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The Evolving Role of the Compliance Officer

BY: Ben A. Indek of Morgan Lewis & Bockius LLP

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Moderators

Gary DeWaal
Senior Managing Director and Group General Counsel
Newedge USA LLC

John Polanin, Jr.,
Managing Director, Legal & Compliance Policy
UBS

Panelists

Laurie Ferber
Executive Vice President and General Counsel
MF Global Holdings Ltd.

Ben A. Indek
Partner
Morgan, Lewis & Bockius LLP

Marc Menchel
Executive Vice President and General Counsel of Regulation
Office of General Counsel
FINRA

Jill Ostergaard
Managing Director and Chief Compliance Officer
Morgan Stanley

Ananda Radhakrishnan
Director, Clearing and Intermediary Oversight
Commodity Futures Trading Commission

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I. INTRODUCTION

This session will examine the changing role of the compliance officer at FCMs, broker-dealers, swap dealers, DCMs and DCOs. In particular, the panel will consider the evolving expectations of compliance officers, including possible new requirements under Dodd-Frank; elements of a successful compliance program; management information; and regulatory liability. The panel will also examine the organization of compliance departments.

II. REGULATORY DEVELOPMENTS AFFECTING COMPLIANCE OFFICERS

Over the last several years, the U.S. Securities and Exchange Commission ("SEC" or "Commission") and the Financial Industry Regulatory Authority ("FINRA") promulgated new rules that affect the duties and responsibilities of broker-dealer and investment adviser compliance officers. These regulations supplement already existing rules in this area. Recently, the Commodity Futures Trading Commission ("CFTC") has proposed rules regarding the compliance activities of certain regulated entities. Three key regulations are outlined below.

A. FINRA Annual Certification of Compliance and Supervisory Processes

In 2004, the SEC approved the NASD's adoption of then-new Rule 3013 requiring (1) each member to designate a principal to serve as Chief Compliance Officer; and (2) each member's Chief Executive Officer to certify annually to having in place "processes to establish, maintain, review, modify, and test policies and procedures reasonably designed to achieve compliance with applicable NASD rules, MSRB rules, and federal securities laws and regulations," and that the CEO has met with the CCO at least once in the prior twelve months to discuss these processes. (This Rule was converted to FINRA Rule 3130 in connection with the rulebook consolidation process.) In addition to the foregoing requirements, the FINRA Rule describes the role of the Chief Compliance Officer at a broker-dealer: such person "is a primary advisor to the member on its overall compliance scheme and the particularized rules, policies and procedures that the member adopts."[2]

B. National Futures Association Compliance Officer Rules

Like FINRA, the National Futures Association requires its member firms to designate an individual as the Chief Compliance Officer. However, in contrast to FINRA Rule 3130, the CCO (not the CEO) must certify annually that the firm has processes in place to establish, maintain, review, modify and test policies and procedures that are reasonably designed to achieve compliance with various laws and rules. A CCO must also confirm to the NFA that his or her firm has compliance protocols in place and that he or she has advised the CEO of the company's compliance efforts, problems and remediation plans. These provisions can be found in NFA Rule 2-36(j).

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[2] In October 2005, the Securities Industry Association published its White Paper on the Role of Compliance. This paper is an excellent summary of the role, responsibility and duty of compliance officers and their departments.

C. Investment Adviser Compliance Programs

Under the "Compliance Rule," investment advisers must establish and implement written policies and procedures reasonably designed to prevent violations of the Investment Advisers Act. Investment advisers are also required to designate a Chief Compliance Officer and review their policies and procedures on an annual basis. These provisions are contained in Rule 206(4)-7 under the Investment Advisers Act.[3]

D. Proposed CFTC Rules

To implement certain provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, in November 2010, the CFTC proposed rules that would require futures commission merchants, swap dealers, and major swap participants to designate a Chief Compliance Officer. The CFTC's proposal also sets forth the qualifications and duties of a CCO and would require that such individual prepare, certify and provide to the CFTC an annual report assessing the entity's compliance activities.[4]

Specifically, under the CFTC proposal, the CCO must have the appropriate background and skill set to carry out the duties and responsibilities of the role. Moreover, the CCO cannot be otherwise disqualified from registration under the Commodities Exchange Act. The proposal would also require that the CCO could only be appointed by a firm's Board of Directors and only that body could determine his or her compensation. CCOs would be required to meet annually with the Board or a senior officer to discuss the firm's compliance program under the proposed new rules.

