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On the Hunt for Broken Windows: Perspectives from the SEC's OCIE and Enforcement

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I. Requirement of Admissions in Certain Settlements

A. In June 2013, in a significant departure from past practice, Chair White announced that the U.S. Securities and Exchange Commission ("SEC" or "Commission") would begin requiring admissions of facts and misconduct from defendants as a condition of settlement in cases where there was a heightened need for public accountability. While she predicted that most cases would continue to settle with the defendants neither admitting nor denying the allegations of wrongdoing, the SEC would begin to require admissions as a condition of settlement in cases involving egregious intentional misconduct, substantial harm to investors, or serious risk to the markets.

B. In FY 2013, the SEC required admissions in two matters. The SEC announced the first settlement implementing this policy shift in August 2013. In a case alleging the misappropriation of $113 million in hedge fund assets by Philip Falcone, Falcone and his advisory firm, Harbinger Capital Partners, admitted to multiple acts of misconduct that harmed investors as part of a settlement with the SEC.[1] Thereafter, in September, the SEC settled with JPMorgan Chase in connection with the so-called "London Whale" trading loss. JPMorgan admitted to a lengthy recitation of detailed facts and that its conduct violated the federal securities laws.[2]

C. The SEC continued to require admissions in FY 2014. In January 2014, Scottrade, Inc. agreed to a $2.5 million penalty and admitted that it violated the recordkeeping provisions of the federal securities laws after it failed to provide the SEC with complete and accurate "blue sheet" data in the course of the SEC's

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[*] Copyright 2014 Morgan, Lewis & Bockius LLP. All rights reserved. This outline was prepared with the help of associate Brian Baltz. Some descriptions of current enforcement actions are drawn from our publication, *Select Broker-Dealer, Investment Adviser, and Investment Company Enforcement Cases and Developments: 2013 Year in Review*, *available at* http://www.morganlewis.com/pubs/Securities_LF_2013YearInReview_19feb14.pdf.

[1] *See* SEC Press Release, "Philip Falcone and Harbinger Capital Agree to Settlement" (Aug. 19, 2013).

[2] *See* SEC Press Release, "JPMorgan Chase Agrees to Pay $200 Million and Admits Wrongdoing to Settle SEC Charges" (Sept. 19, 2013).

investigation.[3] In February 2014, Credit Suisse Group AG agreed to pay $196 million and admit wrongdoing for providing cross-border brokerage and investment advisory services to thousands of U.S. clients without registering with the SEC.[4] In March 2014, Lions Gate Entertainment Corp. agreed to pay $7.5 million and admit wrongdoing to settle the SEC's charges that it failed to fully and accurately disclose corporate transactions that resulted in a management-friendly director owning millions of newly issued company shares in order to thwart a hostile tender offer.[5] Michael A. Horowitz, the architect of a scheme to sell variable annuities contracts designating terminally ill patients as annuitants whose deaths would trigger death benefit payouts to wealthy investors as opportunities to earn short-term investment gains, agreed to pay $850,000, admit wrongdoing, and be barred from the securities industry.[6] Most recently, Wells Fargo Advisors LLC ("WFA") admitted wrongdoing and agreed to pay $5 million to settle charges that it failed to maintain adequate controls to prevent a Wells Fargo broker from insider trading based on nonpublic information obtained from a customer, and for delaying production of documents and providing an altered internal document during the SEC's investigation.[7]

D. While it is too early to predict the frequency with which the SEC will require admissions as a condition of settlement, admissions may well be required in settlements in increasing numbers over the upcoming years. It remains to be seen whether this will become a settlement "term" subject to negotiation and whether, in cases charging multiple parties, all defendants will be treated similarly as the first party to settle in terms of the admissions requirement. This shift in the SEC's settlement policy alters the monetary risk/benefit calculus of settling a matter with the SEC and will require a settling party to factor in the impact of admissions on collateral actions. For regulated entities and individuals, an SEC demand for admissions also reframes the issue of the advisability of litigating against one's primary regulator.

II. Specialized Units

A. Broker-Dealer Task Force: In December 2013, the SEC announced the creation of a new task force in the Division of Enforcement ("Enforcement") to increase its focus on the activities of broker-dealers. The Broker-Dealer Task Force, which

[3] *See* SEC Press Release, "Scottrade Agrees to Pay $2.5 Million and Admits Providing Flawed 'Blue Sheet' Trading Data" (Jan. 29, 2014).

[4] *See* SEC Press Release, "Credit Suisse Agrees to Pay $196 Million and Admits Wrongdoing in Providing Unregistered Services to U.S. Clients" (Feb. 21, 2014).

[5] *See* SEC Press Release, "SEC Charges Lions Gate with Disclosure Failures While Preventing Hostile Takeover; Company Admits Wrongdoing to Settle SEC Charges" (Mar. 13, 2014).

[6] *See* SEC Press Release, "Architect of Variable Annuities Scheme Agrees to Pay $850,000, Admit Wrongdoing, and Be Barred from Securities Industry" (July 31, 2014).

[7] *See* SEC Press Release, "Wells Fargo Advisors Admits Failing to Maintain Controls and Producing Altered Document, Agrees to Pay $5 Million Penalty" (Sept. 22, 2014).

works closely with the SEC's Office of Compliance Inspections and Examinations ("OCIE") and the Division of Trading and Markets, is focused on bolstering efforts to address current issues and practices within the broker-dealer community, including the development of nationwide initiatives to combat problematic practices. The initial initiatives related to anti-money laundering regulations and recidivist brokerage firms that shelter rogue brokers and engage in abusive activities. In FY 2015, the task force will also focus on churning and the failure to comply with anti-money laundering requirements.

B. Private Fund Unit: The SEC has developed a Private Fund Unit within the Division of Enforcement that is co-chaired by Igor Rozenblit and Marc Wyatt. The Private Fund Unit conducts risk-based examinations of private fund advisers and provides experience and training for examiners to help them become subject matter experts. Initially, the unit will include 12 to 15 staff in the Boston, New York, Chicago and San Francisco regional offices.

III. Asset Management "Sweeps"

A. Alternative Mutual Funds: OCIE is conducting a sweep examination of alternative mutual funds, focusing on valuation of illiquid assets, liquidity disclosures, use of leverage, and board oversight of alternative mutual funds. Additional areas of interest include staffing, funding, and empowerment of boards, compliance personnel, and back offices, and how funds are marketed to investors. In 2014, Norm Champ, Director of the SEC's Division of Investment Management, stated that the sweep "will produce valuable insight into how alternative mutual funds attempt to generate yield and how much risk they undertake, in addition to how well boards are carrying out their oversight duties."[8]

B. Private Equity Funds: In October 2012, OCIE sent a letter to senior executives and principals of newly registered investment advisers describing a new presence exam initiative that would conduct focused, risk-based examinations of private equity fund advisers.[9] The presence exams are focused on five key areas: marketing, portfolio management, conflicts of interest, safety of client assets, and valuation.

1. *In the Matter of Lincolnshire Management, Inc.*, Admin. Proc. File No. 3-16139 (Sept. 22, 2014)

a. The SEC filed a settled administrative proceeding against Lincolnshire Management, Inc. ("LMI"), a private equity fund

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[8] Norm Champ, Director, Division of Investment Management, SEC, Remarks to the Practising Law Institute, Private Equity Forum (June 30, 2014), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370542253660#.VGt0vCxOXX4.

[9] U.S. Securities and Exchange Commission Office of Compliance Inspections and Examinations, Letter to Senior Executives or Principals of Newly Registered Investment Advisers (Oct. 9, 2012), *available at* www.sec.gov/about/offices/ocie/letter-presence-exams.pdf.

adviser, for allegedly allocating expenses improperly between two private equity funds that each owned a portion of the same portfolio companies, and failing to adopt and implement written policies and procedures reasonably designed to prevent violations of the Investment Advisers Act of 1940 ("Advisers Act").

b. The SEC alleged that a portion of shared expenses for the two portfolio companies was misallocated and undocumented, which caused one portfolio company to pay more than its share of expenses that benefitted both companies. Following the integration of the two portfolio companies, LMI allocated to only one of the portfolio companies expenses for third-party administrators that provided payroll services and administered the 401(k) programs for both of the portfolio companies. In addition, the salaries of certain employees that performed work for both of the portfolio companies were not properly allocated between the two companies; one of the companies did not pay overhead costs for certain employees of a wholly owned Singapore subsidiary of the other company; and transaction bonuses of two executives who were only employees of one of the companies were partly paid by an owner of the other company.

c. The SEC also alleged that LMI did not adopt or implement any written policies or procedures reasonably designed to prevent violations of the Advisers Act arising from the integration of the two portfolio companies.

d. The settled Order charged that LMI violated Sections 206(2) and 206(4) of the Advisers Act, and Rule 206(4)-7 thereunder.

e. Pursuant to the settlement, LMI agreed to a cease-and-desist order and to pay disgorgement of $1.5 million, prejudgment interest of $358,112, and a civil penalty of $450,000.

IV. Whistleblowers

A. The SEC's whistleblower program completed its fourth year of operation in FY 2014.[10] Persons who voluntarily provide the SEC with original information leading to a successful enforcement case resulting in monetary sanctions of more than $1 million may be eligible to receive an award between 10% and 30% of the funds collected by the Commission or in a related enforcement case.

B. In FY 2014, the SEC's Office of the Whistleblower received 3,630 tips, complaints, and referrals from whistleblowers, an increase of 382 (or

[10] SEC Staff, 2014 Annual Report to Congress on the Dodd-Frank Whistleblower Program (Nov. 2014), *available at* http://www.sec.gov/about/offices/owb/annual-report-2014.pdf.

approximately 11.8%) from the 3,238 received in FY 2013, and an increase of more than 20% since FY 2012. Most complaints fell into three categories: corporate disclosures and financials (16.9%), offering fraud (16%), and manipulation (15.5%).

C. Since the inception of the whistleblower program, the SEC has authorized awards to fourteen whistleblowers—nine of the awards were authorized in FY 2014. One of these awards was for more than $30 million, the largest award to date.[11] The SEC used the information provided by that whistleblower, who was a foreign resident, to discover and bring successful enforcement actions for a substantial and ongoing fraud that would have been difficult to detect otherwise. The SEC considered the significance of the information provided, the assistance provided, and the law enforcement interests at issue in reaching the award determination. The SEC allowed the award notwithstanding the claimant's unreasonable delay in reporting the securities violations, some of which occurred before creation of the whistleblower program. The SEC determined not to apply the unreasonable delay consideration as severely as it might have otherwise done had the claimant's delay occurred entirely after creation of the whistleblower program.

D. On June 16, 2014, the SEC, in its first time exercising its anti-retaliation authority, charged hedge fund advisory firm Paradigm Capital Management, Inc. ("Paradigm") with retaliating against an employee, the firm's head trader, who reported to the SEC that Paradigm was engaging in principal transactions with an affiliated broker-dealer without providing effective disclosure or receiving consent from a hedge fund client.[12] The SEC alleged that Paradigm retaliated against the whistleblower by removing the whistleblower from the head trader position, tasking the whistleblower with investigating the reported conduct while blocking access to meaningful resources, changing the whistleblower's job function to a full-time compliance assistant, and stripping the whistleblower of supervisory responsibilities. These actions caused the whistleblower to resign. Paradigm and its owner agreed to pay $2.2 million to settle the charges.

E. The SEC clarified that the anti-retaliation provisions under the Dodd-Frank Wall Street Reform and Protection Act apply regardless of whether the potential securities law violations are reported internally or to the SEC. The SEC has filed amicus curiae briefs in several cases urging courts to defer to Rule 21F-2(b)(1) under the Securities Exchange Act of 1934 ("Exchange Act"), which provides that retaliation protections are not limited to those individuals who report securities law violations directly to the Commission, but also to those individuals who report potential violations internally.[13] In *Peters v. LifeLock, Inc.*, the court

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[11] *See* Order Determining Award Claim, Admin. Proc. File No. 2014-10 (Sept. 22, 2014), *available at* http://www.sec.gov/rules/other/2014/34-73174.pdf.

[12] *See In the Matter of Paradigm Capital Management, Inc. and Candace King Weir*, Admin. Proc. File No. 3-15930 (June 16, 2014).

[13] *See* 240 C.F.R. § 21F-2(b)(1); *see, e.g.*, *Doe v. Oppenheimer Asset Mgmt., Inc.*, 14-cv-00779 (S.D.N.Y. 2014); *Peters v. LifeLock, Inc.*, 14-cv-00576 (D. Ariz. 2014).

agreed with the SEC that internal reports can be protected by the anti-retaliation provisions.[14]

V. Highlights from Recent SEC Cases

A. Insider Trading

1. Insider trading remains a core focus of the Enforcement program, with aggressive insider trading actions targeting a wide range of entities and individuals, including financial professionals, hedge fund managers, and corporate insiders. To support its enforcement efforts in this priority area, in 2013, the SEC developed the Advanced Bluesheet Analysis Program, an initiative to analyze data on specific securities transactions provided to the SEC by market participants and identify suspicious trading in advance of market-moving events.

2. The SEC's investigations and enforcement actions are often instituted in tandem with the Department of Justice. For example, in 2013 the SEC collaborated with the Department of Justice in enforcement efforts against individuals and entities associated with Steven A. Cohen, the founder and owner of S.A.C. Capital Advisors LLC (which later became S.A.C. Capital Advisors L.P.) ("S.A.C. Capital") and a number of affiliated investment advisers that managed portfolios with assets exceeding $15 billion. These actions ultimately led to the SEC filing a highly publicized contested administrative action against Cohen individually in July 2013, alleging that Cohen failed reasonably to supervise two portfolio managers employed by subsidiaries of S.A.C. Capital and controlled by him.

3. A series of recent cases illustrate that the regulators are heavily focused on firm supervision and culture of compliance.

4. *In the Matter of Wells Fargo Advisors, LLC*, Admin. Proc. File No. 3-16153 (Sept. 22, 2014)

   a. The SEC filed a settled administrative proceeding against WFA, a dually registered broker-dealer and investment adviser, for failing adequately to establish, maintain, and enforce policies and procedures reasonably designed to prevent the misuse of material nonpublic information, specifically, the material nonpublic information obtained from its customers and advisory clients.

   b. WFA's policies and procedures to prevent the misuse of material nonpublic information were not reasonably designed to address the risk that its associated persons could obtain material nonpublic information from its customers and advisory clients even though

[14] *See Peters v. LifeLock, Inc.*, Order at 6-13 (Sept. 19, 2014).

the firm expressly identified that risk in multiple internal documents. In 2010, one of its registered representatives used nonpublic information received from one of his customers about Burger King Holdings, Inc. securities and traded on the basis of that information and tipped others about the information.

c. Multiple units within the firm received indications suggesting that the registered representative was misusing material nonpublic information obtained from a customer to trade in Burger King securities. However, because of a lack of assigned responsibility or coordination, each of these units failed to (a) recognize the significance of those indications, (b) properly consider them, and (c) elevate those indications within their own group or communicate with other groups responsible for conducting surveillance. As a result, the way in which the policies and procedures were designed caused WFA not to recognize several red flags that its representative was engaging in insider trading in Burger King securities.

d. In addition, WFA did not effectively maintain or enforce its policies and procedures. Although WFA's policies and procedures required WFA's Retail Control Group ("RCG") to contact the branch manager if an employee's trading raised red flags, there were times when the RCG did not contact the branch manager. In addition, RCG Failed to perform timely reviews of at least forty instances of possible insider trading flagged for review over a ten-month period.

e. WFA also unreasonably delayed production of documents relating to the RCG review without explaining why they were not produced and later produced a document that had been altered by an employee prior to production to the SEC.

f. As a result, WFA violated Sections 15(g), 17(a), and 17(b) of the Exchange Act and Rule 17a-4(j) thereunder and Sections 204(a) and 204A of the Advisers Act.

g. Pursuant to the settlement, WFA agreed to a censure and a $5 million civil money penalty, and to retain an independent compliance consultant to review and recommend improvements to WFA's policies and procedures.

