervise its soft dollar program, failed to respond timely to FINRA's requests for information, and failed to retain electronic instant messages.

5. Terra Nova consented to a censure, a $400,000 fine, and an undertaking to hire an outside consultant to review and report on the firm's policies, procedures and systems related to soft dollar operations. Jordan consented to a 30-day suspension and a $20,000 fine. Teuber consented to a 20-day suspension and a $15,000 fine. Persenaire consented to a 10-day suspension and a $10,000 fine.

Stock Loan

The SEC and FINRA continue their focus on stock loan cases as evidenced below.

A. *RBC Capital Markets Corp. and Benedict Patrick Tommasino* (Jun. 17, 2009)

1. FINRA settled a matter with RBC and Benedict Patrick Tommasino, the head trader on RBC's stock loan desk, in which it alleged that RBC used a non-registered finder to perform functions requiring registration and failed to supervise reasonably the activities of its stock loan desk.

2. FINRA alleged that between March 2004 and November 2004, the firm, acting though Tommasino, allowed a non-registered finder to select counterparties and to negotiate terms in connection with transactions in which the firm borrowed securities. FINRA alleged that the finder's activities in these transactions went beyond those performed by "legitimate finders" and therefore required the finder to be registered.

3. In addition, Tommasino knew that the finder had been barred by the SEC in connection with his role in aiding and abetting violations of the securities laws.

4. FINRA also alleged that the firm lacked operational and supervisory procedures regarding the use and compensation

of finders and that the firm's books and records failed to reflect the true nature of payments intended for the finder.

5. RBC consented to a censure and a $400,000 fine. Tommasino consented to a $30,000 fine and agreed to a 20-month suspension in all capacities and a consecutive two-month suspension in a principal capacity.

6. In 2008, FINRA settled a matter with Raymond James arising from the same transactions discussed above, in which it alleged, among other violations, that Raymond James allowed a non-registered finder to perform functions requiring registration and made payments to certain finders who did not provide any services in connection with stock loan transactions. Raymond James consented to a censure and a fine of $1 million.

Supervision

FINRA actions continue to emphasize the importance of supervision in cases relating to early retirees. The first action below is yet another example of this kind of case – and the substantial fines being levied in such actions. The second case involves widespread supervisory issues relating to the production of certain managers; this has also been a hot button topic for FINRA.

A. *Morgan Stanley & Co., Inc.* (Mar. 25, 2009)

1. FINRA settled a matter with Morgan Stanley in which it alleged that the firm's supervisory system failed to detect and prevent two of its brokers from persuading customers to elect early retirement based on: (i) unrealistic promises of consistently high investment returns, and (ii) unsuitable strategies.

2. FINRA alleged that Morgan Stanley representatives Michael J. Kazacos and David M. Isabella persuaded customers in their 50s to take early retirement and turn over their retirement accounts to Morgan Stanley, promising that their investments would achieve ten percent annual returns and that they could withdraw those profits without invading their principal. Based on Kazacos' and Isabella's representations, many individuals transferred their retirement accounts to Morgan Stanley, and some retired early.

3. The brokers invested their customers' money in unsuitable and over-concentrated investments, including variable annuities, and advised many customers to liquidate their mutual fund holdings and purchase new securities through Morgan Stanley with annual fees of 1.75% to 2.5%. Nearly 200 customers were harmed, and many were forced to return to work due to their inability to make the expected withdrawals.

4. FINRA found that during the relevant period, Morgan Stanley was aware that these representatives were actively marketing rollover IRA accounts and failed to take reasonable steps to verify that their customers received proper risk disclosures. Morgan Stanley also allowed Isabella to use marketing materials that misstated annual returns, annual fees, and Isabella's professional designation.

5. FINRA also alleged that Isabella, a former Xerox employee, provided gifts to certain current Xerox employees and obtained improperly confidential information concerning Xerox employees, including their retirement status. In addition, FINRA charged Isabella with falsifying records regarding his customers' financial goals and giving false testimony to FINRA during its investigation.

6. Morgan Stanley consented to a censure, a fine of $3 million, and payment of restitution to 90 former customers of more than $4 million, including interest. According to FINRA, the firm had already settled with many of the affected customers.

7. Kazacos and Isabella consented to permanent bars from associating with FINRA members, while Ira S. Miller, the manager of the branch in which Kazacos and Isabella worked, consented to a $50,000 fine and a one-year suspension from acting in a principal capacity.

B. *NEXT Financial Group, Inc.* ("NEXT") (Jul. 22, 2009)

1. FINRA settled a matter with NEXT in which it alleged that the firm and Karen Eyster (NEXT's executive vice president, chief operating officer, and chief compliance officer) failed to supervise adequately its Office of Supervisory Jurisdiction ("OSJ") managers, and as a result, failed to detect, among other alleged violations, churning and excessive markups/markdowns.

2. Between January 2005 and November 2006, NEXT permitted its 130 OSJ managers to self-review the suitability of their own transactions. The firm's written procedures in effect during this time period did not specify how the firm supervised transactions of branch managers. In practice, the firm delegated the supervision of branch managers to its Compliance Department; however, compliance principals rarely reviewed the suitability of transactions.

3. In the fall of 2006, NEXT established a new system whereby regional managers supervised OSJ managers, in part by reviewing their trades. FINRA alleged that the system was inadequate because each regional manager was assigned too many OSJ managers to supervise and was not given sufficient technological support to supervise the OSJ managers effectively, despite complaints from the regional managers. In addition, the firm did not provide reasonable written guidance to the regional managers explaining how to perform their supervision of OSJ managers.

4. FINRA alleged that the firm's inadequate supervisory policies and procedures resulted in its failure to detect unreasonable mark-ups and mark-downs, as well as its failure to detect churning in customer accounts by a branch manager and a registered representative.

5. FINRA also alleged that: (i) the firm's systems and procedures related to variable annuity sales were inadequate because they did not provide sufficient guidance and criteria as to when to recommend switches; (ii) the firm failed to enforce its heightened supervision policies and procedures consistently; (iii) the firm did not establish and test an appropriate supervisory control system; and (iv) the firm hired a statutorily disqualified employee after failing to conduct a background check on, or fingerprint, him.