The CFTC's proposal also sets forth certain duties to be carried out by the CCO, including the duty to perform certain reviews, administer required policies, identify and resolve conflicts of interest and identify issues of non-compliance and implement procedures to remedy such matters.

Finally, the CCO would be required under the proposal to write and file with the CFTC an annual report. Among other things, the report would describe the firm's compliance with the CEA and its rules.

In its joint comment letter to the CFTC, the FIA and SIFMA assert that the proposal would create a compliance framework that is substantially different than that currently in place pursuant to the rules of the SEC, certain banking regulators and the model set out by the CFTC itself. Although both associations support the CFTC's overall efforts, their comment letter stated that the proposals extend beyond Dodd-Frank's mandate, seem to misconstrue certain provisions of the Act and are inconsistent with the compliance models put in place by financial service firms. The letter makes the following ten key points:

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[3] A succinct description of the general rules applicable to newly-registered investment advisers has been prepared by the staff of the SEC. It is available at: http://www.sec.gov/divisions/investment/advoverview.htm.

[4] See Designation of a Chief Compliance Officer; required Compliance Policies; and Annual Report, 75 Fed. Reg. 70881 (Proposed Nov. 19, 2010); see also the detailed comment letters filed jointly by the FIA and SIFMA, the NFA and Newedge USA, LLC.

- "The proposed rules should not ignore well-established compliance practices.
- The proposed rules should not make the CCO a supervisor and should not fundamentally change the role of the CCO.
- The proposed rule should clarify the CCO's duty to "ensure" compliance.
- The requirement to resolve conflicts should be clarified.
- The CEO, not the CCO, should certify the required annual report.
- The requirement for a description of policies and procedures that "ensure compliance" in the annual report should mean a description of reasonable compliance policies and procedures.
- CCO reporting and supervision should be more flexible.
- The CCO requirements for FCMs, SDs and MSPs can be harmonized in a single regime based on the existing financial services model.
- In the event that the CFTC does not modify the proposed rules, the existing financial services model should at least apply to FCMs.
- CCOs should not be subject to potential criminal liability."

The comment period on the CFTC's proposal ended on January 18, 2011.

III. STRENGTHENING THE SEC'S ENFORCEMENT ARSENAL: DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT[5]

On July 15, 2010, the U.S. Senate passed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). President Obama signed the bill into law on July 21, 2010. This landmark legislation contains an array of important new measures that significantly expand the enforcement authority of the SEC and strengthen its oversight and regulatory authority over the securities markets.[6] These new measures will dramatically improve the SEC's "real-time enforcement" abilities, as it attempts to deliver on its promise to move more swiftly in enforcement actions to restore investors' faith in the markets.[7]

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

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

[7] Morgan Lewis has published several articles about the SEC's reform efforts, including: "SEC Announces New Cooperative Initiatives," available at:

One of the most important changes under Dodd-Frank is the new whistleblower rules described below.[8]

Background

The Dodd-Frank Act includes new whistleblower provisions designed to motivate those with inside knowledge to come forward voluntarily and assist the SEC in identifying and prosecuting persons who have violated federal securities laws. Previously, the SEC had the authority to compensate individuals for providing information leading to the recovery of civil penalties in insider trading cases, but the total amount of bounties that could be paid from a civil penalty could not exceed 10% of the collected penalties.[9]

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

Moreover, under the Dodd-Frank Act, SEC whistleblowers subject to retaliatory discrimination may directly file suit in federal district court instead of having to first file a complaint with the Department of Labor. Such actions must be filed no more than six years after the date of the alleged violation, or three years after the date when facts material to the right of action are known or reasonably should have been known by the employee alleging the violation. No action, however, may be brought more than 10 years after the date on which the violation occurred.

In addition, the Dodd-Frank Act expands the whistleblower protections already in place under the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley")[10] to expressly prohibit retaliation against whistleblowing employees of subsidiaries and affiliates of publicly traded companies, extends the current statute of limitations for Sarbanes-Oxley whistleblower claims from 90 days to 180 days, and permits a jury trial. The Dodd-Frank Act also extends whistleblower protections to employees of nationally recognized statistical rating organizations (credit-rating agencies).

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

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http://www.morganlewis.com/pubs/WP_SECAnnouncesNewCooperationInitiative_Jan2010.pdf; and "SEC Speaks 2010: Fast-Paced Reform Continues in 2010," available at: http://www.morganlewis.com/pubs/SecuritiesLF_SECSpeaks2010_11feb10.pdf.