5. *SEC v. Sigma Capital Management LLC*, 13 CV 1740 (S.D.N.Y. Mar. 15, 2013), and *SEC v. Michael Steinberg*, 13 CV 2082 (S.D.N.Y. Mar. 29, 2013)

a. In March 2013, the SEC charged hedge fund advisory firm Sigma Capital Management ("Sigma") and Michael Steinberg, a portfolio manager employed by Sigma, with trading on insider information ahead of quarterly announcements by Dell and Nvidia Corporation. The SEC alleged that Steinberg's conduct caused Sigma and its affiliate S.A.C. Capital to generate more than $6 million in illegal profits and avoid losses. The SEC additionally named two affiliated hedge funds – Sigma Capital Associates and S.A.C. Select Fund – as relief defendants that unjustly benefited from Sigma's violations. S.A.C. Select Fund was managed by S.A.C. Capital, controlled by Steven A. Cohen.[15]

b. The SEC's complaint alleges Sigma received material nonpublic information concerning quarterly earnings at Dell and Nvidia through one of its research analysts, Jon Horvath, and traded on that information in advance of the companies' earnings announcements. The SEC alleged that Horvath relayed this information to Steinberg, who was a portfolio manager at Sigma, who then executed trades in Dell and Nvidia, and tipped off other portfolio managers to this same information. In a parallel action, the U.S. Attorney's Office for the Southern District of New York charged Steinberg with one count of conspiracy to commit securities fraud and four counts of securities fraud.

c. According to the SEC, Horvath received the material nonpublic information from a group of analysts at other hedge funds who regularly shared information. The Commission has alleged that the inside information Horvath obtained differed significantly from the predictions of market analysts.

d. The SEC's complaints charged Sigma and Steinberg with violating Section 17(a) of the Securities Act of 1933 ("Securities Act"), and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

e. On March 28, 2013, the Honorable Harold Baer of the United States District Court for the Southern District of New York approved settlements reached with the SEC and Sigma in which the hedge fund along with the two relief defendant affiliates,

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[15] The first of the actions against entities and individuals associated with Cohen was filed in November 2012 against hedge fund advisory firm CR Intrinsic Investors, LLC, an affiliate of S.A.C. Capital, and its former portfolio manager, Matthew Martoma, along with a medical consultant for an expert network firm, for their roles in an insider trading scheme involving a clinical trial for an Alzheimer's drug being jointly developed by two pharmaceutical companies. In March 2013, CR Intrinsic agreed to the largest insider trading settlement in SEC history. The terms of the settlement required CR Intrinsic to pay more than $600 million in disgorgement, penalties and prejudgment interest. *See SEC v. CR Intrinsic Investors, LLC et al.*, 12 Civ. 8466 (S.D.N.Y. Mar. 18, 2013). Also in November 2012, the Department of Justice filed parallel criminal charges against Mr. Martoma; he was recently found guilty of certain charges.

Sigma Capital Associates and S.A.C. Select Fund, agreed to pay nearly $14 million in disgorgement and civil penalties to settle the charges.

f. With respect to Steinberg, the SEC alleged that he understood that he was receiving quarterly financial information from Horvath that originated from insiders within Dell and Nvidia. For example, the SEC alleged that Steinberg was copied on an email from Horvath that stated that he had a "2nd hand read from someone at the company [Dell]" and indicated that the company was going to miss gross margins. Based on this and other inside information, Steinberg executed illegal trades in advance of at least four quarterly earnings announcements during 2008 and 2009 and, on at least one occasion, arranged to share the Dell inside information with another portfolio manager at Sigma.

g. On May 16, 2014, a final judgment in the criminal case was imposed against Steinberg. Steinberg was sentenced to a prison term of 42 months followed by three years of supervised release. He was also ordered to pay a fine of $2 million and $365,142.30 in criminal forfeiture. On October 14, 2014, the SEC's Chief Administrative Law Judge issued an order barring Steinberg from association with an investment adviser, broker, dealer, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization.

6. *In the Matter of Steven A. Cohen*, Admin. Proc. File No. 3-15382 (July 19, 2013)

a. As noted above, borne out of its ongoing settlements and litigation with S.A.C.-related entities and individuals, on July 19, 2013, the SEC instituted public administrative proceedings against the chief executive officer of S.A.C. Capital, Steven A. Cohen, for failing to supervise Mathew Martoma and Michael Steinberg, two senior portfolio managers whom Cohen supervised, and failing to prevent them from insider trading under his watch.

b. Martoma and Steinberg were portfolio managers who worked at CR Intrinsic Investors, LLC and Sigma Capital Management, LLC respectively, subsidiaries of S.A.C. Capital. Cohen allegedly received highly suspicious information from Martoma and Steinberg, as well as their colleagues, regarding trades related to pharmaceutical companies Elan and Wyeth, as well as Dell Computers, which, according to the SEC, should have caused any reasonable hedge fund manager to investigate the basis for the trades. Instead, Cohen allegedly ignored numerous red flags and praised the portfolio managers for the trades at issue and rewarded

Martoma with a $9 million bonus for his work on Elan and Wyeth. Cohen's hedge funds earned profits and avoided losses of more than $275 million as a result of the trades. The SEC seeks to bar Cohen from overseeing investor funds.

c. According to the SEC's Order, Cohen required Martoma and Steinberg to provide to him updates on their stock trading generally and the reasons for their trades. The SEC alleges that both individuals were at various times unlawfully in possession of material nonpublic information regarding the Elan, Wyeth, and Dell trades, and that they traded on this information. The SEC alleges that Martoma received material nonpublic information from Dr. Sidney Gilman who served as a consultant to Elan and Wyeth and who participated in a clinical trial of a drug with the potential to treat patients with Alzheimer's. The SEC alleges that Steinberg received material nonpublic information about an upcoming earnings announcement at Dell from a research analyst who reported to him, and that Steinberg traded on this information.

d. The SEC's Order alleges that on several occasions Martoma and Steinberg provided information to Cohen indicating their potential access to inside information to support their trading. For example, Cohen was aware that Martoma and other portfolio analysts had spoken to a doctor who "implied" that he had seen confidential clinical trial data compiled by Elan and Wyeth. With respect to the Dell trades, the SEC alleges that a research analyst forwarded to Cohen an email on which Steinberg was copied suggesting that the research analyst had a read from "someone at the company" that Dell's gross margins would miss analyst expectations. The SEC alleges that Cohen failed to take any action to determine whether these employees under his supervision were engaged in unlawful conduct or in possession of material nonpublic information and failed to take reasonable steps to prevent violations of the federal securities laws.

e. Notably, the SEC alleges in its Order that other CR Intrinsic analysts raised concerns to Cohen about Martoma being in possession of undisclosed data on the results of the trial.

f. The SEC's Order alleges that Cohen failed reasonably to supervise Martoma and Steinberg with a view toward preventing their violations of the antifraud provisions of the federal securities laws. The administrative proceedings will determine what relief is in the public interest against Cohen, including financial penalties, a supervisory and financial services industry bar, and other relief.

g. As noted, late last December a federal jury convicted Steinberg of four securities fraud charges and a conspiracy charge for insider trading related to his use of material nonpublic information during his tenure at Sigma Capital. In February 2014, Martoma was convicted of two counts of securities fraud and one count of conspiracy.

B. Best Execution

1. The following cases reflect the SEC Staff's continuing scrutiny of the use of affiliated broker-dealers and the potential impact of those arrangements on best execution.

2. *In the Matter of Goelzer Investment Management, Inc. and Gregory W. Goelzer*, Admin. Proc. File No. 3-15400 (July 31, 2013)

a. The SEC filed a settled administrative proceeding against Goelzer Investment Management, Inc. ("GIM"), a dually registered investment adviser and broker-dealer, and Gregory W. Goelzer ("Goelzer"), GIM's chief executive officer and chief compliance cfficer, for allegedly making misrepresentations in its Form ADV about the process of selecting itself as broker for advisory clients. The SEC also alleged that GIM failed to seek best execution for its clients by neglecting to conduct an appropriate analysis to substantiate its decision to place trades for advisory clients through itself as broker.

b. The SEC alleged that GIM's Form ADV stated that transactions for GIM's advisory clients would generally be effected through GIM as broker, "consistent with its obligation to obtain best price and execution," and that GIM's recommendation that clients use GIM as their broker was based on GIM's consideration of several factors, including the products offered, the level of service, the quality of trade execution, the recordkeeping and reporting capabilities, the trading platforms offered, and the ability to meet client needs. The SEC alleged that these statements were misleading because GIM did not take steps to ensure that it was seeking best price and execution for its advisory clients and failed to evaluate brokerage options for its advisory clients in a manner that was consistent with its Form ADV disclosure.

c. The SEC also alleged that GIM failed to seek best execution for its advisory clients because it did not conduct any analysis of its brokerage services that gave it a basis for using itself as broker. The SEC alleged that instead, GIM used itself as broker for its advisory accounts by default rather than as the result of a best execution analysis.

d. The SEC also alleged that GIM failed to adopt and implement policies and procedures reasonably designed to prevent and detect misrepresentations by GIM and that it failed to disclose the negotiability of its advisory fees in its Form ADV.

e. The SEC's settled Order charged that GIM violated Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-7 thereunder; that Goelzer caused GIM's violations; and that GIM and Goelzer violated Section 207 of the Advisers Act.

f. Pursuant to the settlement, GIM and Goelzer consented to a cease-and-desist order. GIM agreed to pay disgorgement of $309,994 and $53,799 in prejudgment interest, and to pay a civil monetary penalty of $100,000. Goelzer consented to a civil monetary penalty of $35,000. GIM also agreed to the engagement of a compliance consultant to conduct a comprehensive review of GIM's compliance program.

3. *In the Matter of A.R. Schmeidler & Co., Inc.*, Admin. Proc. File No. 3-15399 (July 31, 2013)

a. The SEC filed a settled administrative proceeding against A.R. Schmeidler & Co., Inc. ("ARS"), a dually registered investment adviser and broker-dealer, for allegedly failing to seek best execution in breach of its fiduciary duty and allegedly failing to implement policies and procedures reasonably designed to prevent its purported best execution violations.

b. The SEC alleged that ARS's clients generally entered into advisory agreements with ARS, whereby the client authorized ARS to, among other things, select brokers and dealers to execute trades. According to the SEC, unless specifically directed by a client to use a particular broker-dealer, ARS executed trades for advisory accounts in its capacity as an introducing broker. In February 2007, ARS renegotiated its agreement with its clearing firm and increased the percentage of commissions it received on trades for taxable accounts from 80% to 90%. Although the commission rate charged to clients remained consistent at six cents per share, the SEC alleged that ARS did not conduct a sufficient analysis to determine whether it properly sought best execution for trades executed on behalf of advisory clients with taxable accounts. The SEC also alleged that although ARS's policies and procedures governed how to discharge ARS's best execution obligations, ARS failed to implement such policies and procedures.

c. The SEC's settled Order charged that ARS violated Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-7 thereunder.

d. ARS consented to a cease-and-desist order, a censure, and to pay disgorgement of $757,876.88 and prejudgment interest of $78,688.57, and a civil monetary penalty of $175,000. ARS also agreed to engage an independent consultant to undertake to assist ARS in developing and implementing policies and procedures reasonably designed to promote compliance with its duty to seek best execution for advisory clients.

4. *In the Matter of Manarin Investment Counsel, Ltd.*, Admin Proc. File No. 3-15549 (Oct. 2, 2013)

a. The SEC filed a settled administrative proceeding against Manarin Investment Counsel, Ltd. ("MIC"), a registered investment adviser, Manarin Securities Corp. ("MSC"), a registered broker-dealer, and Roland R. Manarin ("Manarin"), the founder, owner, and president of MIC and MSC. The SEC alleged that MIC and Manarin failed to obtain best execution for three investment funds managed by MIC (including a mutual fund) (the "Funds") by purchasing higher-cost mutual fund shares, even though cheaper shares in the same mutual funds were available. As a result, the Funds paid avoidable fees on their mutual fund holdings and passed these fees through to MSC, the affiliated broker-dealer that executed the purchases.

b. According to the SEC, from at least June 2000 through mid-2010, Manarin and MIC breached their fiduciary duties as investment advisers by causing the Funds to buy the Class A shares of underlying mutual funds even when the Funds were eligible to own lower-cost, so-called "institutional" shares of the same mutual funds. As a result, the Funds paid approximately $3.3 million in avoidable 12b-1 fees on their mutual fund holdings, which were passed through to MSC. The SEC alleged that this practice was a violation of MIC's and Manarin's duty to seek best execution and was inconsistent with disclosures in the Fund's offering materials and MIC's Form ADV.

c. The SEC also alleged that, between October 2008 and December 2011, MSC executed transactions in ETF shares on behalf of its affiliated mutual fund and charged commissions that exceeded the usual and customary broker's commission for such transactions.

d. The SEC's settled Order charged that MIC and Manarin violated Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-

8(a)(1) thereunder, (ii) that Manarin violated Section 34(b) of the Investment Company Act of 1940 ("Investment Company Act"); (iii) that MIC, MSC, and Manarin violated Section 17(a)(2) of the Securities Act; and (iv) that MSC violated Section 17(e)(2)(A) of the Investment Company Act.

e. Pursuant to the settlement, MIC, MSC and Manarin consented to cease-and-desist orders and censures. MSC and Manarin also agreed, jointly and severally, to pay disgorgement totaling $685,006.90 and prejudgment interest totaling $267,741.72. Further, Manarin agreed to pay a civil penalty of $100,000.

C. Soft Dollars

1. The following related cases involve the use, documentation and disclosure of soft dollar payments.

2. *In the Matter of J.S. Oliver Capital Management, L.P., Ian O. Mausner, and Douglas F. Drennan*, Admin. Proc. File No. 3-15446 (Aug. 30, 2013)

a. The SEC filed an administrative proceeding against J.S. Oliver Capital Management, L.P. ("J.S. Oliver"), a registered investment adviser, and Ian O. Mausner ("Mausner"), its founder, president, and sole owner, alleging that they engaged in separate schemes to (i) disproportionately allocate favorable trades to affiliated and/or favored hedge fund clients to the detriment of other clients; and (ii) with substantial assistance from Douglas F. Drennan ("Drennan"), an outside research analyst also named in the SEC's Order, used soft dollar credits from client commission arrangements for personal and other undisclosed and unauthorized purposes.

b. The SEC alleges that from June 2008 to November 2009, J.S. Oliver and Mausner allocated profitable equity trades on a preferential basis to six client accounts, including affiliated hedge funds, to the detriment of three other J.S. Oliver clients. The SEC's Order states that Mausner placed block trades in omnibus accounts at various broker-dealers, which were then reported to J.S. Oliver's prime broker. Thereafter, he allegedly used the prime broker's online platform to allocate the shares among client accounts, often waiting until after the close of trading so that he could determine the value of the securities and allocate to preferred accounts those that had increased in value and to disfavored accounts those that had decreased in value. Where there were multiple trades in the same security on the same day, Mausner allegedly allocated the most favorably priced trades to favored accounts.

c. The preferential allocations were contrary to J.S. Oliver's written policies and procedures and to representations made in client agreements, which required that allocations among clients would be fair and equitable and in proportion to account assets or target percentage levels. In addition, the SEC alleges that J.S. Oliver received performance fees from the favored funds, and Mausner and his family profited at certain clients' expense because they were personally invested in some of the favored funds.

d. The SEC alleges that a separate scheme operated from January 2009 through November 2011 in which J.S. Oliver misused over $1.1 million in soft dollar credits accrued from trading commissions paid by J.S. Oliver clients. J.S. Oliver disclosed in its Form ADV allowable uses of soft dollar credits, but Mausner, allegedly with substantial assistance from Drennan, misrepresented and falsely documented the purpose of certain payments, which were directed to unauthorized uses such as Mausner's personal expenses and salary and bonus payments to Drennan.

e. Finally, the SEC alleges that J.S. Oliver failed to maintain a memorandum of each order it gave for the purchase or sale of securities and to maintain originals of Mausner's email messages promoting one of the funds that he favored in his cherry-picking scheme.

f. The SEC's Order alleges (i) that J.S. Oliver and Mausner violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, Sections 206(1), 206(2), 206(4), and 207 of the Advisers Act and Rule 206(4)-8 thereunder; (ii) that J.S. Oliver willfully violated, and Mausner willfully aided, abetted, and caused J.S. Oliver's violations of Sections 204 and 206(4) of the Advisers Act and Rules 204-1(a)(2), 204-2(a)(3), 204-2(a)(7), and 206(4)-7 thereunder; and (iii) that Drennan willfully aided, abetted, and caused J.S. Oliver's violations of Sections 17(a)(1) and (2) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 206(1), 206(2), and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder.

g. An initial decision, dated August 5, 2014, found (i) that Drennan willfully aided and abetted and caused J.S. Oliver's violations of Sections 17(a)(1) and 17(a)(2) of the Securities Act , Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Section 206(1), 206(2), and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder; (ii) that J.S. Oliver willfully violated Section 204 of the Advisers Act and Rules 204-5(a)(3) and 204-2(a)(7) thereunder, and that Mausner willfully aided and abetted and caused J.S. Oliver's violations; (iii) that J.S. Oliver willfully violated Section

206(4) of the Advisers Act and Rule 206(4)-7 thereunder, and that Mausner willfully aided and abetted and caused J.S. Oliver's violations; and (iv) that J.S. Oliver and Mausner willfully violated Section 207 of the Advisers Act, and that J.S. Oliver violated Section 204 of the Advisers Act and Rule 204-1(a)(2) thereunder, violations that Mausner willfully aided and abetted and caused.

h. It was ordered (i) that J.S. Oliver, Mausner, and Drennan cease and desist from committing or causing violations of the securities laws; (ii) that J.S. Oliver and Mausner, jointly and severally, pay disgorgement of $1,376,430 plus prejudgment interest, and Drennan, J.S. Oliver, and Mausner, jointly and severally, pay $482,381 plus prejudgment interest; (iii) that J.S. Oliver pay a civil monetary penalty of $14,975,000, Mausner of $3,040,000, and Drennan of $410,000; (iv) that the investment adviser registration of J.S. Oliver be revoked; and (v) that Mausner and Drennan be permanently barred from association with an investment adviser, broker, dealer, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization. The SEC has granted a petition for review of the initial decision.