6. NEXT consented to a censure, a fine of $1 million, restitution of $5,638, and an undertaking to implement new systems and procedures.

7. Eyster consented to a two-month suspension in all principal and supervisory capacities, a fine of $35,000, re-qualification, and 15 hours of training regarding supervision.

Supervision of E-mail Communications

FINRA continues to bring cases with high fines for alleged deficiencies in e-mail supervision. In the case below, FINRA alleged that the failures led to broker misconduct going undetected.

A. *Metlife Securities, Inc., New England Securities Corp., Walnut Street Securities, Inc., and Tower Square Securities, Inc.* (collectively "the Metlife affiliates") (Nov. 18, 2009)

1. FINRA settled a matter with the Metlife affiliates in which it alleged that they failed to implement an adequate supervisory system to review brokers' e-mail correspondence and failed to establish adequate supervisory procedures to monitor brokers' outside business activities and private securities transactions.

2. FINRA alleged that between March 1999 and December 2006, the firms' written supervisory procedures required principal review of all e-mails sent or received by its registered representatives. The firms relied on their registered representatives to forward e-mails to their principals for review. The firms did not have in place any system to monitor whether the representatives were complying with this requirement and, instead, relied on branch audits and spot checks of representatives' computers.

3. FINRA found that these measures were inadequate. For example, branch audits were unreliable because they were (i) only conducted annually, and (ii) limited to review of hard copy printouts contained in client files. In addition, if a discrepancy was discovered, there was no requirement to review the representative's archived e-mails to determine if other e-mails had not been forwarded. Similarly, spot checks were inadequate because representatives were able to delete e-mails from their computers, and supervisors did not have access to e-mail archives.

4. FINRA alleged that these supervisory inadequacies resulted in examples of misconduct going undetected by the firms. For example, FINRA found that two representatives sent or received more than 100 e-mails reflecting undisclosed outside business activities and private securities transactions but did not forward these e-mails to their principals. One of

these representatives misappropriated almost $6 million from his customers.

5. The firms consented to a censure and a joint and several fine of $1.2 million.

Supervision of Outsourced Responsibilities

Outsourcing is a regulatory hot button. Here are three cases where FINRA brought disciplinary action in this area relating to an initial public offering.

A. *Citigroup Global Markets Inc.* ("CGMI"), *Deutsche Bank Securities Inc.* ("DBSI"), and *UBS Securities, LLC* (Sept. 9, 2009)

1. FINRA settled matters with CGMI, DBSI and UBS in which it alleged that the firms failed to establish and maintain adequate supervisory procedures and systems regarding customer communications that had been outsourced to a third-party vendor in connection with a directed share program ("DSP").

2. In May 2006, Vonage LCC ("Vonage") conducted an initial public offering of its common stock. A portion of the Vonage shares were reserved for eligible Vonage customers via the DSP. Those customers wishing to participate in the DSP were required to open an account with CGMI, DBSI or UBS, which were the three lead underwriters for the IPO.

3. Vonage and the firms agreed to administer the DSP online, and a third party vendor was selected to maintain the DSP website. The majority of communications with DSP customers, including information related to acceptance of offers and share allocation, was effected through the website.

4. As a result of an error by the website vendor during the share allocation process, certain of the firms' customers whose offers to purchase Vonage shares had been accepted saw messages on the website incorrectly stating that they had not been allocated any shares. These customers did not learn that they, in fact, had been allocated shares until several days later, by which time the price of Vonage stock had fallen from the original offering price.

5. FINRA alleged that although the firms had in place written procedures for directed share programs and for outsourcing, the procedures were not followed in connection with the Vonage DSP. Specifically, FINRA alleged that the firms failed to ensure that the vendor maintained sufficient records of communications with the firms' customers, were unable to determine whether and why an error had occurred, failed to respond adequately after they became aware that their customers may have received incorrect allocation information, and failed to ensure that FINRA had the same access to the work performed by the vendor that FINRA would have had if the firms had performed the work themselves.

6. The firms each consented to a censure, a fine, restitution, and an undertaking to certify within 150 days that they had in place policies and procedures relating to outsourcing in connection with public offerings of common stock. Specifically, the firms agreed to the following: (i) CGMI - a fine of $175,000 and restitution of no more than $250,000 to 284 customers; (ii) UBS - a fine of $150,000 and restitution of no more than $118,000 to 126 customers; and (iii) DBSI - a fine of $100,000 and restitution of no more than $52,000 to 59 customers.

7. Although the AWCs in these cases do not explain the different fine amounts, CGMI had the most affected customers, followed by UBS, and then DBSI.

Tax-Related Trading Strategies

A. *Citigroup Global Markets, Inc.* (Jul. 28, 2009)

1. FINRA settled a matter with CGMI in which it alleged that the firm failed to supervise the implementation of two trading strategies designed to provide tax benefits to certain of the firm's foreign clients or foreign affiliates.

2. One trading strategy, which was in use between 2002 and 2005, involved U.S. equities and was designed to enable foreign clients to realize the full value of dividends on securities investments without paying U.S. withholding taxes. A second trading strategy, which was in use between 2000 and 2004, involved Italian equities and structured to enable

CGMI's affiliate, Citi-London, to receive tax refunds due to a tax treaty between the U.K. and Italy.

3. FINRA alleged that for much of the relevant time period, the firm failed to establish written supervisory procedures specific to trades made as part of these strategies. Moreover, even after the firm put into place internal guidelines or received external guidance explaining how to effect these trades properly, the Equity Finance Desk continued to structure these transactions in violation of such guidance.

4. FINRA also alleged that CGMI failed to monitor Bloomberg messages and failed to report to Nasdaq transactions in eligible securities.

5. CGMI consented to a censure and a fine of $600,000.

6. In determining the sanction, FINRA took into consideration that CGMI self-reported the above-referenced violations, hired outside counsel to review its procedures and assist in remediation, and provided substantial assistance to FINRA during the investigation.

Trade Reporting

FINRA continues to focus on trade reporting issues as demonstrated by the five actions below. In two cases, FINRA remarked positively on the firms' self-reporting of certain of the violations.