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

[9] Exchange Act § 21A(e).

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

Proposed Whistleblower Rules

On November 3, 2010, the SEC proposed rules to implement the SEC whistleblower provisions of Dodd-Frank Act. The proposed rules attempt to balance the tension between encouraging whistleblowers to come forward while simultaneously discouraging people from bypassing their company's internal compliance programs. [11]

Whistleblowers Protected from Retaliation

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

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

Award Eligibility

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

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

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

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[11] This section of the paper was drawn from "SEC's Proposed Rules for Implementing Dodd-Frank Whistleblower Provisions: Important Implications for Employers," by Sarah E. Bouchard, Thomas A. Linthorst, Robert M. Romano and Christian J. Mixter of Morgan Lewis & Bockius LLP, published Nov. 12, 2010 and available at: http://www.morganlewis.com/index.cfm/fuseaction/publication.detail/publicationID/cd8ce0db-435c-484f-b3f9-0b81c3df5a86.

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

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

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

Similarly, the SEC's proposed rules would exclude any information gained through the performance by an independent public accountant of an engagement required under the securities laws, if the information relates to a violation by the engagement client or its directors, officers, or other employees. This exception reflects the SEC's recognition of the role of independent public accountants and their preexisting duties under securities laws to detect and report illegal acts.

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

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

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

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

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

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

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

Additional Rules

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

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

Submission of Comments

The comment period ended on December 17, 2010.

Whistleblower Office

Dodd-Frank requires the SEC to create a Whistleblower Office to administer the program.[12] In February 2011, the SEC appointed the head of the new office, a former coroprate and securities counsel at several large, publically traded companies.

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[12] *See* "Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act – Dates to be Determined," available at: http://www.sec.gov/spotlight/dodd-frank/dates_to_be_determined.shtml. In

CFTC Whistleblower Proposal

It should be noted that in November 2010, the CFTC published its proposal to implement the whistleblower provisions of Section 748 of Dodd-Frank. The CFTC's proposal takes a similar – but not identical – approach to the issues as that of the SEC.[13] The CFTC's comment period ended on February 4, 2011.

IV. SEC AND FINRA CASES INVOLVING COMPLIANCE OFFICERS[14]

Although not a large part of their docket by any means, from time to time both the SEC and FINRA bring disciplinary actions involving compliance officers. Outlined below are some recent cases in this area.[15]

SEC Actions

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

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

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

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

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addition to deferring the creation and staffing of the Whistleblower Office, the SEC is also postponing setting up four other offices required to be created by Dodd-Frank.

[13] A useful paper describing and comparing the CFTC and SEC proposals can be found in "The Dodd-Frank Act's Bounty Hunter Provisions," Michael E. Clarke, The Review of Securities and Commodities Regulation, Feb. 9, 2011.

[14] See Year in Review.

[15] For two outstanding articles on this topic, see "While You Were Complying: SEC and FINRA Disciplinary Actions Taken Against Chief Compliance Officers" (September-October, 2010) and "While You Were Complying: SEC and FINRA Disciplinary Actions Taken Against Chief Compliance Officers (Again)" (January-February 2011) by Brian L. Rubin and Katherine L. Kelly of Sutherland Asbill & Brennan LLP. Available at http://www.sutherland.com/files/Publication/9489812f-4c95-4149-bf79-89d75e52f865/Presentation/PublicationAttachment/568db5d2-9786-4372-976a-90bea5b89b5f/2010%20B%20%20Rubin%20K%20%20Kelly%20-%20While%20You%20Were%20Complying-%20SEC%20and%20FINRA%20Disciplinary%20Actions.pdf and http://www.sutherland.com/files/Publication/7a875bb1-606f-4eef-ba21-e11d552008a6/Presentation/PublicationAttachment/989a67ec-b4a2-48fb-bf45-e186f0fce2b3/Rubin-KellyPracticalComplianceandRiskManagementJanFeb2011.pdf.

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

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

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

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

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

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

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

1. The SEC settled an administrative proceeding against Pinnacle and Paciorek, its president and chief compliance officer, alleging that the firm did not comply with an AML rule that requires firms to verify and document the identities of their customers.

2. Section 17(a) of the Exchange Act and Rule 17a-8 thereunder require that broker-dealers comply with certain provisions of the Bank Secrecy Act

("BSA"), including the customer identification program ("CIP") rule, under which firms must establish procedures for identifying and verifying their customers.