3. *In the Matter of Instinet, LLC*, Admin. Proc. File No. 3-15663 (Dec. 26, 2013)

a. In a follow-up to the J.S. Oliver matter, the SEC filed a settled administrative proceeding against Instinet, LLC ("Instinet") for allegedly paying approximately $430,000 in client commission credits (soft dollars) as requested by its investment adviser customer, J.S. Oliver, for expenses that J.S. Oliver had not properly disclosed to its clients, including improper personal expenses of J.S. Oliver's president. The SEC alleged that Instinet made the payments pursuant to J.S. Oliver's requests despite the fact that the information J.S. Oliver provided to Instinet when requesting approval of the payments contained significant red flags that suggested that each payment was improper.

b. The SEC alleged that J.S. Oliver, through Instinet, used soft dollar credits on brokerage commissions to pay for personal expenses that fell outside of the safe harbor provided under Section 28(e) of the Exchange Act and that were not properly disclosed to clients. For example, the SEC alleged that in June 2009 Instinet, pursuant to J.S. Oliver's request, paid J.S. Oliver $329,365 using soft dollar credits for a payment to Mausner's ex-wife based on J.S. Oliver's representations to Instinet that the payment was for employee compensation. The SEC further alleged that an Instinet employee knew of significant red flags that the payment to Mausner's ex-

wife was improper, including that (i) the recipient of the payment was Mausner's ex-wife; (ii) the payment was purportedly related to the Mausners' parting ways professionally after their divorce; (iii) J.S. Oliver gave Instinet a series of inconsistent justifications for the payment; (iv) despite Instinet's requests, J.S. Oliver never provided Instinet with the purported employment agreement or a legal opinion from counsel stating that the use of soft dollars for the payment was permissible; and (v) J.S. Oliver provided Instinet an excerpt of the purported employment agreement (that had been materially altered by J.S. Oliver) and did not indicate that Mausner's ex-wife had conducted any work for J.S. Oliver in three years and did not substantiate the amount paid. The SEC alleged that despite these red flags, the Instinet employee approved the payment.

c. The SEC further alleged that Instinet employees knew of additional red flags relating to the subsequent payment of soft dollars for increased rent on office space located in Mausner's home and for Mausner's personal time-share property in New York City. The SEC alleged that despite significant red flags, Instinet employees approved such soft dollar payments.

d. The SEC's Order charged that Instinet willfully aided and abetted and caused J.S. Oliver's violations of Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder.

e. Pursuant to the settlement, Instinet consented to a cease-and-desist order, a censure, and to pay disgorgement of $378,673.76, prejudgment interest of $59,607.66, and a civil monetary penalty of $375,000. Instinet further consented to retain an independent consultant to undertake to review and report on Instinet's policies, procedures, and practices relating to the payment of soft dollars.

D. Valuation

1. In 2013, the SEC filed a valuation case involving private equity fund valuation practices, and settled a high-profile administrative proceeding against the directors of a mutual fund.

2. *In the Matter of Oppenheimer Asset Management Inc. and Oppenheimer Alternative Investment Management, LLC*, Admin. Proc. File No. 3-15238 (Mar. 11, 2013)

a. The SEC filed a settled administrative proceeding against registered investment advisers Oppenheimer Asset Management Inc. ("OAM") and Oppenheimer Alternative Investment Management, LLC ("OAIM") alleging that the firms made

misrepresentations and omissions to investors and prospective investors about the net asset value of a fund of funds private equity vehicle (the "Fund of Funds") that they managed. The SEC further alleged that the firms' policies and procedures did not contain provisions reasonably designed to prevent such misrepresentations and omissions.

b. The SEC alleged that from October 2009 through 2010, OAM and OAIM disseminated marketing materials to prospective investors and quarterly reports to existing investors stating that the Fund-of-Fund's net asset values were "based on the underlying managers' estimated values" when in fact, the portfolio manager for the Fund-of-Funds decided to value its largest holding at par, which was a significant markup to the underlying manager's estimated value. The change in the valuation methodology for its largest holding made the Fund-of-Fund's performance appear significantly better as measured by its internal rate of return. The employees of OAIM allegedly made further representations in connection with marketing the Fund-of-Funds, including that the increase in the value of the portfolio holding was attributable to performance, when, in fact, it was due to the change in valuation methodology.

c. According to the SEC, the above misrepresentations and omissions were made possible, in part, by the firms' failure to adopt and implement policies and procedures reasonably designed to ensure that valuations were determined in a manner consistent with written representations provided to investors.

d. The SEC's settled Order charged that the firms violated Sections 17(a)(2) and 17(a)(3) of the Securities Act and Section 206(4) of the Advisers Act and Rules 206(4)-7 and 206(4)-8 thereunder.

e. Pursuant to the settlement, OAM and OAIM consented to a censure and a cease-and-desist order. OAM and OAIM also agreed to distribute $2,269,098 to investors who invested in the Fund-of-Funds during the period of the alleged misrepresentations. This amount represented $2,128,232 in disgorgement and $140,866 in prejudgment interest. The firms also agreed to pay a civil penalty of $617,579. The firms agreed to retain an independent consultant to conduct a review of the firms' valuation policies and procedures, send a copy of the Order to existing advisory clients and prominently post a hyperlink to the Order on their website.

f. In considering whether to accept the civil penalty offered by OAM and OAIM, the SEC took into account the firms' cooperation in the investigation and enforcement action.

g. In a separate action brought by the Commonwealth of Massachusetts, OAM and OAIM agreed to pay $376,700 in disgorgement and $23,935 in prejudgment interest. The firms also agreed to pay a penalty of $132,421.

h. In a separate administrative proceeding, the SEC brought charges against the portfolio manager, Brian Williamson ("Williamson"), alleging that he made material false and misleading statements and omissions to investors related to the valuation and performance of the Fund-of-Funds. The SEC alleged that Williamson violated Section 17(a) of the 1933 Act, Section 10(b) of the 1934 Act and Rule 10b-5 thereunder and Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder. In the alternative, the SEC alleged that OAM and OAIM violated the aforementioned statutes and rules and Williamson willfully aided and abetted and caused OAM's and OAIM's violations. This matter was settled on January 22, 2014, with Williamson agreeing to be barred from the securities industry and to pay a $100,000 penalty. *See In the Matter of Brian Williamson*, Admin. Proc. File No. 3-15430 (Jan. 22, 2014).

3. *In the Matter of J. Kenneth Alderman, CPA, et al.*, Admin. Proc. File No. 3-15127 (June 13, 2013)

a. In a settlement of a litigated administration proceeding filed in December 2012, the SEC settled with J. Kenneth Alderman and seven other directors (the "Directors") of five registered investment companies (the "Funds") (collectively, "Respondents") for allegedly abrogating their responsibility to determine the value of the Funds' below-investment-grade debt securities, some of which were backed by subprime mortgages, and failing to establish adequate policies and procedures to determine the fair value of those securities.

b. The SEC alleged that the Directors improperly delegated the determination of the fair value of portfolio securities to the investment adviser of the Funds without providing a fair valuation methodology or other substantive guidance. The SEC asserted the abrogation of duty was particularly significant because fair-valued securities made up the majority of the Funds' net asset values.

c. The SEC alleged that changes to the fair value of a security were arbitrarily made by the portfolio manager without any basis or explanation and were made for the purpose of postponing the decline in the Funds' net asset values. The SEC also asserted that the Funds' accounting group engaged in smoothing prices to gradually reduce, over days or weeks, the value of a security to its lower valuation as provided by the portfolio manager.

d. Although the valuation procedures that were in place required that the Directors receive an explanatory note for the fair values assigned to the securities, the SEC alleged that explanatory notes were not provided and that the Directors failed to inquire or determine what methodology was used to assess the fair value of any particular security.

e. The Directors were found to have caused the Funds to violate Rule 38a-1 under the Investment Company Act by not properly determining the fair value of the securities in accordance with the requirements of Section 2(a)(41)(B) of the Investment Company Act.

f. Respondents consented to a cease-and-desist order to refrain from committing or causing any future violations of Rule 38a-1 under the Investment Company Act.

E. Marketing and representations to clients

1. The SEC continues to bring actions against investment advisers and their personnel for allegedly misleading statements to existing and prospective investors.

2. *In the Matter of Chariot Advisors, LLC and Elliott L. Shifman*, Admin Proc. File No. 3-15433 (Aug. 21, 2013)

a. The SEC filed an administrative proceeding against Chariot Advisors, LLC ("Chariot Advisors"), a registered investment adviser, and Elliott L. Shifman, Chariot Advisors' former owner. The SEC alleged that Chariot Advisors and Shifman misled the board of directors of the Chariot Absolute Return Currency Portfolio (the "Fund"), a registered investment company, about the firm's ability to conduct algorithmic currency trading so they would approve Chariot Advisors' contract to manage the Fund. The Fund was a series of the Northern Lights Variable Trust ("Northern Lights"), which serves as an umbrella trust for a series of mutual funds and provides those funds with turnkey services, including fund governance.

b. The SEC alleged that in December 2008 and again in May 2009, during the approval process for the investment advisory agreement of Chariot Advisors required by Section 15(c) of the Investment Company Act (the "15(c) process"), Shifman misrepresented to the Fund's board of directors Chariot Advisors' ability to conduct algorithmic currency trading and, as a result, misled the Fund's board about the nature, extent, and quality of services that Chariot Advisors could provide.

c. According to the SEC, at the time of Shifman's representations to the Fund's board, Chariot Advisors had not devised nor did it possess any algorithms or computer models capable of engaging in the currency trading that Shifman described during the 15(c) process. Moreover, after the Fund launched in July 2009, Chariot Advisors initially did not use an algorithm to perform the Fund's currency trading as represented to the Fund's Board, but instead hired an individual trader who was allowed to use discretion with respect to trade selection and execution. According to the SEC, these misrepresentations also led directly to misrepresentations and omissions in the Fund's registration statement and prospectus.

d. The SEC's Order alleged (i) that Chariot Advisors violated Section 15(c) of the Investment Company Act and Shifman aided and abetted Chariot Advisors' violation of Section 15(c) of the Investment Company Act; (ii) that Chariot Advisors and Shifman aided and abetted and caused the Fund's violations of Section 34(b) of the Investment Company Act; (iii) that Chariot Advisors violated Sections 206(1), 206(2), and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder; and (iv) that Shifman aided and abetted and caused Chariot Advisors' violations of Sections 206(1) and 206(2) of the Advisers Act.

e. This action was settled on July 3, 2014. The Order Making Findings and Imposing Remedial Sanctions found the following violations: (i) Chariot Advisors violated Section 15(c) of the Investment Company Act; (ii) Shifman caused Chariot Advisors's violations of Section 15(c) of the Investment Company Act; (iii) Chariot Advisors and Shifman caused the Chariot Fund's violations of Section 34(b) of the Investment Company Act; (iv) Chariot Advisors violated Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder; (v) and Chariot Advisors and Shifman willfully violated Section 206(2) of the Advisers Act. Shifman agreed to a 12-month suspension and civil money penalty of $50,000. Chariot Advisors and Shifman agreed to cease and desist from future violations of certain federal securities laws.

3. *In the Matter of Timbervest, LLC, Joel Barth Shapiro, Walter William Anthony Boden, III, Donal David Zell, Jr., and Gordon Jones II*, Admin. Proc. File No. 3-15519 (Sept. 24, 2013)

a. The SEC filed an administrative proceeding against Timbervest, LLC ("Timbervest"), an Atlanta-based investment adviser, and Timbervest's CEO, Joel Barth Shapiro; CIO, Walter William Anthony Boden, III; COO, Donal David Zell, Jr.; and president, Gordon Jones II, (the "Principals") for allegedly receiving unauthorized and undisclosed real estate commissions paid out of

the pension plan assets of Timbervest's largest client (the "Client").

b. The SEC's Order alleges that in or around 2005, the Client ordered Timbervest to reduce the size of the Client's fund by selling substantial amounts of timberland property owned by the fund. The SEC alleges that, in violation of ERISA (which prohibits investment advisers from selling pension plan assets to other funds that they manage) and in violation of the operating agreement entered into between itself and the Client, Timbervest and the Principals sold the Client's fund property to another fund managed by Timbervest and concealed the unauthorized nature of the transaction from the Client through a "parking arrangement" with a middleman.

c. The SEC alleges that the Principals sold the property to a real estate company with the understanding that they would repurchase it in the near future. Six months later, Timbervest repurchased the property with cash from another fund that it managed, paying an undisclosed $1.05 million "parking fee" to the middleman. The SEC alleges that the Principals received unauthorized and undisclosed commissions from the Client's pension fund assets related to the sale of the property. The payments were made to two shell companies that were beneficially owned by one of the Principals. Those companies performed no services in connection with the sale and were established for the sole purpose of receiving the commissions. The SEC alleges that the shell companies were structured to conceal the identity of the recipients and that the commissions were remitted in such a way as to obfuscate the fact that they went to the Principals.

d. The SEC's Order alleges that as a result of these actions, Timbervest violated Sections 206(1) and 206(2) of the Advisers Act and that the Principals willfully aided, abetted, or caused these violations.

e. In an initial decision dated August 20, 2014, Timbervest was found to have violated Section 206(1) and 206(2) of the Advisers Act, and Joel Barth Shapiro, Walter William Anthony Boden, III, Donald David Zell, Jr., and Gordon Jones II were found to have aided and abetted and caused Timbervest's violations of Sections 206(1) and 206(2) of the Advisers Act. The respondents were ordered to cease and desist from further violations of the Advisers Act and to disgorge $1,899,348.49 plus prejudgment interest.

f. The SEC granted petitions for review of the initial decision.

4. *In the Matter of ZPR Investment Management, Inc. and Max E. Zavanelli*, Admin. Proc. No. 3-15263 (Apr. 4, 2013)

   a. The SEC initiated administrative and cease-and-desist proceedings against ZPR Investment Management, Inc. ("ZPR" or "the firm") and its president, Max E. Zavanelli (collectively, "Respondents"), alleging that they distributed misleading advertisements that overstated the firm's performance in relation to its benchmark and falsely claimed compliance with Global Investment Performance Standards ("GIPS").

   b. The SEC alleged that Respondents omitted material information from advertisements in financial magazines that would have revealed the firm was underperforming its benchmark index, rather than outperforming it as suggested in the advertisements, by including only long-term capitalized returns and omitting period-to-date performance.

   c. Respondents claimed, in magazine advertisements and in newsletters distributed to clients and published on the firm's website, that the firm was in compliance with GIPS relating to the calculation and reporting of investment results, yet failed to include with those claims GIPS-required information, such as composite period-to-date performance returns. The SEC alleges that by omitting the required information, Respondents were able to conceal that ZPR was underperforming the market.

   d. The SEC further alleged that Respondents made false statements in reports to Morningstar, Inc. (i) overstating the time period during which its performance figures had been audited for GIPS compliance; and (ii) indicating that it was not under a pending SEC investigation.

   e. Respondents are charged with willfully violating Sections 206(1) and 206(2) of the Advisers Act. Zavanelli, in the alternative, is charged with aiding and abetting ZPR's alleged violations of Sections 206(1) and 206(2) of the Advisers Act. Further, ZPR is charged with willfully violating, and Zavanelli is charged with willfully aiding and abetting and causing ZPR to violate, Section 206(4) of the Advisers Act and Rule 206(4)-1(a)(5) thereunder.

   f. In an initial decision dated May 27, 2014, ZPR was found to have violated Sections 206(1), 206(2), and 206(4) of the Advisers Act by misrepresenting compliance with GIPS in magazine advertisements and investment report newsletters, and to have violated Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-(a)(5) thereunder by making misrepresentations to

Morningstar, Inc. (Morningstar), resulting in two false Morningstar reports on ZPR. Zavanelli was found to have aided and abetted ZPR's violations of Sections 206(1), 206(2), and 206(4) of the Advisers Act regarding the magazine advertisements and investment report newsletters.

g. The initial decision ordered, as to ZPR, a censure, a cease-and-desist order, and civil penalties of $250,000, and as to Zavanelli, a permanent bar from association with any investment adviser, broker, dealer, municipal securities dealer, municipal advisor, transfer agent, and nationally recognized statistical rating organization; a cease-and-desist order; and civil penalties of $660,000.

h. The SEC granted a petition to review the initial decision.