A. *Goldman Sachs & Co.* ("Goldman") (Feb. 2009)

1. FINRA settled a matter with Goldman in which it alleged that Goldman's Equity Finance Group ("EFG") failed to report, or timely report, trade information to Nasdaq.

2. FINRA reviewed trades executed by EFG between September 1, 2003 and September 30, 2004 for which Goldman had direct trading reporting responsibility. FINRA alleged that Goldman failed to report to Nasdaq nine last sale reports for transactions in eligible securities and failed to transmit timely to Nasdaq 34 last sale reports for such securities. Goldman also allegedly failed to report to Nasdaq three last sale reports for transactions in Nasdaq securities

and failed to timely transmit to Nasdaq 11 last sale reports for such securities.

3. FINRA also alleged that Goldman failed to report to Nasdaq that two transactions were short sales, failed to show time of entry or time of execution on the memorandum of 25 brokerage orders, failed to note capacity on 28 order tickets, and could not produce order tickets for five transactions.

4. FINRA alleged that Goldman failed to supervise adequately EFG in order to achieve compliance with applicable rules and regulations.

5. Goldman consented to a censure and a $600,000 fine paid jointly to FINRA and NYSE Regulation.

6. The AWC explained that the sanction amount reflected "substantial credit" for Goldman's discovery and self-reporting of the violations addressed in the settlement.

B. *Citigroup Global Markets, Inc.* (Mar. 17, 2009)

1. FINRA settled a matter with CGMI in which it alleged that CGMI violated OATS rules and fixed income reporting and limit order display requirements and that the firm improperly published non-bona fide quotations, which resulted in non-bona fide transactions.

2. FINRA alleged that between August 1, 1999 and July 10, 2006, CGMI failed to report OATS Reportable Order Events for 6.4 million orders on a total of 1,745 business days. In addition, between July 1, 2005 and September 30, 2005, CGMI allegedly did not report (or did not report accurately) certain information on execution or cancellation reports submitted to OATS, did not immediately display customer limit orders in certain Nasdaq securities on public quotations when required to do so, and failed to report to OATS the limit order display indicator for certain reportable orders.

3. FINRA found that between July 1, 2002 and September 30, 2006, CGMI reported erroneously hundreds of thousands of fixed income transactions. These errors included, *inter alia*, failing to report transactions or reporting incorrect capacity or yield.

4. CGMI's alleged publication of non-bona fide quotations occurred on June 17, 2005, which was a Quadruple Expiration Day, meaning a date on which stock options, index options, stock index futures, and options of stock index futures expired. Before trading opened on that day, CGMI allegedly experienced a data outage due to a server that had inadvertently not been routinely maintained. This data outage caused thousands of the firm's quotations to reflect zero or null values. The firm attempted to redirect the market data to backup servers but was unable to do so because the redirection mechanism did not function properly.

5. As a result of these mechanical difficulties, approximately 6,800 non-bona fide transactions were executed at prices that differed substantially from the market price. After these problems were resolved at approximately 9:46 a.m., CGMI successfully petitioned Nasdaq to cancel the non-bona fide transactions.

6. FINRA alleged that the firm's supervisory procedures with respect to the issues described above were inadequate and that the firm failed to make readily available records related to these transactions.

7. CGMI consented to a censure, a fine of $2 million ($1 million for the system failures on the Quadruple Expiration Day, $325,000 for OATS violations, $625,000 for the fixed income reporting violations, and $50,000 for the limit order display violations), and an undertaking to revise the firm's written supervisory procedures with respect to OATS reporting, fixed income transaction reporting, and the handling of Clearly Erroneous Petitions.

8. In setting the sanction, FINRA took into consideration that CGMI self-reported its OATS and fixed income reporting issues and hired an independent consultant to review its OATS reporting process and shared the consultant's findings with FINRA's staff.

C. *UBS Securities, LLC* (Jun. 15, 2009)

1. FINRA settled a matter with UBS in which it alleged that that the firm transmitted untimely, incomplete, or inaccurate reports to OATS.

2. FINRA alleged that between May 2005 and December 2007, UBS transmitted to OATS over 10 million Execution Reports, Route Reports, Route or Combined Order/Route Reports, New Order Reports, ROEs, or other reports, that were untimely or contained inaccurate, incomplete or improperly formatted information.

3. FINRA also alleged that on July 31, 2007, the firm failed to report to the FINRA/NASDAQ Trade Reporting Facility whether the firm executed 584 transactions in a principal or agency capacity, failed to show the correct capacity for 1,119 brokerage orders, and failed to produce sufficient records, including blotter information, for an additional 11 orders. In addition, the firm included incorrect order information on four occasions in a report on covered orders for the month of June 2007.

4. Finally, FINRA alleged that the firm failed to maintain adequate policies and procedures relating to, *inter alia*, OATS compliance, order handling, sales transactions, soft dollar accounts and trading, and books and records maintenance.

5. UBS consented to a censure, a fine of $320,000 ($225,000 for the OATS violations, $65,000 for supervisory violations, and $30,000 for violations of other rules), and an undertaking to revise certain of the firm's written supervisory procedures.

D. *SG Americas Securities, LLC* ("SGAS") (Aug. 17, 2009)

1. FINRA settled a matter with SGAS in which it alleged that the firm failed to report to FINRA's Trade Reporting and Compliance Engine ("TRACE") timely and/or accurate transaction information and failed to include accurate yield information on electronic customer confirmations.

2. FINRA alleged that between April 2004 and December 2007, SGAS failed to report to TRACE approximately 6,000 transactions in TRACE-eligible securities. These transactions represented 40% of all transactions in TRACE-eligible securities effected by SGAS during that period.

3. In addition, between January and June 2008, SGAS allegedly failed to report 133 transactions in TRACE-eligible securities to TRACE within 15 minutes after execution, and between April and June 2008, SGAS allegedly failed to report to TRACE the correct time of trade execution for 61 transactions in TRACE-eligible securities.

4. FINRA also alleged that between April 2004 and February 2008, SGAS failed to include certain yield information on electronic customer confirmations sent to institutional customers using the Depository Trust Corporation Institutional Delivery ("DTC ID") system in connection with approximately 34,000 transactions.