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

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

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

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

7. In connection with a FINRA action earlier in 2010, Pinnacle was fined $300,000 and also agreed to certain undertakings related to its AML program.

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

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

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

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

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

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

6. The Division of Enforcement petitioned the Commission for a review of the dismissal; Urban cross-petitioned for a review of Chief Judge Murray's ruling that he was Glantz's supervisor.

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

8. This matter is being closely watched by the industry in light of Chief Judge Murray's holding that significantly expands potential supervisory liability for legal and compliance personnel.[16]

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

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

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

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

3. According to the SEC, although Buckingham Research had a written procedure to address the misuse of material, nonpublic information, it did not follow its written procedure. In addition, the SEC alleged that Buckingham Capital's written policies and procedures were not sufficiently clear to enable employees to understand their responsibilities. The SEC further alleged that Buckingham Capital created "replacement" compliance documents in lieu of incomplete or missing compliance records and produced them to SEC examination staff without disclosing that such records were "replacements."

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

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

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

FINRA Actions

A. *Westpark Capital, Inc.* ("Westpark") (May 6, 2010)

1. FINRA settled a matter with Westpark, its former Chief Compliance Officer ("CCO"), and its Chief Operations Officer ("COO") in which it alleged that from February 2006 to July 2007, the firm failed to establish and maintain a reasonably designed supervisory system and written procedures and that the officers failed to supervise six brokers who committed sales practice violations that caused losses in at least 19 customer accounts. The brokers worked from two Long Island branch offices that subsequently were closed by the firm.

2. According to FINRA, the brokers executed unauthorized trades, churned and engaged in unsuitably excessive trading, and reported solicited trades as unsolicited.

3. FINRA alleged that the CCO and COO failed to adequately scrutinize the brokers' conduct in general and failed to investigate and address numerous red flags in particular. The red flags included that one of the branch managers had previously been suspended for failure to supervise and certain of the brokers had previously been associated with disciplined and/or expelled firms, had been disciplined themselves, and/or had a history of customer complaints.

4. FINRA alleged that the firm's deficiencies included inadequate heightened supervision, inadequate monitoring for unsuitably excessive trading, no system for analyzing the fairness of markups, and unqualified branch office supervisors.

5. Westpark consented to a censure, a fine of $100,000, and restitution of $300,000. The former CCO consented to a four-month suspension in any principal capacity and a fine of $5,000 and the COO consented to a three-month suspension in any principal capacity and fine of $20,000.

6. In related actions, FINRA barred a former branch manager from acting in any principal capacity and permanently barred two former brokers. The former branch manager also was ordered to pay a $10,000 fine and one of the former brokers was ordered to pay over $110,000 in restitution to customers. A case against a third broker is still pending.

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

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

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

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

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

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

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

V. SELECTED CFTC AND NFA ACTIONS INVOLVING COMPLIANCE OFFICERS

Similarly, the U.S. Commodity Futures Trading Commission (CFTC) and the National Futures Association (NFA) have brought enforcement actions and imposed disciplinary sanctions in matters involving compliance officers, although less frequently than the SEC or FINRA. Several representative cases are summarized below.[17]

A. *In the Matter of Interactive Brokers LLC,* CFTC Docket No. 07-07 (July 17, 2007)

1. The CFTC ordered Interactive Brokers LLC ("IBL") to relinquish $175,000 in commissions for failing to properly supervise its compliance employees while handling a commodity futures trading account. The NFA separately fined IBL $125,000 regarding the same matter and for failing to maintain adequate books and records.

2. IBL is a discount direct access brokerage firm and registered Futures Commission Merchant ("FCM") headquartered in Greenwich, Connecticut. According to the order, an account was maintained at IBL in the name of a Canadian customer who used the account to defraud more than 200 Canadian, German, and US citizens of over $8 million in a commodity pool fraud that was the subject of an earlier CFTC enforcement action.

3. The CFTC found that, from February 2003 through May 2005, IBL accepted 135 third-party deposits in the form of wire transfers and checks totaling $7.7 million into the Canadian customer's personal account, but did not have procedures reasonably designed to detect the deposit of third-party funds in an individual trading account. The frequency and magnitude of deposits and withdrawals to and from this account, relative

[17] This section was drafted by John Polanin with certain information provided by the NFA.

to the customer's stated liquid net worth, and the pattern of deposits followed by withdrawals indicated the customer might be operating as an unregistered commodity pool operator.