5. *Securities and Exchange Commission v. New Stream Capital, LLC, New Stream Capital (Cayman), Ltd., David A. Bryson, Bart C. Gutekunst, Richard Pereira, and Tara Bryson, et al.*, Civil Action No. 3:13-cv-264 (D. Conn. Feb. 26, 2013)

a. On February 26, 2013, the SEC filed an action in the United States District Court for the District of Connecticut against hedge fund managers David Bryson and Bart Gutekunst, and their unregistered investment advisory firm, New Stream Capital, LLC, for undertaking a scheme and making false statements about their fund's capital structure and financial condition in violation of Section 17(a) of the Securities Act, Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5 thereunder, and Sections 206(1), 206(2), and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder. The SEC also charged New Stream Capital (Cayman), Ltd., a Caymanian adviser entity affiliated with New Stream, Richard Pereira, New Stream's former CFO, and Tara Bryson, New Stream's former head of investor relations, for their alleged role in the scheme.

b. In March 2008, defendants allegedly schemed to secretly revise the hedge fund's capital structure in response to a threat by its largest investor, Gottex Fund Management Ltd., that it would redeem its nearly $300 million investment in the fund unless preferential liquidation rights that Gottex had previously enjoyed were restored.

c. The SEC alleged that, after revising the capital structure to afford Gottex and certain other preferred investors priority over other investors in the event of a liquidation, defendants falsified the fund's financial statements to conceal the restructuring and

continued to market the fund as if all investors had equal liquidation rights. New Stream raised nearly $50 million in new investor funds and secured increased advisory fees on the basis of these misrepresentations.

d. The SEC further alleged that defendants misled investors about the level of redemption requests it received from Gottex and others. By September 2008, as the financial crisis worsened, the fund faced $545 million in redemption requests. In response, it suspended redemptions and fund raising. The fund ultimately filed for bankruptcy. According to the SEC, the defrauded investors are expected to receive approximately five cents on the dollar – substantially less than what Gottex and other preferred investors are expected to receive.

e. In settlement of the SEC's charges against her, Tara Bryson, the fund's former head of investor relations, consented to the entry of final judgment that permanently enjoins her from violating, inter alia, Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder, and bars her from associating with any investment adviser, broker-dealer, municipal securities dealer or transfer agent.

f. The SEC's case against the remaining defendants remains pending. Its complaint seeks a final judgment permanently enjoining them from committing future violations of these provisions, ordering them to disgorge their ill-gotten gains plus prejudgment interest, and imposing financial penalties.

F. Pay-to-Play Rules

1. In FY 2014, the SEC brought the first action involving violations of the investment adviser pay-to-play rules.

2. *In the Matter of TL Ventures Inc.*, Admin. Proc. File No. 3-15940 (June 20, 2014)

a. The SEC filed a settled administrative proceeding against TL Ventures Inc. ("TLV"), a private equity firm, alleging that TLV violated the investment adviser pay-to-play rules and failed to register as an investment adviser with the SEC.

b. TLV violated the pay-to-play rules when a covered associate of TLV made contributions to the campaigns of a candidate for Mayor of Philadelphia and to the Governor of Pennsylvania. The Mayor of Philadelphia and the Governor appoint members to boards of city and state pension systems, respectively, both of which were limited partners in two TLV funds. During the two

years following the campaign contributions, TLV continued to provide investment advisory services to those funds and receive advisory fees for those services.

c. In addition, TLV and Penn Mezzanine Partners Management, L.P. ("Penn Mezzanine"), a related investment adviser, each claimed to be exempt from registration with the SEC. The SEC alleged that the "facts and circumstances surrounding their relationship indicate that the two advisers were under common control, were not operationally independent of each other and thus should have been integrated as a single investment adviser for purposes of the applicable registration requirement and the applicability of any exemption," and that once integrated the two firms would not qualify for any exemption.

d. The SEC's Order alleges that, as a result, TLV willfully violated Sections 203(a), 206(4), and 208(d) of the Advisers Act and Rule 206(4)-5 thereunder.

e. In accepting TLV's settlement offer, the SEC considered steps TLV was undertaking to reorganize its operations and separate its advisory functions from Penn Mezzanine and adoption of policies and procedures reasonably designed to ensure compliance with the applicable rules.

f. The SEC ordered TLV to cease and desist from further violations of the Advisers Act, censured TLV, and ordered TLV to pay disgorgement of $256,697 and prejudgment interest of $3,197.

G. Compliance Reviews, Policies and Procedures

1. The SEC has continued to focus on advisers and their associated persons who failed to have in place required policies and procedures or failed to follow required procedures or to conduct annual compliance reviews under Advisers Act Rule 206(4). Two of the cases discussed below also point to the importance of correcting deficiencies noted in prior SEC examinations, while another involved compliance with the Advisers Act's personal trading requirements.

2. *In the Matter of Barclays Capital, Inc.*, Admin. Proc. File No. 3-16154 (Sept. 23, 2014)

a. The SEC filed a settled administrative proceeding against Barclays Capital, Inc. ("Barclays"), a dually registered investment adviser and broker-dealer, for failing to take steps needed to ensure that its infrastructure was enhanced to support an advisory business acquired from Lehman Brothers Inc., failing to adopt and implement written policies and procedures reasonably designed to

prevent violations of the Advisers Act, and failing to make and keep certain required books and records.

b. The SEC alleged that these failures led to additional violations of the Advisers Act. For example, Barclays executed more than 1,500 principal transactions with its advisory client accounts without making the required written disclosures or obtaining client consent. Barclays also earned revenues and charged commissions and fees that were inconsistent with its disclosures for 2,785 advisory client accounts. Barclays also violated custody provisions of the Advisers Act, and underreported its assets under management by $754 million when it amended its Form ADV on March 31, 2011. The violations resulted in overcharges and client losses of approximately $472,000 and additional revenue to Barclays of more than $3.1 million.

c. The SEC alleged that Barclays willfully violated Sections 204(a), 206(2), 206(3), 206(4), and 207 of the Advisers Act and Rules 204-2(a)(8), 204-2(a)(15), 206(4)-2, and 206(4)-7 thereunder.

d. In considering Barclays' offer of settlement, the SEC considered certain remedial efforts. Barclays reimbursed or credited its affected clients approximately $3.8 million, including interest, and developed and is implementing an action plan in consultation with outside experts.

e. Barclays was ordered to cease and desist from further violations of the Advisers Act, was censured, and was ordered to pay a civil money penalty of $15 million.

3. *In the Matter of IMC Asset Management, Inc.*, Admin. Proc. File No. 3-15190 (Jan. 29, 2013)

a. The SEC filed a settled administrative proceeding against IMC Asset Management, Inc. ("IMCAM"), a registered investment adviser, alleging that the firm failed to conduct annual compliance reviews, employed a compliance officer who performed virtually no compliance functions and failed to adopt and implement written compliance policies and procedures reasonably designed to prevent such violations.

b. According to the SEC, from April 2009 through June 2010, IMCAM employed a chief compliance officer who had no prior compliance experience and who performed virtually no compliance-related functions. Additionally, for more than three years, IMCAM's only written compliance policies and procedures were designed primarily to address IMCAM's predecessor's

broker-dealer activities, did not apply to IMCAM's advisory business and, upon the broker-dealer's withdrawal from registration as a broker-dealer, no longer applied at all to the firm. Further, the firm failed to conduct an annual review of its policies and procedures. During this time, IMCAM provided discretionary investment management services to collateralized debt obligations and two offshore investment funds.

c. Subsequent to an SEC examination that was initiated in November 2010 and that resulted in a deficiency letter issued on March 10, 2011, IMCAM made a number of enhancements to its compliance program. However, in July 2012, IMCAM terminated its CCO and again designated a current employee with minimal compliance experience or training as CCO.

d. The SEC's settled Order charged that IMCAM violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder.

e. Pursuant to the settlement, IMCAM consented to a cease-and-desist order, a censure and a civil penalty of $30,000. IMCAM also agreed to require its CCO to complete comprehensive training on Advisers Act compliance requirements and to retain a compliance consultant for two years.

4. *In the Matter of Equitas Capital Advisors, LLC ("Equitas"), Equitas Partners, LLC ("Equitas Partners"), David S. Thomas, Jr., and Susan Christina*, Admin. Proc. File No. 3-15585 (Oct. 23, 2013)

a. The SEC filed a settled administrative proceeding against Equitas, a registered investment adviser, arising from its alleged inadvertent over-billing and under-billing of certain clients and negligently making false and misleading disclosures to clients and potential clients about its historical performance, compensation, conflicts of interest and prior examination deficiencies. The settled administrative proceeding also named Equitas Partners, a registered investment adviser under common control with Equitas, for allegedly failing to conduct annual compliance reviews and, as with Equitas, failing to maintain written policies and procedures. David Thomas, the principal and CEO of the two advisers, and Susan Christina, their CCO, were also charged.

b. The SEC alleged that from at least January 2008 through 2010, Equitas overcharged at least 16 clients a total of approximately $70,826 for investment advisory services and undercharged 44 clients a total of approximately $411,855. According to the Order, Equitas refunded the overcharged amounts, plus interest, and decided not to pursue collections of the undercharged amounts.

The SEC alleged that although these billing errors were inadvertent, they resulted from Equitas's failure to adopt and implement sufficient policies and procedures reasonably designed to prevent billing errors. These compliance exceptions were identified in three SEC examinations occurring in 2005, 2008 and 2011.

c. In addition, the SEC alleged that despite prior warning from the staff about inadequate and misleading disclosure regarding fee offsets, credit balances and the conflicts created by each, Equitas failed to sufficiently remedy such disclosure in client communications. The SEC further alleged that Equitas failed to disclose financial incentives to recommend that clients invest in a related fund-of-fund vehicle and that Equitas distributed advertisements containing misleading and out-dated historical performance and advertisements without appropriate disclosures. Equitas and Equitas Partners also allegedly failed to conduct annual reviews of their compliance policies and procedures as noted in the deficiency letters the firms received. According to the SEC, Christina was partially responsible for failing to conduct annual reviews in accordance with the SEC's prior examination comments and she also did not take sufficient steps to make compliance improvements that she herself identified.

d. The SEC further alleged that in 2005, 2008 and 2011, the Staff notified Equitas and Thomas orally and in writing about numerous deficiencies, which Equitas, Equitas Partners, and Thomas should have disclosed, but did not disclose, to potential clients in response to questions posed in certain RFPs and due diligence questionnaires.

e. The SEC's Order charged (i) that Equitas violated Sections 206(2), 206(4), and 207 of the Advisers Act and Rules 206(4)-1(a)(5) and 206(4)-7 thereunder; (ii) that Equitas Partners violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder; (iii) that Thomas aided and abetted and caused Equitas's violation of Section 206(4) of the Advisers Act and Rules 206(4)-1(a)(5) and 206(4)-7 thereunder and Equitas Partners's violations of Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder; and (iv) that Christina aided and abetted and caused Equitas's and Equitas Partners's violations of Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder.

f. Pursuant to the settlement, Equitas consented to a cease-and-desist order and a censure, and to pay a civil monetary penalty of $100,000. Equitas Partners consented to a cease-and-desist order and a censure. Thomas consented to a cease-and-desist order and

to pay a civil monetary penalty of $35,000. Christina consented to a cease-and-desist order.

5. *In the Matter of Modern Portfolio Management, Inc. ("MPM"), G. Thomas Damasco II, and Bryan F. Ohm*, Admin. Proc. File No. 3-15583 (Oct. 23, 2013)

a. The SEC filed a settled administrative proceeding against MPM, an SEC-registered investment adviser, and its principals, Damasco and Ohm, for allegedly failing to correct ongoing violations of the Advisers Act, including by failing to complete an annual compliance review, making misleading statements on MPM's website, omitting disclosures in its performance information that were required by MPM's own policies and procedures, and making misleading statements in its performance information by providing model results that did not deduct advisory fees. The SEC further alleged that despite providing assurances that the violations would be corrected, the same failures were identified in a subsequent SEC examination. The SEC alleged that Damasco and Ohm were aware of the deficiencies identified in the initial 2008 examination and did not take appropriate corrective steps to prevent future violations.

b. The SEC alleged that MPM's policies and procedures required, among other things, that MPM's CCO complete annual compliance reviews, and that MPM's marketing materials "be truthful and accurate, and prepared and presented in a manner consistent with applicable rules and regulatory guidelines," and that "all relevant disclosures and facts be made as necessary in marketing materials," including "making any and all disclosures required by the Clover Capital Management no-action letter." The SEC further alleged that Damasco and Ohm were responsible for reviewing such materials but delegated that responsibility to MPM's chief operating officer; however, they were unaware of and took no steps to determine, whether the COO was familiar with the Clover Capital Management no-action letter or the rules and regulatory guidelines applicable to marketing materials.

c. The SEC staff conducted an examination in 2008 in which the staff identified compliance failures relating to annual compliance reviews and misleading information in MPM's marketing materials. The SEC alleged that the Staff sent a deficiency letter to MPM identifying the compliance failures and stating its concern whether the MPM's designated chief compliance officer was sufficiently knowledgeable to administer the compliance program. The SEC further alleged that Damasco and Ohm sent a written response to the deficiency letter providing assurances that MPM

would take corrective action to remedy the compliance exceptions noted in the deficiency letter.

d. The SEC Staff commenced a subsequent examination in 2011 where it found that MPM, among other things, had not taken sufficient steps to remedy the deficiencies identified in its 2008 examination.

e. The SEC alleged that MPM violated Sections 206(2) and 206(4) of the Advisers Act and Rules 206(4)-1(a)(5) and 206(4)-7 thereunder. The SEC also alleged that Damasco and Ohm aided and abetted and caused MPM's violations of Advisers Act Sections 206(2) and 206(4) of the Advisers Act and Rules 206(4)-1(a)(5) and 206(4)-7 thereunder.

f. MPM consented to a cease-and-desist order and a censure, and to pay a civil monetary penalty in the amount of $75,000. Damasco consented to a cease-and-desist order and a censure, and to pay a civil monetary penalty of $25,000. Ohm consented to a cease-and-desist order and a censure, and to pay a civil monetary penalty of $50,000. Further, Damasco and Ohm undertook to complete thirty hours of compliance training relating to the Advisers Act. MPM agreed to continue to retain a compliance consultant to provide ongoing compliance services for three years and to designate a new CCO.

g. In considering the settlement, the SEC took into account the remedial actions promptly undertaken by MPM, Damasco and Ohm, including engaging a compliance consultant, and the cooperation afforded to the SEC Staff.