5. Finally, FINRA alleged that the firm failed to establish and maintain adequate supervisory systems regarding customer confirmations using the DTC ID system.

6. SGAS consented to a censure and a $250,000 fine.

E. *thinkorswim, Inc.* ("SWIM") (Aug. 24, 2009)

1. FINRA settled a matter with SWIM in which it alleged that the firm transmitted inaccurate trade information to OATS and the Real-time Transaction Reporting System ("RTRS"), failed to publish quarterly reports in a timely manner, and failed to adjust properly open limit orders.

2. FINRA alleged that between October 2003 and May 2009, SWIM transmitted to OATS approximately 367,000 Route or Combined Order/Route Reports, Reportable Order Events ("ROEs"), or other reports that contained inaccurate or incomplete information. SWIM also failed to report or timely report approximately 2,083,000 ROEs.

3. FINRA also alleged that (i) in 2006 and 2007, SWIM failed to make publicly available in a timely manner two of the firm's quarterly order-routing reports; (ii) between January 1, 2006 and May 31, 2009, SWIM reported to the RTRS certain transactions in municipal securities to which it was not a party and thus did not need to be reported; and (iii) between August 28 and 29, 2007, SWIM failed to properly adjust eight open limit orders prior to executing the orders.

4. Finally, FINRA alleged that the firm failed to maintain adequate policies and procedures regarding, among other things, the OATS rules and the reporting of transactions in municipal securities.

5. SWIM consented to a censure, a $275,000 fine (including $170,000 for the OATS violations and $75,000 for the related supervisory violations), and an undertaking to revise the firm's written supervisory procedures.

6. FINRA noted in the AWC that SWIM self-reported certain of its OATS-related violations, which led to a reduced fine.

Variable Annuity Sales

Sales practices surrounding variable annuities continue to be an enforcement priority for FINRA. To demonstrate that point, below are seven significant cases involving the sale of variable annuities. Five of these cases involve bank broker-dealers (McDonald Investments, IFMG Securities, Wells Fargo, PNC Investments, and WM Financial Services) and were released by FINRA on the same day in July 2009.

A. *PNC Investments LLC* ("PNCI") (Feb. 19, 2009)

1. FINRA settled a matter with PNCI in which it alleged that the firm had inadequate supervisory systems and procedures related to the sale of variable annuities.

2. FINRA alleged that between January 2004 and June 2005:

(a) although the firm's written supervisory procedures directed principals to consider a number of specified factors as part of their review of variable annuity transactions, PNCI failed to capture and consistently make available to supervisors information necessary for supervisors to assess the suitability of variable annuities;

(b) The firm's WSPs failed to provide sufficient guidance to assist supervisors in making suitability determinations; and

(c) PNCI's supervisory systems and procedures failed to detect patterns of potentially problematic sales of variable annuities with Guaranteed Minimum Income Benefit riders (which could not be exercised for an extended holding period), including sales to senior citizens.

3. PNCI consented to a censure, a fine of $250,000, and an undertaking to review its policies and procedures concerning the suitability of variable annuities.

B. *McDonald Investments (n/k/a KeyBank Capital Markets Inc.)* ("McDonald") (Apr. 13, 2009)

1. FINRA settled a matter with McDonald in which it alleged that the firm recommended unsuitable variable annuity transactions and failed to establish and maintain adequate supervisory systems and procedures related to its sales of variable annuities.

2. In November 2003, McDonald had placed one of its registered representatives, CB, under heightened supervision due to customer complaints concerning her sale of variable annuities. FINRA alleged that while on heightened supervision, CB maintained her unsuitable sales practices, and the majority of her business was still comprised of sales of variable annuities to elderly customers. Between June 2004 and January 2006, CB allegedly sold 32 unsuitable VAs to 25 customers, each of which was approved by a supervisor. FINRA alleged that the firm failed to implement procedures that provided guidance to principals when approving variable annuity transactions.

3. FINRA also alleged when the firm became aware of numerous red flags indicating that CB was engaging in unsuitable sales of VAs, it failed to investigate. First, CB had been the subject of prior customer complaints. Second, the firm's Compliance Department had recommended that CB be disallowed from offering variable annuities to her customers and that she receive closer supervision. Third, her transactions appeared on an exception report for trades involving elderly customers 88 times in 2004 and 2005. Nevertheless, the firm allegedly did not take appropriate

follow up action and also failed to implement systems that adequately flagged potentially unsuitable variable annuities.

4. Finally, FINRA alleged that McDonald failed to retain required records of rejected variable annuity sales transactions.

5. McDonald consented to a censure and a fine of $425,000 and agreed to permit certain customers to rescind their purchase of specified variable annuities with a rebate for the price of the original investment.

C. *Fifth Third Securities, Inc.* (“FTS”) (Apr. 14, 2009)

1. FINRA settled a matter with FTS, a subsidiary of Fifth Third Bank, in which it alleged that FTS representatives recommended unsuitable exchanges and sales of variable annuities.

2. FINRA alleged that between January 2004 and December 2006, 42 FTS brokers made unsuitable recommendations to 197 customers, each of which was approved by the firm. FINRA alleged that the recommendations were unsuitable in light of the customers’ ages, incomes, financial situations and investment objectives.

3. A single FTS broker was responsible for 118 of the unsuitable exchanges. The representative had recently joined FTS and did not want his customers’ assets to remain with his prior firm, so he exchanged 74 customers’ variable annuities for a single annuity product sold through FTS, despite the fact that the customers’ ages (ranging from 26 to 85), sophistication and investment objectives varied greatly. These customers incurred at least $260,000 in surrender charges to exit their old annuities and enter new annuities with longer holding periods and higher expenses. In such instances, customers used cash to purchase a variable annuity that was less liquid and had higher costs than their prior investments.

4. FINRA also alleged that FTS failed to maintain an adequate system of supervision. In 2004 and 2005, FTS conducted audits of its Principal Review Desk (“PRD”) and identified issues with the way PRD reviewed and approved variable

annuity transactions. However, many of these issues were not addressed fully until March 2007.

5. Finally, FINRA alleged that FTS failed to maintain accurate books and records regarding variable annuity transactions. Among other things, FTS failed to retain certain correspondence to customers, and the information retained by FTS regarding the exchange transactions was incomplete.