4. IBL compliance staff telephoned the customer on several occasions to inquire about the trading activity in his account. Yet, IBL's compliance staff each time accepted the customer's explanations as reasonable without conducting any additional or independent inquiries. The order states that IBL's procedures for determining the source of funds received through wire transfers were inadequate to meet its supervisory responsibilities.

5. This case is a reminder that the ability to determine if funds in customer accounts are coming from someone other than the account holder is a necessary part of an FCM's supervisory system and compliance controls. If an FCM fails to monitor the source of funds being deposited into customer accounts at the time those funds are received, its ability to detect illegal activity such as pool fraud or money laundering is impaired to an unacceptable extent.

B. *In the Matter of Tradeco Clearing Group LLC*, NFA Case No. 07-BCC-031 (Dec. 4, 2007)

1. In this Business Conduct Committee decision involving anti-money laundering procedures and other compliance issues, the NFA permanently barred from NFA membership Tradeco Clearing Group LLC, ("Tradeco") a foreign exchange dealer member located in San Diego, California.

2. The Committee found that Tradeco used deceptive and misleading promotional material, failed to maintain required financial books and records, failed to develop and implement an adequate anti-money laundering program, failed to maintain required adjusted net capital, and failed to file required financial notices with NFA.

3. In light of the extremely serious nature of the violations – which involved customer fraud, touting the performance of a non-existent trading platform, failing to maintain required net capital for three consecutive months, and failing to implement an adequate AML program – as well as Tradeco's failure to respond to the complaint, NFA determined to impose the severe sanction of an immediate and permanent bar from membership and from being a principal of any NFA member firm.

4. Tradeco's director of operations, who also served as the firm's AML compliance officer, was charged with failing to diligently supervise under NFA Compliance Rule 2-36(e). In addition to the violations listed above, the firm's AML procedures did not require the firm to determine whether its customers or their countries of residence were subject to sanctions by the Office of Foreign Assets Control of the US Department of Treasury or the list of Specially Designated Nationals.

C. *CFTC v. Walsh, et al.,* Civil Action No. 09-01749 (Feb. 25, 2009)

1. The CFTC charged Stephen Walsh of Sands Point, New York, and Paul Greenwood of North Salem, New York, with misappropriating at least $553 million from commodity pool participants in connection with entities they owned and controlled, such as Westridge Capital Management, Inc., WG Trading Investors, LP, and WGIA, LLC. The defendants' alleged misappropriation was uncovered during an audit by the NFA.

2. The CFTC's complaint charged Walsh and Greenwood with futures fraud and misappropriation of pool funds. In conjunction with the CFTC's filing, the United States District Court for the Southern District of New York issued a restraining order freezing defendants' assets and preserving records. At the same time, the U.S. Attorney for the Southern District of New York filed a criminal complaint against Walsh and Greenwood, and the SEC filed a civil action against Walsh, Greenwood and others.

3. The CFTC complaint alleged that, from at least 1996 until the complaint was filed, Walsh and Greenwood fraudulently solicited approximately $1.3 billion from individuals and entities through Westridge Capital Management, WG Trading Investors, LP, and other entities. The complaint charged that the defendants defrauded victims by falsely depicting that all pool participants' funds would be employed in a single investment strategy that consisted of index arbitrage. However, pool participants' funds were transferred to another entity from which Walsh and Greenwood siphoned funds.

4. According to the complaint, to cover-up their misappropriation of pool participants ' funds, Greenwood and Walsh manufactured promissory notes to present the appearance that pool participants' funds had been loaned to them. Walsh and Greenwood allegedly misappropriated approximately $553 million in pool participants' funds in this manner. More than $160 million was used for Walsh and Greenwood' s personal expenses, including purchasing rare books, horses, Steiff teddy bears for as much as $80,000, and a $3 million residence for Walsh's ex-wife.

5. In order to account for and locate pool participant funds, Westridge Capital Management Enhancement Funds Inc., WG Trading Company LP, WGI LLC, K&L Investments, and Janet Walsh were named in the complaint as relief defendants, because they received funds as a result of defendants' fraudulent conduct and had no legitimate entitlement to those funds. In the resulting litigation, the CFTC sought restitution, disgorgement, civil monetary penalties, and permanent injunctions against further violations of the federal commodities laws and against further trading.