6. *In the Matter of Carl D. Johns*, Admin. Proc. File No. 3-15440 (Aug. 27, 2013)

a. The SEC filed a settled administrative proceeding against Carl D. Johns, an assistant portfolio manager to several registered investment companies (the "Boulder Funds"), alleging that Johns failed to comply with SEC reporting requirements regarding personal securities trading and that Johns failed to comply with the reporting and pre-clearance requirements for personal securities transactions outlined in the Code of Ethics of the investment advisers with which Johns was associated ("Code of Ethics"). The SEC further alleged that Johns intentionally misled the chief compliance officers of the investment advisers with which he was associated, in violation of Rule 38a-1(c) of the Investment Company Act. Notably, this is the first time the SEC issued an order alleging violations of Rule 38a-1(c).

b. According to the Order, Johns was required to submit quarterly reports of his securities transactions and annual reports of his securities holdings under Rule 17j-1 of the Investment Company Act. Further, under the Code of Ethics, Johns was (i) required to pre-clear all securities transactions, subject to limited exceptions, (ii) restricted from trading in securities that the Boulder Funds were buying or selling, and (iii) required to certify annually that he had complied with the terms of the Code of Ethics.

c. The SEC alleged that Johns engaged in active personal trading in securities, including securities of companies held or to be acquired by the Boulder Funds, without complying with the SEC's reporting requirements or the Code of Ethics. Specifically, the SEC alleged that between 2006 and 2010 Johns executed approximately 850 personal securities transactions, approximately 640 of which were not pre-cleared or reported. The SEC also alleged that in order to conceal his personal securities trading, Johns submitted false quarterly and annual reports, and falsely certified his annual compliance with the Code of Ethics. The SEC further alleged that Johns physically altered brokerage statements, trade confirmations and pre-clearance approvals.

d. The SEC's Order charged that Johns violated Section 17(j) of the Investment Company Act and Rules 17j-1(b), 17j-1(d), and 38a-1(c) thereunder.

e. Pursuant to the settlement, Johns consented to a cease-and-desist order and to pay disgorgement of $231,169, prejudgment interest of $23,889, and a civil monetary penalty of $100,000. Johns further consented to being barred from the securities industry with the right to reapply for reentry after five years.

H. Custody Rule

1. The cases discussed below, three of which were all announced on the same day by the SEC, demonstrate a renewed focus on compliance with the Advisers Act's Custody Rule. An additional action against an individual is also summarized in this section.

2. *In the Matter of Further Lane Asset Management, LLC, Osprey Group, Inc. and Jose Miguel Araiz a/k/a Joseph Michael Araiz*, Admin. Proc. File No. 3-15590 (Oct. 28, 2013)

a. The SEC filed a settled administrative proceeding against Further Lane Asset Management ("FLAM"), Osprey Group, Inc. ("OGI") (an adviser associated with FLAM) and Araiz, FLAM's CEO and CCO, for allegedly failing to arrange for an annual surprise

examination in accordance with the Custody Rule. FLAM also allegedly caused a fund-of-funds under its control to invest in instruments that materially differed from its investment strategy, failed to obtain client consent prior to engaging in principal transactions, failed to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and failed to maintain certain required books and records. FLAM advises three hedge funds and a number of separately managed accounts, and OGI manages a fourth hedge fund.

b. During a prior SEC examination in 2003, FLAM received a deficiency letter advising FLAM of certain issues associated with the custody of client assets and noting that it had engaged in principal transactions without prior client consent. The SEC alleged that in 2008, FLAM and Araiz caused a hedge fund with a fund-of-funds strategy to invest in promissory notes issued by entities that were controlled by Araiz, causing the fund to materially deviate from its investment strategy. FLAM did not provide investors with notice of the change in the fund's investment strategy or disclose that it had acquired promissory notes that constituted 58% of the portfolio.

c. Although FLAM was deemed to have custody of client funds and securities because it had physical possession of the promissory notes and due to the fact that FLAM and its affiliates served as general partners of the fund, it allegedly violated the Custody Rule by failing to be subject to an annual surprise examination for four consecutive years.

d. The SEC also alleged that FLAM and OGI engaged in undisclosed principal transactions in their clients' accounts through their affiliated broker-dealer without obtaining appropriate consent. With respect to their hedge fund clients, FLAM and OGI engaged in unlawful principal transactions because the limited partnership agreements for those funds required FLAM and OGI to obtain investors' consent to principal trades. FLAM and OGI allegedly failed to do so. The affiliated broker allegedly earned markups and markdowns of at least $312,760 on those principal transactions.

e. FLAM's Form ADV also allegedly contained false statements in that it stated that FLAM did not have custody over client assets and did not engage in principal transactions. Finally, the SEC alleged that FLAM's compliance manual was materially outdated, FLAM failed to conduct an annual compliance review and FLAM failed to maintain certain books and records relating to order tickets,

correspondence with clients, contracts related to the firm's business, and custody.

f. The SEC's settled Order charged that FLAM violated Sections 206(2), 206(3), 206(4), 204(a) and 207 of the Advisers Act and Rules 206(4)-8, 206(4)-2, 206(4)-7, 204-2(a)(3), 204-2(a)(7), 204-2(a)(10) and 204-2(a)(17) thereunder, that Araiz committed, aided and abetted and caused certain of these same violations, and that OGI violated Section 206(3) of the Advisers Act.

g. Pursuant to the settlement, the respondents each consented to a cease-and-desist order and a censure. FLAM, OGI and Araiz also agreed to pay disgorgement of $338,017 and prejudgment interest of $9,105. FLAM also undertook to, among other things, implement a new set of compliance policies, develop a new supervisory framework and internal controls, conduct the annual reviews required under Rule 206(4)-7 for 2013 and 2014, prominently display a summary of the SEC Order with a link to the entire Order on its website and distribute the Order to existing clients and investors. It also agreed that for a period of five years from the entry of the Order it would employ a CCO who does not simultaneously hold any other officer or employee position at FLAM.

3. *In the Matter of GW & Wade, LLC*, Admin. Proc. File No. 3-15589 (Oct. 28, 2013)

a. The SEC filed a settled administrative proceeding against GW & Wade, LLC ("GW & Wade") alleging that GW & Wade violated the Custody Rule and failed to adequately implement its policies and procedures for calculating advisory fees for discretionary accounts.

b. The SEC alleged that GW & Wade used pre-signed Letters of Authorization ("LOAs") for over 900 accounts. The pre-signed LOAs permitted GW & Wade to transfer client funds without obtaining client signatures in connection with each transfer. This practice allegedly contributed to a third-party fraud that occurred in one client account.

c. GW & Wade was deemed to have custody of client assets for those accounts for which it maintained pre-signed LOAs, as well as for other accounts where it has been granted check-writing authority or possessed login information and passwords for outside client accounts such as employee retirement and brokerage accounts. Although it was deemed to have custody over client assets, GW & Wade allegedly failed to obtain annual surprise audits, as required

by the Custody Rule, inaccurately disclosed the amount of assets over which it had custody, failed to implement appropriate policies and procedures to keep client assets safe, and failed to maintain appropriate books and records.

d. Finally, the SEC alleged that GW & Wade overbilled certain clients by incorrectly including class C shares in advisory fee calculations when it had a policy of excluding class C shares from its fee calculation.

e. The SEC's settled Order charged that GW & Wade violated Sections 206(4), 207 and 204 of the Advisers Act and Rules 206(4)-2, 206(4)-7, 204-2(a)(3) and 204-2(b)(1) thereunder.

f. Pursuant to the settlement, GW & Wade consented to a cease-and-desist order and a censure, and to pay a civil monetary penalty of $250,000. GW & Wade also agreed to hire an independent compliance consultant to review its written compliance policies and procedures relating to custody and the calculation of advisory fees.

g. In considering the settlement, the SEC took into account remedial acts undertaken by GW & Wade, including (i) implementing a Wire, Checks and Journal Disbursements Policy that eliminates the use of pre-signed LOAs; (ii) agreeing to implement an account management system under which access to most client accounts is read-only; (iii) implementing policies and procedures for password and login information for client accounts and maintaining books and records of all transactions in custodied outside accounts; (iv) implementing a policy for heightened review of client bills to prevent overbilling; and (v) reimbursing overcharged clients.

4. *In the Matter of Knelman Asset Management Group, LLC and Irving P. Knelman*, Admin. Proc. File No. 3-15588 (Oct. 28, 2013)

a. The SEC filed a settled administrative proceeding against Knelman Asset Management Group, LLC ("KAMG") and Knelman, KAMG's CEO and CCO, for allegedly violating the Custody Rule, using a distribution methodology that differed from a fund's LLC Agreement and PPM, failing to conduct an annual compliance review, failing to maintain certain books and records, and making false statements on KAMG's Form ADV.

b. The SEC alleged that KAMG, which was the manager of Rancho Partners I, LLC ("Rancho"), a fund of private equity funds, did not maintain Rancho's assets with a qualified custodian as required by the Custody Rule. Further, the SEC alleged that Rancho's funds

were not subject to annual surprise examinations and its financial statements were not audited or distributed to members. Further, KAMG was aware of the custody issue as it had previously received a deficiency letter in 2005 notifying the firm of Custody Rule violations.

c. The SEC also alleged that KAMG made improper distributions to members by allocating distributions to clients pro rata based on members' capital commitments rather than on their capital account balances as set forth in Rancho's LLC Agreement and PPM. Further, the SEC alleged that KAMG made improper discretionary cash distributions to some, but not all, of Rancho's members.

d. The SEC also alleged that KAMG failed to adopt written policies and procedures reasonably designed to prevent violations of the Custody Rule and failed to conduct annual compliance reviews. KAMG also allegedly failed to keep certain books and records and made false statements on its Form ADV, stating that it did not have custody of client assets.

e. The SEC's alleged Order charged that KAMG and Knelman violated Sections 206(2), 206(4) and 207 of the Advisers Act and Rule 206(4)-8 thereunder. The SEC also alleged that KAMG violated, and Knelman aided and abetted KAMG's violation of, Sections 206(4) and 204 of the Advisers Act and Rules 206(4)-2, 206(4)-7, 206(4)-8, 204-2(b)(1), 204-2(b)(2) and 204-2(c)(2) thereunder.

f. Pursuant to the settlement, KAMG consented to a cease-and-desist order and a censure, and to pay a civil monetary penalty of $60,000. KAMG also agreed to retain an independent compliance consultant, hire a new CCO other than Knelman, and deliver a copy of the SEC Order to existing clients and investors. Knelman consented to a cease-and-desist order, to be barred from acting as CCO of any SEC registrant for three years, to pay a civil monetary penalty of $75,000, and to complete thirty hours of compliance training.

g. In considering the settlement, the SEC took into account remedial acts promptly undertaken by KAMG.

5. *In the Matter of Mark M. Wayne*, Admin. Proc. File No. 3-15644 (Dec. 12, 2013)

a. The SEC filed a settled administrative proceeding against Mark M. Wayne, the former president, CEO and CCO of Freedom One Investment Advisers, Inc. ("Freedom One"), alleging that Wayne

and Freedom One failed to comply with various provisions of the Custody Rule.

b. The SEC alleged that, from 2008 through 2010, Freedom One was deemed to have custody of client assets held in two omnibus accounts because its affiliate had the authority to direct the custodians to make client distributions. Despite the fact that Freedom One was deemed to have custody over those assets, it allegedly failed to have an independent public accountant conduct annual surprise exams to verify those assets. According to the SEC, Freedom One engaged an accountant to perform a surprise exam in 2008, but Wayne took no action to determine whether the accountant completed the examination. For 2009 and 2010, Wayne allegedly delegated responsibility for the surprise examinations to an employee who did not have any training or experience in investment advisory regulation or compliance and was not familiar with which accounts Freedom One was deemed to have custody of. The 2009 and 2010 examinations were completed by another accounting firm, but they were deficient because they apparently covered only one of the omnibus accounts that contained client assets.

c. The SEC further alleged that Freedom One violated the Custody Rule's account statement delivery requirement because during 2008 and 2009, an affiliate of Freedom One that was not a qualified custodian delivered quarterly account statements in violation of the requirement under the prior version of the Custody Rule that a qualified custodian provide statements to clients. Furthermore, for 2010, when the current version of the Custody Rule became effective, Freedom One was required to have a reasonable basis for believing that a qualified custodian was sending quarterly statements to clients, but it failed to do so.

d. The SEC also alleged that, from October 2008 through March 2011, Freedom One's policies and procedures, which Wayne approved in his capacity as CCO, were not reasonably designed to prevent violations of the Custody Rule and that, from January 2009 through July 2010, certain Freedom One transactions were not properly reflected in its books and records. According to the SEC, Wayne appointed a controller who lacked the necessary skills and did not provide the controller with adequate support and training to maintain the firm's books and records accurately.

e. The SEC alleged that Wayne willfully aided and abetted and caused Freedom One's violations of Sections 204 and 206(4) of the Advisers Act and Rules 204-2, 206(4)-2 and 206(4)-7 thereunder.

f. Wayne agreed to a cease-and-desist order, to complete 30 hours of compliance training relating to the Adviser's Act and to be barred for one year from acting as the chief compliance officer for any firm in the securities industry. Further, Wayne agreed to pay a civil monetary penalty of $40,000.

g. In a separate case, the SEC filed a settled administrative proceeding against Rodney A. Smith, Michael Santicchia, CPA, and Stephen D. Cheaney, CPA (the "Accountants"), who were associated with one of the accounting firms engaged to conduct surprise exams of Freedom One. The SEC alleged that the Accountants failed to perform the surprise exams (i.e., conduct fieldwork, prepare and issue a surprise exam report and file Form ADV-E) that they were hired to complete. According to the SEC Order, the Accountants caused or willfully aided and abetted Freedom One's violations of Section 206(4) of the Advisers Act and Rule 206(4)-2 thereunder, and two of the Accountants engaged in improper professional conduct within the meaning of Section 4C of the Exchange Act and Rule 102(e)(1)(ii) of the SEC's Rules of Practice. The Accountants agreed to be denied the privilege of appearing or practicing before the SEC as accountants, with the possibility of applying for reinstatement in two or three years, subject to certain conditions. *See In the Matter of Rodney A. Smith, Michael Santicchia, CPA, and Stephen D. Cheaney, CPA*, Admin Proc. File No. 3-15645 (Dec, 12, 2013).

I. Internal Controls

1. Some of the SEC's top priorities for broker-dealer enforcement include (i) effectiveness of key control functions (liquidity, credit, and market risk management practices); (ii) internal audit function; (iii) valuation practices; and (iv) overall compliance function. Last year the SEC brought its first Market Access Rule case.

2. *In the Matter of Knight Capital Americas LLC*, Admin. Proc. File No. 3-15570 (Oct. 16, 2013)

a. On October 16, 2013, the SEC announced that Knight Capital Americas LLC ("Knight") had agreed to settle charges that it had violated the Market Access Rule, Exchange Act Rule 15c-3-5, which requires brokers and dealers to have risk controls in place before providing their customers with access to the market. In its first enforcement case under the 2010 rule, the SEC alleged that Knight failed to have in place a system of risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory and other risks of market access. As a result, Knight failed to prevent a significant error in the

operation of its automated routing system for equity orders, with the result that the system routed millions of erroneous orders into the market, leaving Knight with billions of dollars in unwanted equity positions and over $460 million in losses associated with those positions.

b. According to the SEC, Knight deployed new software code in its automated, high-speed, algorithmic order routing system, called SMARS, as part of an effort designed to facilitate customer participation in the Retail Liquidity Program ("RLP") at the New York Stock Exchange. The new code was deployed in stages on eight servers on successive days. In that process, a Knight technician failed to copy the new code to one of the designated servers. Knight did not have written procedures requiring a review of the deployment, and a second technician did not review it. As a result, Knight did not detect that the new SMARS code had not been installed on the eighth server, or that unused code from a discontinued parent-child order functionality had not been removed from that server. On August 1, 2012, the first day that Knight received RLP-eligible orders, the seven servers on which the new SMARS code had been deployed processed them correctly; orders sent to the eighth server triggered the obsolete code, which caused the generation of millions of erroneous child orders and, consequently, millions of erroneous executions. In the 45 minutes before the error was detected, Knight inadvertently accumulated a net long position of approximately $3.5 billion in 80 stocks and a net short position of approximately $3.15 billion in 74 securities.

c. The SEC also alleged that on the morning of August 1, 2012, before the markets opened, a Knight system generated nearly 100 automated emails that referenced SMARS and identified an error. Although email messages of the kind generated on that date were not designed as alerts and were not generally reviewed by recipients when received, the SEC alleged that the messages were caused by the deployment failure and provided a potential opportunity to detect and correct the coding errors prior to the market open and to diagnose the problem after the open.

d. In addition to the market access rule violation, the SEC also charged Knight with violations of Rules 200(g) and 203(b) of Regulation SHO. Without admitting or denying the SEC's findings, Knight consented to an order imposing a censure and ordering it to cease and desist from committing or causing violations of the noted rules, and agreed to pay a $12 million penalty and retain an independent consultant to conduct a

comprehensive review of the firm's controls and procedures to ensure compliance with the market access rule.