6. FTS consented to a censure, a fine of $1,750,000, and to pay restitution to the 74 customers who incurred surrender charges when exchanging variable annuities. In addition, FTS agreed to allow all 197 customers to rescind their transactions. FTS also agreed to retain an independent consultant to review its supervisory system.

7. In a press release announcing the settlement, FINRA Enforcement Chief, Susan Merrill, warned firms to diligently supervise sales of variable annuities by their sales force, particularly brokers who recently joined from other firms.

D. *IFMG Securities, Inc.* ("IFMG") (Apr. 27, 2009)

1. FINRA settled a matter with IFMG in which it alleged that the firm's supervisory systems and procedures were not reasonably designed to monitor its variable annuities and mutual fund transactions for suitability.

2. Between January 2004 and March 2006, the firm's Compliance Department performed an initial suitability review of transactions on the daily blotter on the day after a trade; however, the blotter was missing important information necessary for a suitability review, such as investment horizon, risk tolerance and assets owned by the customer. In addition, certain information, such as liquid net worth, was displayed inaccurately as a high point of a range, rather than the actual value or the entire range (*e.g.*, $500,000 instead of a value or a range of $100,000 - $500,000).

3. The Compliance Department also conducted a second review of documents associated with each transaction, which included a suitability assessment. However, this

review took place 10 days after the trade (and when backlogs built up, took more than 12 months to resolve), by which time commissions had been paid to the firm's registered representatives, leaving them with little incentive to assist the Compliance Department. This delay in performing the secondary review contributed to difficulty in clearing "deficiencies" for these trades, such as missing paperwork or information. By May 2006, the backlog of completed but unapproved trades totaled over 26,000 transactions with more than 44,000 deficiencies.

4. Finally, FINRA alleged that the firm's supervisory procedures did not provide sufficient guidance to the Compliance Department regarding how to review blotters, and failed to address adequately the backlog of unapproved trades by, for example, hiring additional compliance personnel.

5. IFMG consented to a censure and a fine of $450,000.

E. *WM Financial Services, Inc.* ("WMFS") (May 29, 2009)

1. FINRA settled a matter with WMFS in which it alleged that the firm failed to supervise adequately sales and exchanges of unit investment trusts ("UITs"), including exchanges of variable annuities to UITs, and failed to retain properly electronic communications.

2. FINRA alleged that between January 2004 and April 2005, WMFS did not have adequate supervisory systems and procedures regarding UIT sales and exchanges from variable annuities and mutual funds to UITs. WMFS's procedures failed to provide guidance to compliance principals and specialists regarding how to review and analyze exchange paperwork or exception reports, including how to determine whether exchange transactions were suitable. FINRA alleged that the firm's systems and procedures did not explicitly address UITs.

3. FINRA also alleged that during the same period, WMFS failed to address adequately red flags relating to potentially unsuitable UIT transactions and exchanges.

4. Finally, FINRA alleged that between December 2003 and November 2006, WMFS's archiving system failed to retain

e-mails properly. As a result, approximately 370,000 e-mails (or 1.4% of all e-mails during that time) were irretrievable.

5. WMFS consented to a censure and a fine of $250,000.

F. *Wells Fargo Investments, LLC* ("WFI") (Jun. 12, 2009)

1. FINRA settled a matter with WFI in which it alleged that the firm failed to maintain adequate supervisory systems and procedures related to the sale of variable annuities.

2. FINRA alleged that between January 2004 and December 2007, WFI's written procedures failed to provide sufficient guidance to principals to assist them in determining the suitability of variable annuity transactions. The firm's procedures lacked guidance for brokers and principals to determine the suitability of variable annuity transactions. The firm amended its procedures to include a list of factors for brokers and principals to consider when recommending variable annuities; however, WFI failed to offer guidance regarding the application of these factors in determining suitability and failed to capture systematically information relating to these factors. WFI subsequently removed this list of factors from its written procedures without substituting any guidance how to determine the suitability of variable annuity transactions.

3. FINRA also alleged that WFI failed to provide adequate training regarding variable annuities for its brokers and supervisors. As a result, some of these individuals did not understand completely the variable annuity products that they sold.

4. Finally, FINRA alleged that WFI failed to identify or investigate red flags relating to potentially questionable variable annuities sales patterns, such as when brokers sold particular riders to all of their customers or sold death benefits to customers who were ineligible to purchase them.

5. WFI consented to a censure and a fine of $275,000. In addition, WFI agreed to retain an independent consultant to conduct a comprehensive review of its policies and procedures concerning the suitability of variable annuity transactions.

G. *Department of Enforcement v. Mutual Service Corp.* ("MSC"), *et al.* (Dec. 16, 2008)[47]

1. FINRA brought a contested action against MSC and several of its employees for failing to monitor MSC's variable annuity business and/or falsifying records related thereto.

2. By way of background, in December 2001, MSC had entered into an AWC in which it accepted findings related to deficiencies in MSC's supervision of variable annuity transactions. In connection with the AWC, MSC created a new unit in its compliance department to provide heightened review of such transactions and a "Red Flag Blotter" designed to capture for further review transactions that triggered one or more red flags.

3. In this case, a hearing panel found that between March 15 and May 31, 2004, there was a "complete meltdown" of the firm's supervisory system, during which Dennis Kaminski (the firm's chief administrative officer) and Michael Poston (the firm's chief compliance officer), directed compliance personnel to stop the Red Flag Blotter reviews due to resource constraints. Ultimately, the process was reinstated, but the backlog of Red Flag Blotters was not reviewed until August 2004. To give the appearance that trades on the Red Flag Blotter were being reviewed, certain employees backdated the exception reports to 1-2 days after the trade occurred.

4. The panel found that during that same period, senior MSC officials met with FINRA staff and misled it about the firm's review of variable annuity trades, specifically failing to mention that it had ceased reviewing the Red Flag Blotter and mentioning a report that, in fact, was not yet being utilized. To give the appearance that the new report was being used, certain employees created 49 fake letters and put them in files and then "de-backdated" these records and documents prior to submitting them to FINRA in an attempt to conceal this misconduct.