6. On August 4, 2009, the CFTC obtained a court order freezing an additional $7.6 million in assets held by Janet Schaberg, the ex-wife of

Stephen Walsh of Sands Point, New York, thus expanding the scope of the asset freeze imposed at the outset of the litigation. The court found that Walsh, during the period of the alleged fraud, regularly transferred funds from WG Trading Investors, LP, an entity that he controlled, to Schaberg. The court concluded that the CFTC was likely to prevail on the merits of its claim that the funds transferred to Schaberg constituted fraudulent proceeds. The court also found that Schaberg likely did not have a legitimate claim to those assets.

7. Walsh and Greenwood were subsequently indicted in the Southern District of New York in the related criminal complaint filed by the U.S. Attorney, and Deborah Duffy, WG Trading's compliance officer, pled guilty to a criminal information in the same matter.

D. *In the Matter of I Trade FX LLC (Isaac Martinez)*, NFA Case No. 08-BCC-014 (Jan. 21, 2010)[18]

1. Isaac Martinez was the AML compliance officer for I Trade, a Forex Dealer Member in Florida. NFA's Appeals Committee found that Martinez failed to diligently exercise his duties as AML compliance officer in that he failed to ensure that I Trade's AML procedures were followed with respect to several customer accounts in which suspicious activity occurred. Among other omissions, Martinez failed to identify, thoroughly investigate, or report such suspicious activity. The Appeals Committee found that Martinez's gross failure to diligently exercise his supervisory duties resulted in serious lapses in I Trade's AML compliance. The Committee fined Martinez $50,000.

E. *In the Matter of Tiger Financial Group, et al. (Eric M. Golub)*, NFA Case No. 08-BCC-017 (July 28, 2009)[19]

1. Eric Golub was the compliance officer at Tiger Financial Group, an IB in Los Angeles. NFA's BCC issued a Complaint against Tiger and Golub, which charged Tiger and its APs with making deceptive and misleading sales solicitations and failing to uphold high standards of commercial honor and just and equitable principles of trade. The Complaint also charged Golub with failure to diligently supervise Tiger's APs so as to detect and prevent misleading sales practices and abusive trading practices. A hearing was held and mid way through the hearing Tiger and Golub submitted a settlement offer which the Hearing Panel approved. Under the settlement, Tiger was permanently barred from NFA membership and Golub was barred from being an AP of an NFA member for six years and permanently barred from being a principal of an NFA Member or working for any NFA Member, either directly or indirectly, in any compliance capacity involving futures or options on futures.

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18 http://www.nfa.futures.org/basicnet/Case.aspx?entityid=0369360&case=08BCC00014&contrib=NFA.

19 http://www.nfa.futures.org/basicnet/Case.aspx?entityid=0316740&case=08BCC00017&contrib=NFA.

F. ***In the Matter of International Commodity Clearing and Steven I. Zander*, NFA Case No. 06-BCC-004 (Feb. 27, 2007)**[20]

1. Steve Zander was the compliance director at International Commodity Clearing ("ICC"), an FCM in Ft. Lauderdale. NFA's BCC issued a Complaint against ICC and Zander which charged ICC and Zander with failing to supervise ICC's GIBs. The Complaint also charged ICC, as the guarantor FCM of these IBs, with making deceptive, misleading and high-pressured sales solicitations. ICC and Zander submitted a settlement offer which the Hearing Panel approved. Under the settlement, ICC was ordered to never reapply for NFA membership and Zander was ordered not to reapply for NFA membership or associate membership, or act as a principal of an NFA Member, or act in a supervisory capacity for an NFA Member, for one year.

G. ***In the Matter of The Siegel Trading Co Inc, (Robert Benedetto)*, NFA Case No. 01-BCC-011 (Oct. 17, 2003)**[21]

1. Robert Benedetto was the compliance officer for The Siegel Trading Co, an FCM in Chicago. NFA's Appeals Committee affirmed a Decision of an NFA Hearing Panel which found that Siegel's APs made deceptive, misleading, and high-pressure sales solicitations, and that Benedetto, as compliance officer, failed to diligently supervise Siegel's APs' sales practices and turned his back on his supervisory responsibilities and allowed the firm's APs fraud to continue unchecked. Siegel was permanently barred from NFA membership and Benedetto was barred for 4 years from NFA membership and permanently barred from acting as a principal, partner, officer, director or branch manager of any NFA Member.

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[20] http://www.nfa.futures.org/basicnet/Case.aspx?entityid=0006487&case=06BCC00004&contrib=NFA.

[21] http://www.nfa.futures.org/basicnet/Case.aspx?entityid=0053172&case=01BCC00011&contrib=NFA.