J. Anti-Money Laundering ("AML")

1. The SEC's top priorities for broker-dealer enforcement in the AML space include a focus on AML programs of proprietary trading firms that allow customers direct access to the markets from higher-risk jurisdictions.

K. Fixed Income Markets

1. The SEC's top priorities for broker-dealer enforcement in the fixed income market include (i) the structure and transparency of the market and its effect on the quality of executions; (ii) the use of filters by market participants to control what is displayed by fixed income alternative trading systems ("ATSs"); and (iii) a focus on transparency in the municipal securities market (e.g., riskless principal markup disclosure).

VI. Recent Developments Expanding Oversight of Advisers

A. SEC Funding for FY 2015

1. "There is an immediate and pressing need for significant additional resources to permit the SEC to increase its examination coverage of registered investment advisers so as to better protect investors and our markets."[16]

2. During FY 2014, the SEC examined 10% of advisers comprising more than 30% of assets under management.

3. A "top priority" is to add 316 additional OCIE staff to examine more registered firms in the investment management industry and private fund advisers, among other things.

4. The federal government is operating under a continuing resolution through December 11, 2014, which holds SEC funding at FY 2014 levels.

VII. Current Examination Priorities

A. Market-Wide Initiatives

1. <u>Fraud Detection and Prevention</u>: The SEC has increased its reliance on risk monitoring and data analytics (quantitative and qualitative tools) to identify fraudulent or unethical behavior.

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[16] *Fiscal Year 2015 Budget Hearing – Securities and Exchange Commission, Subcomm. on Fin. Servs. & Gen. Gov't of the H. Comm. on Appropriations* (Apr. 1, 2014) (statement of Mary Jo White, Chair, Securities and Exchange Commission).

a. OCIE's Risk Assessment and Surveillance Group ("RAS"), which has for several years aggregated and analyzed data from SEC filings to identify activity that may warrant examination, expanded its efforts to include data from sources internal and external to the Commission, such as data collected by or filed with other regulators, SROs, and exchanges, and information that registrants provide to data aggregators. This expanded data collection and analysis has enhanced OCIE's ability to identify operational red flags and has enabled examiners to better understand a firm's business activities prior to conducting an examination.

b. OCIE also has highly skilled technologists in its Quantitative Analytics Unit ("QAU") that develop analytic tools for examiners to use. For example, in FY 2014, the QAU developed the National Exam Analytics Tool ("NEAT"). NEAT replaces manual review of a registrant's trading data with a program that can completely and systematically analyze years' worth of trading data in minutes. QAU is also developing technologies to help examiners detect suspicious activity in other areas, such as money laundering and high-frequency trading.

c. OCIE's Risk Analysis Examination Group ("RAE") leverages technology to examine clearing firms and large broker-dealers. In FY 2014, RAE collected and analyzed approximately 1.3 billion transactions from 350 firms. RAE subjects the data analyzed to a broad range of queries designed to identify problematic behavior. This has allowed RAE to identify unsuitable recommendations, misrepresentations, inadequate supervision, churning, and reverse churning. In some cases, RAE's findings have resulted in referrals for focused examinations by OCIE and investigation by Enforcement.

2. Corporate Governance, Conflicts of Interest, and Enterprise Risk Management: OCIE will continue meeting with senior management and boards of directors of registered entities and their affiliates to discuss identification and mitigation of conflicts of interest and risks (e.g., legal, compliance, financial, and operational risks). OCIE's goal is to evaluate "tone at the top"; understand how firms approach conflicts and risk management; and discuss key risks and regulatory requirements.

3. Technology: OCIE is examining how firms govern and supervise information technology systems, operational capability, market access, information security, and preparedness for systems malfunctions and outages. In August 2013, following a review conducted in the aftermath of Hurricane Sandy, the SEC issued a risk alert identifying observations, weaknesses, and possible future considerations regarding business

continuity and disaster recovery plans.[17] OCIE identified the following possible future considerations:

a. Develop policies and procedures to address and anticipate widespread events;

b. Evaluate how the firm will operate when faced with the possibility of loss of electricity and other utility services, such as by having back-up sites or additional sites away from the main office;

c. Review the information technology infrastructure of service providers;

d. Evaluate how the firm would operate if the adviser's or a service provider's facilities were impacted by weather-related events;

e. Consider the availability of alternate internet providers or guaranteed redundancy;

f. Explore whether back-up files and systems should be stored in the adviser's primary office location, and consider contacting clients before a weather-related event to see whether they have any transactions they will need executed;

g. Regularly update business continuity plans to include new regulatory requirements; and

h. Consider testing all critical systems using various scenarios.

4. Dual Registrants: OCIE is looking into how dual registrants influence customers' selection of brokerage and advisory accounts; any risks presented by the migration from brokerage accounts to advisory accounts; and the different supervisory structures and legal standards of conduct that apply when providing brokerage and advisory services. As discussed above, the SEC has brought several enforcement actions involving best execution.

5. New Laws and Regulations: OCIE has also stated that examining for compliance with new laws is a priority. This includes a review of general solicitation practices and verification of accredited investor status under Rule 506(c) under the Securities Act and broker-dealer and investment adviser due diligence for private offerings;[18] compliance with due

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[17] National Exam Program, Risk Alert: SEC Examinations of Business Continuity Plans of Certain Advisers Following Operational Disruptions Caused by Weather-Related Events Last Year (Aug. 27, 2013).

[18] *See* White Paper, Morgan, Lewis & Bockius LLP, SEC Approves General Solicitation in Private Offerings and Proposes Further Regulation D Amendments (July 2013), *available at*

diligence obligations when using alternative investments for advisory clients; and compliance with the rules for municipal advisors adopted in September 2013.

a. In January 2014, OCIE issued a risk alert regarding due diligence investment advisers conduct when selecting alternative investments and their respective managers.[19] The staff observed that advisers are (i) seeking more information from managers; (ii) utilizing third parties to supplement their analyses; (iii) performing additional quantitative analyses and risk measures; and (iv) enhancing and expanding due diligence. Some material deficiencies identified as part of the review included (i) failure of investment advisers to include a review of due diligence policies and procedures for alternative investments in their annual compliance reviews; (ii) disclosures that deviated from actual practice, and advisers that did not review disclosures for consistency with fiduciary principles; (iii) marketing claims that exaggerated the due diligence process; and (iv) failure to address in the code of ethics conflicts of interest created when access persons receive preferential terms when investing in alternative investments.

b. In August 2014, OCIE sent a letter to senior executives and principals of newly registered municipal advisors introducing them to the National Exam Program and outlining the scope of the exam initiative, including an engagement phase, an examination phase, and a phase to inform policy.[20] Examinations would focus on whether municipal advisors are in compliance with SEC and Municipal Securities Rulemaking Board ("MSRB") registration requirements; the municipal advisor's statutory fiduciary duty to municipal entity clients;[21] disclosure, fair dealing, supervision, and training/qualifications requirements under MSRB rules; and books and records requirements under SEC and MSRB rules.

B. Core Risks

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http://www.morganlewis.com/pubs/Securities_WhitePaper_SignificantChangesPrivateOfferingRules_July2013.pdf.

[19] National Exam Program, Risk Alert: Investment Adviser Due Diligence Processes for Selecting Alternative Investments and Their Respective Managers (Jan. 2014).

[20] U.S. Securities and Exchange Commission Office of Compliance Inspections and Examinations, Letter to Senior Executives or Principals of Newly Registered Municipal Advisors (Aug. 19, 2014), *available at* http://www.sec.gov/about/offices/ocie/muni-advisor-letter-081914.pdf.

[21] According to OCIE, this requires the municipal advisor "to act honestly and in the best interest of its client without regard to its own financial or other interests, and to provide full and fair disclosure of material facts and conflicts of interest."

1. Safety of Assets and Custody: OCIE has continued to look at compliance with the custody rule and to confirm the existence of assets using a risk-based verification process. OCIE stated that examiners are paying close attention to instances in which advisers do not realize they have custody. In March 2013, OCIE issued a risk alert regarding custody issues in which it identified the following deficiencies: (i) failure by investment advisers to recognize they have custody; (ii) failure to file Form ADV-E as required or to conduct exams on a surprise basis; (iii) failure to satisfy the requirement that advisers use a qualified custodian; and (iv) failure to comply with the requirements when using the audit approach for pooled investment vehicles.[22] In addition, as discussed above, the SEC has brought several enforcement actions for violations of the custody rule.

2. Conflicts of Interest: OCIE is also reviewing conflicts of interest that are inherent in certain investment adviser business models. Conflicts of interest that OCIE is reviewing include compensation arrangements, allocation of investment opportunities, side-by-side management of accounts, risk controls and disclosure, and higher risk products or strategies targeted to retail investors. Many of the SEC enforcement actions discussed above, such as *In the Matter of Manarin Investment Counsel, Ltd.* and *In the Matter of J.S. Oliver Capital Management, L.P., Ian O. Mausner, and Douglas F. Drennan*, involved conflicts of interest.

3. Marketing and Performance: OCIE is reviewing the accuracy and completeness of any claims investment advisers make about their investment objectives and performance, including hypothetical and back-tested performance; composite performance figures; performance record keeping; and compliance oversight of marketing activities. For an example of marketing and performance issues, see the discussion of *In the Matter of Modern Portfolio Management, Inc. ("MGM"), G. Thomas Damasco II, and Bryan F. Ohm* above.

C. New and Emerging Issues

1. Wrap Fee Programs: OCIE is conducting an assessment of whether advisers are fulfilling their fiduciary and contractual obligations to clients as well as a review of processes for monitoring program recommendations, conflicts, best execution, and trading away, as well as related disclosures.

2. Quantitative Trading Models: OCIE is examining advisers that rely substantially on quantitative portfolio management and trading strategies to assess whether those advisers have adopted and implemented

[22] National Exam Program, Risk Alert: Significant Deficiencies Involving Adviser Custody and Safety of Client Assets (Mar. 2013).

compliance policies and procedures tailored to performance and maintenance of those proprietary models.

3. Payments for Distribution in Guise: OCIE is looking at payments that advisers and funds make to distributors and intermediaries, whether disclosures made to fund boards are adequate, and how boards are overseeing those payments to determine whether the payments are for distribution and preferential treatment.

4. Fixed Income Investment Companies: OCIE is monitoring the impact of a changing interest rate environment on bond funds and related risk disclosures.

5. Money Market Funds: OCIE is targeting examinations at money market funds, with a focus on how those funds manage stress events, and is also working with the Division of Investment Management to identify and examine funds that exhibit outlier behavior.[23]

6. "Alternative" Investment Companies: As discussed above, OCIE is conducting a sweep examination of alternative mutual funds, focusing on valuation of illiquid assets, liquidity disclosures, use of leverage, and board oversight of alternative mutual funds. Additional areas of interest include staffing, funding, and empowerment of boards, compliance personnel, and back offices, and how funds are marketed to investors. In 2014, Norm Champ, Director of the SEC's Division of Investment Management, stated that the sweep "will produce valuable insight into how alternative mutual funds attempt to generate yield and how much risk they undertake, in addition to how well boards are carrying out their oversight duties."[24]

7. Securities Lending Arrangements: OCIE is looking at compliance with exemptive orders and consistency with relevant no-action letters for securities lending arrangements.

VIII. FINRA Developments

A. There were several FINRA enforcement developments of note last year.

B. First, in late 2013, FINRA publicly described its efforts to monitor certain "high-risk" brokers and the firms that hire such individuals. According to FINRA, two

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[23] *See* Morgan, Lewis & Bockius LLP, White Paper, The New Era of Money Market Fund Regulation (Sept. 2014), *available at* http://www.morganlewis.com/pubs/WhitePaper_NewEraOfMoneyMarketFundRegulation_Sept2014.pdf (discussing recent amendments to the regulatory framework of money market funds adopted by the SEC).

[24] Norm Champ, Director, Division of Investment Management, SEC, Remarks to the Practising Law Institute, Private Equity Forum (June 30, 2014), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370542253660#.VGt0vCxOXX4.

of the primary tools used in this area are its Broker Migration Model and Problem Broker Model.[25] The Broker Migration Model tracks the movement of certain registered representatives from firm to firm using a variety of risk metrics. The information developed is used by FINRA's Staff to prioritize its surveillance, examination, and enforcement resources, enabling it to conduct targeted examinations and enforcement actions. The Problem Broker Model identifies and monitors registered representatives who have significant regulatory disclosures. FINRA also uses the information derived from this model to target brokers in its surveillance, examination, and enforcement activities. FINRA has reported that, since February 2013, 42 brokers have been identified as "high-risk," leading to fast-tracked regulatory actions, including 16 completed cases (all of which resulted in bars from the industry). In its 2014 letter setting forth its regulatory and examination priorities, FINRA indicated that it will expand its "high-risk" program and establish a dedicated team within the Department of Enforcement to prosecute such cases.

C. Second, in December 2013, FINRA issued Regulatory Notice 13-27 announcing amendments to Rule 8313, which governs the publicity of its disciplinary actions. Key changes include the elimination of the publicity thresholds in the rule, the establishment of general standards for the release of disciplinary information, and clarity on the scope of information subject to Rule 8313. Of particular note, the prior monetary sanction threshold of $10,000 for publication of disciplinary actions has been eliminated. Effective December 16, 2013, disciplinary complaints and decisions, independent of the sanction amount, will be shared with the public. Moreover, the amendments also changed the scope of the information FINRA will share with the public regarding many types of matters, including temporary cease-and-desist orders ("TCDOs"), statutory disqualification decisions, expedited proceedings, decisions, summary actions, membership application appeals and disciplinary decision appeals to the SEC. These disclosures are subject to limited, case-by-case exceptions at FINRA's discretion.

D. Third, last year, senior FINRA officials emphasized that the agency was focused on responding quickly to address fraudulent conduct. As examples of this effort, in at least two matters in 2013, FINRA filed for TCDOs against firms when it learned of alleged fraudulent conduct. In a matter against Westor Capital Group, Inc. and its president, chief compliance officer, and financial operations principal, Richard Hans Bach, FINRA filed a TCDO and a complaint in January 2013 alleging that the respondents misappropriated and misused customer funds. FINRA alleged that the respondents (i) misused customer securities to effect and cover short sales in other customer accounts without the customers' knowledge and (ii) failed to honor customer requests for withdrawals of funds and delivery of securities. In a separate matter against John Carris Investments, LLC, its chief

[25] *See* FINRA's November 13, 2013 letter to United States Senator Edward J. Markey, *available at* http://www.markey.senate.gov/news/press-releases/markey-urges-finra-to-continue-enforcement-actions-improve-disclosures-on-rogue-brokers. This letter was written in response to an inquiry from Senator Markey regarding concerns about protecting investors from so-called "rogue brokers."

executive officer, George Carris, and five other firm principals, FINRA filed a TCDO and a complaint alleging that the respondents fraudulently solicited customers to buy a certain stock while, at the same time, the respondents were selling their shares in that security. FINRA alleged that the respondents were fraudulently inflating the price of the stock through prearranged trading and unauthorized purchases in customers' accounts.

E. FINRA Cases

1. AML—Failure to Monitor Suspicious Securities Trades: AML cases are a steady part of FINRA's examination and enforcement efforts, and it regularly brings cases in this area. Last year FINRA announced the settlement of three cases (involving Firstrade Securities, Atlas One Financial Group and World Trade Financial Corp.) on the same day. Two other cases began as litigated actions, but were subsequently settled. Moreover, demonstrating its continued emphasis on AML, in its recently published 2014 regulatory and examination priorities letter, FINRA stated that it will focus on AML issues associated with institutional businesses this year.

a. *Firstrade Securities, Inc.* ("Firstrade") (May 7, 2013)

(i) FINRA settled a matter with Firstrade in which it alleged that the firm engaged in certain AML, supervision, and order ticket recording violations.

(ii) Between May 2008 and July 2011, Firstrade, an online trading firm that catered to the Chinese community, failed to implement an adequate AML program to detect and report suspicious transactions, including potential manipulative trading. Specifically, FINRA alleged that Firstrade failed to investigate suspicious activity, including transactions involving certain types of securities, such as penny stocks, pre-arranged trades of Chinese issuer stock done in related accounts, and excessive journal entries between unrelated accounts, in accordance with the firm's procedures.

(iii) In addition, FINRA alleged that Firstrade did not have any procedures for the detection, review, and reporting of suspicious activity related to the deposit of physical certificates and deposits/withdrawals at custodians.

(iv) FINRA also alleged that from May 2008 to March 2010, in a sampling of 30 order tickets for municipal securities, Firstrade failed to include a time of entry on all of the order tickets in the sample.