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[47] Although the Hearing Panel's Decision is dated December 16, 2008, FINRA did not release this decision publicly until March 2009.

5. When FINRA found out about the backlog of trades, it sent Rule 8210 requests to the firm for documents, to which MSC did not respond completely and truthfully.

6. MSC was fined $1.535 million, broken down as follows: $500,000 for failing to reasonably supervise its variable annuity business and the maintenance of accurate books and records; $1 million for maintaining inaccurate books and records; $10,000 for failing to conduct timely internal inspections; and $25,000 for failing to respond fully to FINRA's requests for information.

7. Kaminski and Susan Coates (MSC's director of operations) were suspended in all principal capacities for six months, and each was fined $50,000. Poston was suspended in all principal capacities for seven months and fined $20,000. Denise Roth (an operations manager) and two compliance examiners, Gari Sanfilippo, and Kevin Cohen, were barred in all capacities from associating with any firm for falsifying the firm's books and records.

8. Cohen and Sanfilippo have appealed the rulings to the NAC, and the NAC called for a review of the sanctions imposed against Kaminski.

Notwithstanding the July 2007 merger between NYSE Regulation and the NASD, which formed FINRA, NYSE Regulation retained independent oversight and enforcement responsibility for trading violations occurring on the NYSE's systems and facilities.

NYSE Regulation announced enforcement actions in 2009 (or early 2010 with 2009 case numbers), including matters against broker-dealers regarding its Market on Close ("MOC")/Limit on Close ("LOC"), trade reporting, supervision, and Rule 92 provisions. In addition, in early 2009 NYSE Regulation published a decision in a contested matter regarding supervision of a foreign branch office. This Outline focuses on these cases.

Not surprisingly, given its reduced mandate, the number of cases brought by NYSE Regulation dropped substantially from prior years. NYSE Regulation released 25 Hearing Board Decisions that have a 2009 decision number (four of which relate to a single case involving four affiliates of one firm).

Pursuant to a regulatory services agreement, NYSE Regulation also regulates the trading on NYSE Arca and NYSE Amex. In 2009, these two entities released approximately 46 decisions relating to their marketplaces. Our Outline describes two NYSE Arca cases below.

NYSE Regulation Enforcement Actions

MOC/LOC

In 2007, NYSE Regulation settled a case with Calyon Securities (USA) LLC for alleged failures to comply with requirements governing MOC/LOC orders. A similar case was settled with Calyon in March 2009. Citigroup was also sanctioned last year for MOC/LOC violations.

A. *Calyon Securities (USA) LLC* ("Calyon"), HBD 09-09 (Mar. 24, 2009)

1. NYSE Regulation settled a case with Calyon in which it alleged that the firm failed to comply with NYSE rules governing MOC and LOC orders.

2. In a 2007 matter, NYSE Regulation alleged that Calyon failed to comply with MOC/LOC order requirements. As part of the settlement, the firm instituted a number of improvements to its then-existing MOC/LOC policies and procedures. Among the improvements was implementation of a block on its electronic order system designed to prevent the entry of MOC/LOC orders after 3:40 p.m.

3. In the case that settled in 2009, NYSE Regulation alleged that between July 2007 and August 2008, the firm improperly entered or cancelled 4,102 MOC/LOC orders on six trade dates, most of which occurred on a single day (September 21, 2007) when the firm improperly entered or cancelled 3,793 LOC orders.

4. The September 21, 2007 violations occurred when orders entered before 3:40 p.m. were briefly frozen due to volume constraints and then unfrozen just after 3:40 p.m. The block was ineffective in preventing order entry because the orders were entered before 3:40 p.m., and a programming error allowed the orders to be routed to the NYSE. Calyon promptly discovered this issue and cancelled the orders, resulting in additional violations for cancelling LOC orders after 3:40 p.m.

5. NYSE also alleged that the firm's MOC/LOC policies and procedures were inadequate. Specifically, during the relevant time period, the firm's method of randomly sampling certain trade dates for potentially improper MOC/LOC entries was insufficient to detect or prevent MOC/LOC violations. In addition, NYSE Regulation found that the firm took too long to identify and correct its technical issues.

6. Calyon consented to a censure and a fine of $110,000.

7. In determining the sanction, NYSE Regulation considered that: (i) the firm subsequently made significant improvements

to its MOC/LOC systems, began reviewing all MOC/LOC orders on a daily basis and subscribed to the NYSE's "hard block" technology; (ii) the firm's violations had little, if any, impact on the published imbalances or the closing prices of the relevant securities; and (iii) the violations had a different cause than the violations in the 2007 case.

B. *Citigroup Global Markets, Inc.*, HBD 09-19 (Aug. 21, 2009)

1. NYSE Regulation settled a matter with CGMI in which it alleged that the firm failed to comply with NYSE rules governing the entry and cancellation of MOC and LOC orders.

2. NYSE Regulation alleged that between February 2007 and June 2007, the firm cancelled improperly 365 MOC orders on four trade dates. The vast majority of the issues affecting the cancellation of the MOC orders involved system latency, whereby messages concerning orders cancelled before 3:40 p.m. were not transmitted until after the 3:40 p.m. cutoff. Another MOC order was cancelled after 3:40 due to a server failure that to a delay in transmission of the order to the NYSE.

3. NYSE Regulation alleged that between December 2008 and February 2009, the firm submitted more than 12,400 LOC orders due almost entirely to an error in an algorithm that was used to submit orders to offset regulatory imbalances.

4. NYSE Regulation also alleged a failure to supervise by the firm. Specifically, during the relevant time period, the firm failed to prevent "soft blocks" (*i.e.*, on-screen notifications when action was taken on LOC/MOC orders after 3:40 p.m.) from being manually overridden improperly.

5. CGMI consented to a censure and a fine of $150,000.

6. In determining the sanction, NYSE Regulation considered the firm's remedial steps, including upgrades to its platforms and servers and the supervision of its order routing system.

Rule 92

Last year NYSE Regulation brought two cases that focused on compliance with NYSE Rule 92.