(v) Firstrade consented to a censure and a $300,000 fine, $25,000 of which pertained to the municipal securities violations.

b. *Atlas One Financial Group, LLC* ("Atlas One") (May 8, 2013)

(i) FINRA settled a matter with Atlas One in which it alleged that, between February 2007 and May 2011, Atlas One failed to establish and implement policies and procedures reasonably designed to detect and cause the reporting of suspicious transactions in accordance with AML rules, failed to maintain accurate books and records, and failed to timely report certain matters.

(ii) Specifically, FINRA alleged that Atlas One's AML program required the firm's chief compliance officer to monitor for potentially suspicious activity and AML red flags and investigate and report suspicious activity by filing a suspicious activity report when necessary, which he failed to do.

(iii) FINRA alleged that Atlas One failed to perform any additional scrutiny of accounts that shared the same contact information as six accounts that were frozen by the United States Department of Justice in connection with a conspiracy to launder hundreds of millions of dollars in a judicial bribery scheme in Italy and engaged in little or no securities activity but conducted approximately 125 wire transfers totaling over $10 million.

(iv) FINRA also alleged that certain customers' accounts engaged in a pattern of activity consisting of moving millions of dollars through customer accounts, which was inconsistent with the customers' stated annual income and liquid net worth (e.g., a customer whose annual income and liquid net worth were $500,000 and $850,000, respectively, later sent an outgoing wire in an amount in excess of $25 million).

(v) FINRA also alleged that Atlas One opened an account for an Argentinean professional polo player who made very few securities transactions and engaged in a pattern of wire transfers in increments of less than $10,000 to and from Nigerian nationals. This activity continued despite concerns from Atlas One's clearing firm.

(vi) In addition, FINRA alleged that Atlas One failed to timely report 16 of the 19 customer grievances it received between November 2008 and April 2012 and to timely update Forms U-4 and U-5 in 14 instances.

(vii) Atlas One consented to a censure and a $350,000 fine ($25,000 of which was joint and several with the chief compliance officer, who also received a three-month suspension from acting in a principal capacity).

c. *World Trade Financial Corp.* ("WTF") (May 8, 2013)

(i) FINRA settled a matter with WTF in which it alleged that between March 2009 and August 2011, WTF bought and sold more than 27.5 billion shares of 12 penny stock issues on behalf of one customer, generating approximately $61 million in investor proceeds, which represented the majority of the firm's business and revenue.

(ii) FINRA alleged that WTF ignored red flags indicating that the customer was engaging in the unlawful distribution of securities.

(iii) FINRA also alleged that WTF traded securities that were not properly registered and were not eligible for an exemption to registration.

(iv) FINRA also alleged that WTF failed to have a program reasonably designed to monitor for and detect and report suspicious activity, which would be considered an AML red flag.

(v) WTF consented to a censure, a $250,000 fine, and a temporary ban from certain activities.

(vi) The firm's president and owner, chief executive officer, and trading desk supervisor were fined from $5,000 to $40,000 and suspended from three to nine months for failure to supervise.

(vii) In setting the sanctions, FINRA noted that the respondents had previously been sanctioned by FINRA for the sale of unregistered securities and that the SEC had affirmed the sanctions.

d. *Oppenheimer & Co., Inc.* ("Oppenheimer") (Aug. 5, 2013)

(i) FINRA settled a matter with Oppenheimer related to sales of over one billion shares of unregistered penny stocks and a failure to have in place adequate systems and policies to detect and investigate that the securities were unregistered and that activity in them was suspicious.

(ii) This settlement resolved a complaint initiated against the firm by FINRA in May 2013.

(iii) According to FINRA, the sales took place between August 19, 2008 and September 20, 2010, in accounts opened by 13 customers at five branch offices throughout the United States. In many instances, the customers, some of whom appeared to be affiliated with issuers, deposited share certificates for recently issued stock, or for amounts of stock that represented a large percentage of the float for the stock. Shortly thereafter, the customers sold the stock and wired out the proceeds.

(iv) FINRA alleged that Oppenheimer had no system or procedure to determine whether stocks were restricted or freely tradable and failed to conduct adequate supervisory reviews to determine whether the securities were registered, notwithstanding the presence of one or more "red flags" known to the firm's branch administration, surveillance or compliance staff.

(v) FINRA also alleged that Oppenheimer's AML program failed to identify suspicious activity in penny stocks and that Oppenheimer failed to investigate the suspicious activity. The firm's AML policy focused on asset movements instead of securities transactions and thus did not systematically review trading in penny stocks for suspicious activity. In addition, the firm failed to monitor compliance with those aspects of its AML policy applicable to one of the customer accounts, held by a foreign financial institution ("FFI"). In particular, the firm failed to assess the customer's risk as an FFI and did not enforce its own restrictions on that customer's trading activity.

(vi) The firm consented to a censure, a fine of $1,425,000, and an undertaking to retain an independent consultant to conduct a comprehensive review of the adequacy of its policies, systems, procedures and training related to the purchase and sale of penny stocks, the supervision of FFIs, and AML.

(vii) In announcing the settlement of this matter, FINRA stated that "[t]his is the second time Oppenheimer has been found to have violated its AML obligations." According to the Offer of Settlement resolving the case, the firm was fined $2.8 million in 2005 for allegations relating to failure to supervise in the AML area.

e. *Legent Clearing LLC (n/k/a COR Clearing LLC)* ("COR Clearing") (Dec. 16, 2013)

(i) FINRA settled a matter in which it alleged that COR Clearing failed to comply with AML, financial reporting and supervisory obligations. This matter resulted from various FINRA examinations of the firm from 2009 through 2013.

(ii) Like the Oppenheimer case, this case began as a litigated matter. However, the firm and FINRA agreed to resolve the matter late last year. The settlement covered not only the original charges but also additional violations identified by FINRA in recent examinations of the firm.

(iii) COR Clearing provides clearing services for approximately 86 correspondent firms. The introducing firms it serviced had significant numbers of accounts that conducted activity in low-priced securities and engaged in third-party wire activity. According to FINRA, COR Clearing's types of accounts present a high risk of money laundering and other fraudulent activity.

(iv) FINRA alleged certain AML-related violations, including the following:

(a) From 2009 to 2013, COR Clearing's AML surveillance program was not reasonably designed to detect and cause reporting of transactions required under the Bank Secrecy Act ("BSA"). The firm failed to implement a reasonable program to detect and evaluate AML "red flags," and it failed to ensure that its employees were aware of criteria for identifying red flags.

(b) COR Clearing's AML program relied in part on introducing firms for surveillance of suspicious activity, even though it did not conduct any review of the introducing firms' AML programs.

(c) COR Clearing’s procedures relied on manual reports for monitoring suspicious activity, and had inadequate staff and resources devoted to this monitoring.

(d) In 2009, COR Clearing implemented a “Defensive SARS” program, which the firm used to file suspicious activity reports without first completing the investigation necessary to support filing the report.

(e) For several months in 2012, COR Clearing’s AML surveillance system failed altogether, resulting in the firm's failure to conduct any systematic reviews to identify and investigate suspicious activity.

(f) In 2007, the firm failed to file a Foreign Bank and Financial Accounts Report (“FBAR”), which is required for foreign bank accounts with a balance over $10,000. The firm failed to establish adequate written procedures and controls regarding FBARs.

(v) FINRA alleged various additional violations including the firm’s (i) repeated erroneous computations of customer reserve and net capital computations; (ii) failure to maintain the physical possession and control of fully paid securities; (iii) failure to properly classify securities in its custody and control; (iv) failure to have written procedures for the solicitation and acceptance of checks from customers made payable to correspondents; and (v) failure to have the firm’s insurance coverage include a required provision for notification to FINRA in the event the coverage is materially modified.

(vi) FINRA alleged multiple supervisory violations, including (i) failure to establish adequate supervisory systems relating to Reg SHO; (ii) the filing of an incorrect FOCUS report; (iii) failure to maintain adequate supervision of control stocks; (iv) improper outsourcing of back-office functions; (v) inadequate due diligence of microcap securities; (vi) inadequate supervision of National Securities Clearing Corporation illiquid charges; (vii) inadequate retention and review of e-mails of one executive; (viii) inadequate controls for the fixed income trading desk; (ix) inadequate controls over funding and liquidity; (x) inadequate supervision of RVP/DVP

accounts; and (xi) failure to ensure that its president was properly registered as a principal.

(vii) COR Clearing consented to a censure and a fine of $1 million, and also agreed to retain a consultant to review its policies, systems procedures and training. The firm also agreed to submit proposed new clearing agreements to FINRA for its approval for a period of time. Finally, COR Clearing undertook to submit certifications by two senior officers stating that each individual had reviewed the firm's customer reserve and net capital computations for accuracy prior to filing with FINRA.

2. Trade and Position Reporting: Firms' electronic transaction reporting has been the subject of regulatory interest for a number of years. The following three cases involve various trade reporting issues.

a. *Citigroup Global Markets Inc.* ("Citigroup") (May 30, 2013)

(i) FINRA settled a matter in which it alleged that, at certain times between February 2002 and August 2011, Citigroup failed to accurately transmit last sale reports to the FINRA/Nasdaq Trade Reporting Facility ("FNTRF") and the OTC Reporting Facility ("OTCRF").

(ii) Specifically, regarding last trade reports required to be transmitted to FNTRF, FINRA alleged that Citigroup (i) failed to transmit or timely transmit last sale reports and failed to designate some of the reports as late; (ii) failed to report the correct time of execution; (iii) improperly designated some reports as ".PRP"; (iv) failed to mark transactions as riskless principal transactions; and (v) incorrectly reported the second leg of riskless principal transactions.

(iii) With respect to last trade reports required to be reported to OTCRF, FINRA alleged that Citigroup (i) failed to timely report last-sale reports of transactions in OTC equity securities and failed to designate some of the reports as late; (ii) failed to report correct execution times for reportable securities; (iii) failed to accept or decline trade reports in reportable securities within 20 minutes after execution; and (iv) erroneously reported to OTCRF foreign equity securities transactions that were executed and reported in foreign countries.

(iv) The violations affected over 600,000 last sale reports in designated securities.

(v) FINRA alleged that Citigroup did not provide for adequate supervision reasonably designed to achieve compliance with applicable securities laws, regulations, and rules concerning trade reporting.

(vi) FINRA also alleged that, from January 2009 to March 2009 and from January 2010 to March 2010, Citigroup transmitted approximately 150 reports to Order Audit Trail System ("OATS") that contained inaccurate, incomplete, or improperly formatted data or that failed to show the time of order receipt.

(vii) In addition, FINRA alleged that, between January 2007 and June 2007, Citigroup (i) effected 16 transactions in seven securities while a trading halt was in effect; (ii) effected four transactions in one security after the securities registration was revoked; and (iii) failed to fully and promptly execute a customer market order in 78 instances.

(viii) Citigroup consented to a censure, a fine of $800,000, restitution to certain customers in the amount of $1,055, and certain other undertakings. In settling the matter, FINRA also noted three previous matters wherein Citigroup had been sanctioned for trade reporting violations.

b. *Barclays Capital Inc.* ("Barclays") (June 7, 2013)

(i) FINRA settled a matter in which it alleged that, between September 2008 and July 2011, Barclays failed to timely transmit accurate and complete submissions to OATS.

(ii) Specifically, FINRA alleged that, from September 2008 to December 2009, Barclays failed to transmit 630 Reportable Order Events ("ROEs") to OATS. This represented 100% of the ROEs that Barclays was required to submit during that time period. In a separate review period of nine months, the firm again failed to transmit over 100 million ROEs to OATS, representing 6% of all ROEs that the firm was required to transmit to OATS, for a period of nine months.

(iii) FINRA alleged that for a period of 12 nonconsecutive months, Barclays transmitted reports to OATS that contained inaccurate, incomplete, or improperly formatted

data, or that were not timely filed. Barclays' reports represented 4% of all reports transmitted to OATS.

(iv) FINRA also alleged that for a period of over two years, Barclays improperly reported almost six million Execution Reports to OATS, representing 5% of all the Execution Reports submitted by Barclays.

(v) FINRA alleged that between September 2008 and July 2011, Barclays disclosed inaccurate information on customer confirmations on 33 occasions.

(vi) In addition, FINRA alleged that Barclays' supervisory system failed to achieve compliance with applicable securities laws, regulations, and rules to ensure that Barclays' submissions to OATS were timely, accurate, and complete.

(vii) Barclays consented to a censure, a $550,000 fine, and an undertaking to revise the firm's written supervisory procedures.

c. *Wedbush Securities, Inc.* ("Wedbush") (June 25, 2013)

(i) In May 2012, FINRA's Department of Market Regulation filed a complaint against Wedbush alleging several billion violations of the OATS rules. After a hearing on the merits, a FINRA Hearing Panel issued an order accepting an Offer of Settlement of the action, which alleged that Wedbush failed to (i) meet OATS reporting obligations for over one billion ROEs; (ii) have in place a supervisory system reasonably designed to achieve compliance with the OATS reporting rules; (iii) conduct supervisory reviews required by its written supervisory procedures; and (iv) properly register the supervisor of personnel responsible for OATS reporting.

(ii) FINRA alleged that between January 1, 2005 and July 7, 2006, the firm failed to send to OATS approximately 1.6 billion ROEs, a number representing 99.92% of the firm's overall reporting obligation for that time period. FINRA also alleged that between 2006 and 2010, Wedbush submitted 270 million ROEs late, which made the firm's late reporting violation rates significantly higher than its peer group and industry averages.

(iii) FINRA further alleged that 12.7 million ROEs submitted by the firm were rejected due to context or syntax errors,

and 45 million order reports submitted by the firm contained inaccurate, incomplete or improperly formatted data that prevented OATS from linking to the related order.

(iv) FINRA noted that Wedbush continued to have OATS reporting violations subsequent to the review periods that were the subject of its complaint. For example, Wedbush submitted 607 million late ROEs in four months in 2012.

(v) Wedbush consented to a censure and a fine of $750,000, which included $500,000 for OATS reporting violations, $225,000 for supervisory violations and $25,000 for failure to register its principal. The firm also agreed to an undertaking to retain an independent consultant to conduct a comprehensive review of its policies, systems, controls, procedures and training relating to OATS reporting and its supervision of OATS reporting.

3. Prospectus, Trade Confirmation, and Account Statement Delivery: For years, regulators have brought cases involving firms' deficiencies regarding delivery of prospectuses and various client account records. Two examples from last year and one brought on December 31, 2012 but announced in early 2013 follow:

a. *Ameriprise Financial Services, Inc.* ("AFSI") (Apr. 18, 2013)

(i) FINRA settled a matter with AFSI in which it alleged that in approximately 580,000 instances between January 1, 2009 and June 30, 2011, AFSI failed to timely deliver mutual fund prospectuses to its customers within the required time period, and failed to maintain and enforce an adequate supervisory system or written procedures to supervise this delivery requirement.

(ii) AFSI contracted with two third-party service providers for the delivery of mutual fund prospectuses and provided the service providers with daily information regarding the mutual fund transactions that required delivery of a prospectus.

(iii) FINRA alleged that AFSI's written supervisory procedures did not require an adequate review of the service providers' performance. According to FINRA, AFSI had no systems or procedures related to daily or weekly review of the service providers' performance. Also, while AFSI's procedures did require a monthly sample review of the service providers' performance, they did not specifically

describe what reviewers should look for or what action to take if a deficiency was identified. Rather, AFSI's supervision of the service providers involved substantial reliance on the service providers themselves. FINRA also alleged that the sample size reviewed by AFSI was likely too small.

(iv) FINRA noted that the primary cause of the late deliveries was an insufficient supply of paper copies of prospectuses provided by certain mutual fund companies. While the primary service provider contracted by AFSI did make a "print on demand" service available, AFSI did not utilize the service and did not implement any alternative for the first 26 months of the review period; AFSI utilized the print on demand service beginning in March 2011.

(v) AFSI consented to a censure and a fine of $525,000.

b. *UBS Securities LLC* ("UBS") (Sept. 9, 2013)

(i) FINRA settled a matter in which it alleged that, from 2003 to June 2011, UBS failed to deliver certain trade confirmations and account statements, and in certain instances failed to disclose required transaction information to institutional customers who executed trades in foreign securities through non-registered foreign affiliates.

(ii) UBS used its non-registered foreign affiliates to execute trades in non-U.S. securities for U.S. institutional customers. UBS, however, was still required to send trade confirmations and account statements to the clients including all required disclosure language.