A. *J.P. Morgan Securities Inc.*, HBD 09-14 (Jun. 23, 2009)

1. NYSE Regulation settled a matter with JPMS in which it alleged that the firm failed to comply with NYSE rules concerning, among other things, trading ahead of or alongside customers, entry and cancellation of MOC and LOC orders, submission of Daily Program Trade Reports ("DPTRs"), submission of account type indicators, and reasonable supervision.

2. NYSE Regulation alleged that on five occasions between January 2005 and December 2006, JPMS traded ahead of or alongside customers by entering proprietary orders before or at the same time it entered customer orders without obtaining consent to do so. On four other occasions during the same period, JPMS failed to document whether it had received customer consent to trade ahead or alongside customers' orders.

3. NYSE Regulation also alleged that, on six occasions between April 2006 and June 2008, the firm untimely entered or cancelled MOC or LOC orders.

4. Finally, NYSE Regulation alleged that the firm entered into an improper cross transaction with no change in beneficial ownership in connection with the cancellation of an MOC order, handled improperly various error transactions and reports, submitted inaccurate Daily Program Trade Reports that omitted proprietary index arbitrage trading, and failed to supervise and implement controls reasonably designed to comply with relevant NYSE rules.

5. JPMS consented to a censure and a $175,000 fine.

6. In determining the sanction, NYSE Regulation considered the remedial steps taken by the firm, including the implementation of new system enhancements and controls.

B. *Morgan Stanley & Co. Inc.*, HBD 09-16 (Aug. 11, 2009)

1. NYSE Regulation settled a matter with Morgan Stanley in which it alleged that the firm failed to comply with NYSE rules concerning, among other things, trading ahead of or alongside customers.

2. NYSE Regulation alleged that on 11 occasions between January 2005 and December 2008, Morgan Stanley traded ahead of or alongside customers by entering proprietary orders before or at the same time that it entered customer orders without obtaining consent to do so. In addition, on 15 occasions, the firm obtained customer consent to trade along with the customers' orders but allocated executions between the firm and the customers in amounts inconsistent with the documented consent.

3. Finally, NYSE Regulation alleged that, in four other instances, the firm failed to document when it obtained customer consent and, in one instance, failed to document a customer's instruction to halt trading on an order.

4. Interestingly, without any explanation, NYSE Regulation did not charge Morgan Stanley with failure to supervise, which is typically alleged in these kinds of cases.

5. Morgan Stanley consented to a censure and a $200,000 fine.

6. In determining the sanction, NYSE Regulation considered the firm's self-reporting of several of the violations referenced above, its efforts to implement new system enhancements and controls, and its offer of remuneration in the amount of $7,420 to the two customers who suffered the most significant harm in connection with Rule 92 violations.

Supervision of Algorithmic Trading

A. *Credit Suisse Securities (USA) LLC*, HBD 09-24 (Nov. 27, 2009)

1. NYSE Regulation settled a matter with Credit Suisse in which it alleged that the firm failed to adequately supervise the development and operation of a proprietary algorithm,

and failed to adhere to the principles of good business practice.

2. In 2007, Credit Suisse implemented an algorithm called the SmartWB, which reviewed closing imbalances and market data and then tried to trade profitably based on that information. In November 2007, a firm trader/programmer modified this algorithm in order to allow the user to manually change the limit prices of unexecuted orders that had already been sent to a market and subsequent orders. This revision was made by the firm trader/programmer without any supervisory approval.

3. After the price had been modified, clicking on an up or down arrow on the computer screen would create cancel/replace instructions for unfilled orders with the new price. If the user double clicked on an arrow, two sets of cancel/replace orders would be sent for all unexecuted orders.

4. On November 14, 2007, the trader/programmer changed the price parameter in the algorithm and double clicked the up arrow. Because the second click occurred so close in time to the first click, the SmartWB did not have time to send out all of the cancel/replace requests associated with the first click. In 7 securities, SuperDot rejected the requests associated with the second click because it never received the orders from the first click. The SmartWB was not programmed to respond to the SuperDOT reject messages and so continued to re-send the cancel/replace requests. Ultimately, the SmartWB sent approximately 600,000 cancel/replace requests and SuperDot sent about 405,000 reject messages back to the SmartWB. As a result of this abnormally high volume of message traffic, trading at five posts on the NYSE floor was disrupted and the posts' closing times were delayed.

5. NYSE alleged that Credit Suisse failed to adequately supervise and adhere to the principles of good business practice in connection with its operation of the SmartWB algorithm. Specifically, the firm failed to ensure that the SmartWB was designed to prevent or detect the submission of erroneous cancel/replace requests and to alert the firm in the event of rejected messages. The firm also failed to adequately supervise the development and testing of the

algorithm, and failed to monitor for any potential issues affecting the performance of the SmartWB.

6. Credit Suisse consented to a censure and a $150,000 fine. The decision noted that NYSE Regulation considered: (1) the firm's efforts to implement new written supervisory policies and procedures relating to proprietary algorithms; (2) the firm's reprogramming of the SmartWB to address the double-clicking issue and to notify the user if reject message are sent by the NYSE; and (3) the firm's proactive help to the NYSE investigation through the provision of substantial technical assistance and data.

Supervision of Branch Offices

Historically, very few firms litigated against NYSE Regulation. A contested proceeding, which appears to have begun prior to the FINRA merger, is described below.

A. *Wedbush Morgan Securities, Inc.* ("Wedbush"), HBD 09-01 (Jan. 6, 2009)

1. In a contested matter, a Hearing Panel found that Wedbush improperly established and supervised its Paris branch office, among other violations. The charges arose out of three NYSE examinations that occurred between 2002 and 2005.

2. In March 2002, Wedbush submitted an application to the NYSE for the registration of an office in Paris, France, which would be staffed by two independent contractors. The application was rejected because, at the time, the NYSE did not permit an independent contractor to manage a branch office. The Panel found that despite failing to obtain approval, the firm opened an office in Paris and permitted the unregistered independent contractors to perform duties usually performed by registered representatives. Despite the fact that in December 2004 NYSE informed Wedbush that it could not continue to operate its Paris office without NYSE authorization, the firm continued to operate in that location as a branch office and did not receive NYSE approval (to operate as a correspondent firm) until October 2005.

3. In addition, the Panel also found that between April 2002 and October 2005, the firm, among other violations, failed to review or supervise the activities of the Paris office, failed to undertake proper due diligence with respect to new accounts opened by that office, and did not review or approve correspondence to or from that office. The Paris office also failed to maintain properly all order tickets and failed to review order tickets and execution reports.

4. The Panel found additional violations by the firm related to use of unregistered independent contractors to perform registered representatives' duties and use of offices without NYSE consent. The Panel also concluded that the firm failed to verify customer information as required by AML rules and improperly made withdrawals from its special reserve account, causing hindsight deficiencies on seven different occasions.

5. The Panel rejected NYSE's allegations that registered representatives in Wedbush's Paris office failed to comply with continuing education requirements and that the firm failed to monitor adequately employees' personal trading.

6. The Division of Enforcement requested a censure, a fine of $600,000 and an undertaking to retain an independent consultant to review several areas of the firm's business. The Panel imposed a censure, a fine of $100,000, and an undertaking to retain an independent consultant.

7. The decision noted that the underlying cause of the violations at issue was understaffing of the firm's legal and compliance departments, which the firm had taken measures to address. In addition, the Panel found that aspects of Wedbush's AML program were appropriate and that the firm had promptly detected and corrected issues with the reserve account.

Transaction Reporting

In 2009, NYSE Regulation settled a case with various subsidiaries of the Goldman Sachs Group, Inc. for alleged violations of transaction reporting requirements.

A. *Goldman, Sachs & Co.* (“Goldman”), *Goldman Sachs Execution & Clearing, L.P.* (“GSEC”), *Spear, Leeds & Kellogg Specialists, L.L.C.* (“Spear Leeds”), *and SLK Index Specialists L.L.C.* (“SLK”), HBDs 09-05 through 09-08 and 09-AMEX-4 (Mar. 20, 2009)

1. NYSE Regulation settled a case with the respondent firms in which it alleged that they failed to file accurately or timely various reports with the NYSE or the Amex.

2. NYSE Regulation alleged that between October 2000 and September 2005, the respondent firms committed various reporting violations with respect to filings required by the NYSE relating to certain transactions, including round-lot short sales, program trading, and short interest reporting. Goldman also allegedly failed to timely notify the NYSE of its participation in three stock distributions in which it was associated with the Affiliated Specialist, and submitted inaccurate account type indicators to the NYSE’s On-Line Comparison System.

3. NYSE Regulation alleged that GESC filed inaccurate mid-month and end-of-month reports with the Amex regarding short interest positions and round-lot sales and that Spear Leeds and SLK filed with the NYSE inaccurate reports regarding round-lot transactions. NYSE Regulation alleged that as a result of these deficient reports and filings, the respondent firms failed to maintain accurate books and records or provide for adequate supervision and control regarding their reporting processes.

4. The respondent firms each consented to a censure and monetary fines totaling $410,000, as follows: Goldman - $160,000; GSEC - $220,000, Spear Leeds - $20,000; and SLK - $10,000.

5. In setting the sanction, NYSE Regulation considered that: (i) in August 2004, the Goldman Sachs Group, Inc., the respondent firms’ parent company, centralized its reporting obligations to improve its reporting processes and ability to remediate reporting issues; (ii) the respondents conducted a thorough review of their transaction reporting and shared the results with NYSE Regulation; (iii) and between 2005 and 2008, the respondent firms implemented substantial remedial measures to enhance their reporting capabilities.

NYSE Arca Enforcement Actions

Pre-Arranged Trading

A. *NYSE Arca Equities, Inc. v. Schonfeld Securities, LLC* ("Schonfeld Securities") *and Steven B. Schonfeld* (Dec. 31, 2008)

1. NYSE Arca Equities settled charges with Schonfeld Securities and Schonfeld (the firm's chairman and principal), related to pre-arranged trading, net capital, books and records, odd lot orders, and supervision.

2. Between January 2005 and March 2005, the firm allegedly engaged in pre-arranged "round trip" transactions, whereby the firm sold securities with an understanding that the firm would repurchase them subsequently at the same or a higher price in an effort to appear to comply with net capital requirements. Notwithstanding these trades, the firm failed to meet its minimum net capital requirements on 25 days and failed to inform regulators of this deficiency promptly. NYSE Arca Equities also alleged that by marking the "round-trip" transactions as legitimate trades, Schonfeld Securities violated certain books and records rules.

3. NYSE Arca Equities further alleged that between June 2005 and January 2007, the firm executed almost 1,000 odd lot orders that could have been aggregated into round lots.

4. Finally, NYSE Arca Equities alleged that Schonfeld Securities and Schonfeld each failed to supervise adequately the firm's activities relating to prearranged trades, net capital requirements, books and records, and odd lot trading.

5. Schonfeld Securities consented to a censure and a fine of $900,000. Schonfeld consented to a censure, a $200,000 fine, a 90-day suspension from acting in a supervisory capacity, and a requirement that he retake and pass the Series 24 Examination before resuming a supervisory role.

6. In determining the sanction, NYSE Arca Equities took into consideration that the firm undertook to enhance its supervisory systems.

Regulation SHO

A. *Tradebot Systems, Inc.* ("Tradebot"), HBD 09-ARCA-10 (Oct. 15, 2009)

1. NYSE Arca alleged that Tradebot violated Regulation SHO by mismarking certain sell orders as "long" when the orders should have been labeled as "short" or "short exempt," violated the tick test as a result of inaccurate order marking, and failed to supervise adequately its short sale practices.

2. Between 2006 and July 2009, Tradebot entered multiple sell orders, none of which alone exceeded the firm's position in the relevant security. However, when these sell orders were aggregated, the combined order often exceeded the firm's long position. Because Tradebot did not "decrement" each sell order at the time of order entry, it marked these sell orders as long.

3. In addition, NYSE Arca alleged that between 2006 and July 2007, the firm violated the then-existing tick test as a result of this order mismarking activity because the firm executed some short sales on minus, or zero minus, ticks.

4. Finally, NYSE Arca alleged that the firm failed to maintain adequate policies and procedures related to the proper marking and execution of short sell orders.

5. Tradebot consented to a censure and a $125,000 fine.