(iii) In June 2011, UBS discovered through self-testing that it had failed to send trade confirmations and account statements to U.S. institutional clients who executed trades in non-U.S. securities in certain European, Middle Eastern, Asian and African markets. UBS discovered that the issues stemmed from improper coding of certain accounts and missing or incorrect data in the firm's main systems used to generate trade confirmations and account statements.

(iv) FINRA alleged that, from June 2010 to June 2011, UBS failed to send trade confirmations to institutional customers for 28,332 transactions. Additionally, UBS sent trade confirmations to institutional customers for 60,290 transactions, but those confirmations did not include certain

required transaction disclosure language. Further, trade confirmations for OTC equity derivative transactions did not include certain required disclosure language.

(v) FINRA alleged that, from May 2011 to June 2011, UBS failed to deliver 1,728 account statements due to missing or invalid customer address information or other missing data. The firm did not have a process to monitor for missing customer addresses.

(vi) FINRA alleged that UBS failed to have adequate procedures to supervise and monitor the systems for delivery of trade confirmations and account statements. The firm reviewed a sample of confirmations periodically, but because none of the affected confirmations were included in the sample, the issue was not detected timely. Further, the sample review was not designed to detect missing codes.

(vii) In settling the matter, FINRA acknowledged that UBS discovered the violations after internal testing, investigated the conduct and proactively remediated the problems prior to self-reporting the issues. FINRA also acknowledged the firm's substantial assistance during its investigation. Accordingly, FINRA noted that the sanctions imposed on the firm reflected these mitigating factors.

(viii) UBS consented to a censure and a fine of $575,000.

c. *LPL Financial, LLC* ("LPL") (Dec. 31, 2012)

(i) FINRA settled a matter in which it alleged that LPL failed to establish and maintain an adequate supervisory system and written procedures reasonably designed to ensure timely delivery of mutual fund prospectuses.

(ii) From January 2009 through June 2011, LPL executed approximately 16 million mutual fund purchases or exchange transactions. Approximately 3.4 million of those transactions required LPL to deliver a mutual fund prospectus to the customer within three business days.

(iii) FINRA alleged that, during the relevant time period, LPL relied on its registered representatives to deliver prospectuses and to obtain confirmations from customers that they received the prospectuses. FINRA further alleged that the firm did not adequately supervise to determine

whether the confirmations were received, or whether the prospectuses were delivered.

(iv) FINRA alleged two inadequacies in LPL's supervisory procedures. First, LPL relied on representations from its registered representatives in an annual compliance questionnaire as confirmation that the prospectuses had been delivered and the required confirmations of receipt had been received from clients. Second, LPL conducted inadequate branch audits in that (i) there was no requirement that mutual fund transactions be included in the sample for the purpose of testing whether prospectuses were delivered; (ii) where gaps were found in prospectus delivery, they were not cited in the branch deficiency letter; and (iii) there was no procedure to determine whether prospectuses were delivered late.

(v) FINRA further alleged that the firm was aware that its procedures were failing and that representatives were failing to obtain delivery confirmations from clients consistently; however, the firm did not take any corrective action.

(vi) In settling the matter, the firm consented to a censure and a fine of $400,000.

4. <u>Retention and Review of Electronic Communications</u>: Over the years, regulators have brought numerous cases involving the failure to retain and/or supervise e-mail communications. Below are two examples of cases from 2013. In addition, a third case opened a new front in the record retention area: a firm was sanctioned for failure to keep certain business records in the required format.

a. *Direct Services, LLC, ING America Equities, Inc., ING Financial Advisers, LLC, ING Financial Partners, Inc. and ING Investment Advisers, LLC* (collectively "firms") (Feb. 19, 2013)

(i) FINRA settled a matter in which it alleged that these five affiliated firms failed to retain and review, or timely review, millions of e-mail communications affecting hundreds of the firms' employees.

(ii) FINRA stated that the firms' e-mail retention system worked by journaling or copying e-mails from the firms' exchange server, where they were initially kept, to an e-mail archive, which was designed to maintain the e-mails for the required time periods.

(iii) FINRA alleged that two of the firms failed to journal e-mails to the archive between 2008 and 2010 that were sent or received by nearly 1,000 registered representatives who were hired as independent contractors by the two firms or whose accounts were hosted on external servers.

(iv) FINRA also alleged that four of the firms failed to configure secondary e-mail addresses of 332 registered representatives and associated persons at the firms between February 2008 and September 2010 in a manner that would ensure the messages were journaled and archived.

(v) In addition, FINRA alleged that four of the firms also failed to journal e-mails sent to distribution lists, e-mails sent as blind carbon copies, encrypted e-mails and e-mails sent from a third-party software provider's application.

(vi) Lastly, FINRA alleged that the firms failed to review nearly six million e-mails that were retained and flagged for supervisory review.

(vii) The firms consented to a censure and a joint and several fine of $1.2 million. The firms also agreed to an undertaking to review their procedures regarding the capturing, retention and review of e-mails, and to ensure that reasonable policies and procedures are in place to address and correct the violations.

(viii) In setting the fine, FINRA acknowledged that the firms self-reported the e-mail issues and undertook an internal review of their relevant supervisory policies and procedures, and also recognized the substantial assistance the firms provided to FINRA during its investigation.

b. *LPL Financial LLC* ("LPL") (May 21, 2013)

(i) FINRA settled a matter in which it alleged that LPL had significant e-mail system failures that prevented it from accessing hundreds of millions of e-mails and reviewing tens of millions of other messages. FINRA also alleged that LPL made material misstatements to FINRA during its investigation.

(ii) FINRA alleged that, from 2007 to 2013, LPL's e-mail review and retention systems failed at least 35 times, preventing LPL from capturing e-mail, supervising its representatives and responding to regulatory requests. As a result of its deficiencies, LPL failed to produce e-mails to

certain federal and state regulators, as well as certain private litigants and customers in arbitration proceedings.

(iii) Some examples of the e-mail retention and review failures alleged by FINRA include:

(1) During a four-year period, LPL failed to supervise 28 million "doing business as" ("DBA") e-mails sent and received by thousands of representatives who acted as independent contractors. Approximately 2,500 e-mail addresses used by LPL independent contractors were not linked to LPL's supervisory system;

(2) During a transition to a less costly e-mail archive provider in March 2009, the firm failed to retain access to hundreds of millions of e-mails. For a five-month period in 2009, the firm had limited access to certain e-mails. Additionally, from October 2009 through March 2010, LPL had no access to 280 million archived e-mails, and it made little effort to regain access. When the archived e-mails were finally restored, approximately 80 million e-mails had become corrupted;

(3) Over a seven-year period, LPL failed to retain, review or archive 3.5 million Bloomberg messages;

(4) Prior to 2011, the firm failed to supervise e-mails of any of its registered employees, other than its independent advisors;

(5) From 2008 to 2011, LPL identified 1,029 instances of advisors using unauthorized DBA e-mail addresses, but it failed to discipline the advisors, prohibit advisors from using unauthorized DBA addresses, or archive and review the e-mails sent through the unauthorized e-mail addresses;

(6) LPL failed to archive e-mails sent to customers through third-party e-mail–based advertising platforms; and

(7) In 2011, three financial institutions were unable to transfer approximately 700,000 e-mails to LPL's system for supervisory review. Additionally, over 200 e-mail addresses from these institutions were not reported to the firm, resulting in those accounts not being supervised.

(iv) FINRA also alleged that LPL made material misstatements to FINRA during its investigation of LPL's e-mail failures. Specifically, FINRA alleged that, in a letter, LPL inaccurately stated that the firm discovered the DBA e-mail issue in June 2011 and that there were no "red flags" suggesting an issue, when in fact there were numerous red flags and certain LPL personnel had information that would have uncovered the issue in 2008.

(v) LPL consented to a censure and a fine in the amount of $7.5 million. Additionally, LPL was ordered to establish a $1.5 million fund to compensate customer claimants who were potentially affected by LPL's failure to produce the e-mails.

(vi) The firm also undertook to certify to FINRA that it had established policies and procedures reasonably designed to achieve compliance with the rules regarding e-mail retention and supervision. LPL also agreed to notify regulators who may have received incomplete e-mail productions.

c. *Barclays Capital Inc.* ("Barclays") (Dec. 26, 2013)

(i) FINRA settled a matter in which it alleged that Barclays failed to preserve electronic business records and certain e-mails and instant messages ("IMs") in the required "Write-Once, Read Many" ("WORM") format for a period of at least 10 years.

(ii) FINRA alleged that, between 2002 and 2012, the firm failed to maintain certain business-related records in WORM format, including order and trade ticket data, trade confirmations, blotters, settlements, account records and ledgers, exception reports, and records supporting FOCUS reports and annual financial statements and schedules. According to FINRA, the WORM issues affected various electronic books and records related to many of the firm's

business units, including Equities, Futures, Commodities, Securitized Products, and Finance.

(iii) Although Barclays performed certain testing to confirm that its records were properly retained, FINRA alleged that the testing did not focus on the format in which the firm's records were stored, including whether they were maintained in a WORM-compliant format.

(iv) FINRA alleged that, between May 2007 and May 2010, the firm failed to properly ingest into its archive certain Bloomberg attachments. Specifically, due to an error in the ingestion script, the firm did not properly ingest attachments that were associated with more than one Bloomberg e-mail. Once an attachment was ingested in connection with one Bloomberg e-mail, the attachment failed to be associated with subsequently processed Bloomberg e-mails that contained the same attachment. The firm was not able to determine the number of Bloomberg e-mails affected, but FINRA noted that the firm generates approximately 500,000 Bloomberg e-mails per day (18% of the firm's electronic communications).

(v) FINRA further alleged that, between October 2008 and May 2010, the firm failed to retain approximately 3.3 million Bloomberg IMs. Specifically, the ingestion script stopped processing all Bloomberg IMs for the day if it attempted to process an attachment that had already been processed as an attachment to a Bloomberg IM that same day. FINRA alleged that these Bloomberg-related issues impacted the firm's ability to respond to requests in regulatory and civil matters.

(vi) FINRA alleged that, for both the electronic document retention issues and the Bloomberg-related issues, the firm did not have an adequate supervisory system or written procedures in place to comply with relevant rules and to timely detect and remedy deficiencies.

(vii) Barclays consented to a censure and a fine of $3.75 million. In determining the sanction imposed, FINRA acknowledged that the firm self-reported the issues, undertook an internal review, and hired an independent consultant to review its supervisory systems related to these issues.

5. <u>Sale of Unsuitable and Complex Products to Retail Investors</u>: FINRA routinely brings cases involving suitability. Below are descriptions of two 2013 settlements.

   a. *Wells Fargo Advisors, LLC* ("Wells Fargo")*, as successor in interest to Wells Fargo Investments, LLC, and Merrill Lynch, Fenner & Smith Inc., as successor in interest to Banc of America Investment Services, Inc.* ("BAI") (collectively, the "firms") (June 4, 2013)

      (i) FINRA settled separate matters with Wells Fargo and BAI in which it alleged that the firms made unsuitable recommendations of floating-rate bank loan funds, failed to train their sales forces regarding characteristics of the funds and failed to reasonably supervise sales of the funds.

      (ii) FINRA stated that between January 1, 2007 and December 31, 2008, the firms' respective registered representatives recommended floating-rate bank loan funds to customers without conducting adequate suitability assessments. In particular, representatives recommended the funds, which are subject to high credit risk and can be illiquid, to customers looking to preserve principal and with a conservative risk tolerance. Unsuitable transactions in the funds resulted in losses of approximately $1.9 million to 214 Wells Fargo customers and losses of approximately $1.1 million to 214 BAI customers.

      (iii) FINRA also alleged that the firms failed to reasonably supervise fund sales and train their personnel regarding the risks and features of the funds or the customers for whom the funds were a suitable investment.

      (iv) With respect to Wells Fargo, FINRA alleged that, in response to potential concerns raised internally, the firm had conducted a review and prepared guidance to its sales force regarding the sale of floating rate loan fund sales but failed to distribute that information adequately.

      (v) With respect to BAI, FINRA alleged that the firm did not respond adequately to developments in the market for floating rates loan funds that affected the risks associated with them, for example by providing alerts to its sales force or adapting its supervision of fund sales.

(vi) Wells Fargo consented to a censure, a fine of $1,250,000.00, and restitution to customers in the amount of $1,981,561.70.

(vii) BAI consented to a censure, a fine of $900,000.00, and restitution to customers in the amount of $1,095,680.83.

b. *VSR Financial Services, Inc.* ("VSR") *and Donald J. Beary* ("Beary") (May 15, 2013)

(i) FINRA settled a matter with VSR and Beary, who is VSR's co-founder, executive vice president, chairman of its board of directors and direct participation principal, in which it alleged (i) supervisory failures by VSR related to customer account concentration levels in alternative investments and review and approval of the use of consolidated financial account reports; and (ii) unsuitable sales of high-risk private placements and related supervisory failures.

(ii) According to FINRA, from July 28, 2005 through August 19, 2010 there were numerous instances of customer account concentrations in alternative investments exceeding limits set in VSR's policies, which provided that no more than 40%-50% of a client's "exclusive net worth" – total net worth minus home, automobiles and furnishings – could be invested in alternative investments unless there was a well-documented, substantial reason to exceed such threshold.

(iii) A "discount program" was used that artificially reduced the amount of customer positions for concentration purposes, which the firm and Beary continued to implement despite warnings from the SEC in 2006 and 2008 regarding the lack of related supervisory procedures. VSR also reduced the risk ratings on many investments from the levels assigned by the alternative investment program sponsors and also lowered its own internal risk ratings after the firm's acceptance of several products.

(iv) Despite the discount program and risk level adjustments, there were numerous instances of customers' investments exceeding the 40% concentration guideline VSR established, with several exceeding 50%, yet there was no documentation supporting a "substantial reason" for the concentration, as required by the firm's policies.

(v) FINRA also alleged that, between January 1, 2006 and January 1, 2012, VSR failed to require pre-approval of the use of consolidated customer financial reports, did not determine whether accurate pricing and disclosures were being used, and had no system to promptly review consolidated reports after transmission to customers. VSR had limited procedures related to the use of consolidated reports and provided limited guidance during the time period, all of which preceded a FINRA notice to members reminding firms of their obligations related to consolidated reports and emphasizing firms' supervisory responsibilities.

(vi) FINRA also alleged that, between March 1, 2005 and December 12, 2008, VSR recommended and sold high-risk private placements to customers for whom the investments were unsuitable given their financial circumstances and the risk tolerances, resulting in millions of dollars in customer losses. VSR earned commissions totaling $62,182 for these transactions sold by one particular registered representative, who was barred for his related conduct, among other things. VSR earned an additional $483,077 in commissions for these transactions sold by a separate registered representative.

(vii) According to FINRA, VSR failed to supervise the registered representatives responsible for the unsuitable sales. FINRA noted that the transactions were each reviewed and approved by one of the firm's principals, but that the principals failed to detect or investigate red flags, which included falsification of customer net worth and risk tolerance information, and that the "discount program" and risk level adjustments described above may have contributed to the alleged misconduct.

(viii) VSR consented to a censure and a fine of $550,000. Beary consented to a fine of $10,000 and a 45-day suspension from association with any FINRA member firm.

6. <u>Reg SHO and Illegal Short Selling</u>: FINRA has brought a few enforcement actions against member firms for violations of Reg SHO and illegal short selling. A recent example is described below.

7. *Merrill Lynch Professional Clearing Corp.* ("MLPC") *and Merrill Lynch, Pierce, Fenner & Smith Inc.* ("MLPFS") (Oct. 27, 2014)

   a. FINRA settled a matter with MLPC and MLPFS alleging that MLPC violated Reg SHO and MLPFS failed to establish, maintain

and enforce supervisory systems and procedures related to Reg SHO and other areas.

b. FINRA found that MLPC did not take any action to close out certain fail-to-deliver positions over a four-year period and did not have systems and procedures in place to address Reg SHO's close-out requirements for a majority of that four-year period.

c. FINRA also found that for a two-and-one-half-year period, MLPFS's supervisory systems and procedures were inadequate and allowed the firm to allocate fail-to-deliver positions to clients without determining whether each client contributed to the fail-to-deliver position.

d. MLPC agreed to a censure and a $5 million fine, and MLPFS agreed to a censure, a $2.5 million fine, and an undertaking to adopt and implement supervisory systems and written procedures reasonably designed to achieve compliance with Rule 204 of Reg SHO.