2005 NASD, NYSE AND SEC ENFORCEMENT DEVELOPMENTS

Ben A. Indek
Michael Kraut
Morgan, Lewis & Bockius LLP

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I. NASD

A. Background

1. NASD filed a record number of new disciplinary actions in 2005 (1,412), a slight increase over the number of actions filed in 2004 (1,396) and 2003 (1,410).

2. NASD collected a record amount of fines in 2005 ($125..4 million), which represented a 21% increase over the amount of fines collected in 2004 and a 278% increase over the amount of fines collected in 2003.

3. NASD suspended fewer individuals in 2005 (356) than in 2004 (379), although not as few as in 2003 (333).

4. NASD continues to use creative sanctions in fashioning appropriate discipline in enforcement cases.

5. NASD continues to bring matters not only against firms, but individuals as well.

B. Enforcement Matters

1. Directed Brokerage

   a. Under NASD's Anti-Reciprocal Rule, brokerage commissions (which are assets of mutual fund shareholders) cannot be used in quid pro quo arrangements to compensate brokerage firms for their sale of the funds' shares. The rule was also designed so that brokerage firms recommend mutual funds to customers objectively without the consideration of other factors, such as incentives the firm and/or its registered representatives may receive in commissions from fund complexes.

   b. During 2005, a number of actions resulted from an NASD enforcement sweep that focused on the receipt by NASD-regulated entities of directed brokerage from mutual fund companies in exchange for preferential treatment.

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c. In 2005, NASD brought and/or settled enforcement actions involving directed brokerage against, among others:

(i) *American Funds Distributors, Inc. ("AFD")* (February 16, 2005)

(a) AFD, the principal underwriter and distributor of American Funds, was charged with directing approximately $100 million in brokerage commissions to approximately 50 brokerage firms between 2001 and 2003 as a reward for their prior sales of American Funds and to encourage continued sales efforts. This matter has not yet been resolved.

(ii) *Quick & Reilly, Inc. ("Quick & Reilly") and Piper Jaffray & Co. ("Piper Jaffray")* (February 22, 2005)

(a) Quick & Reilly and Piper Jaffray consented to findings that they each conducted "preferred partner" or "shelf space" programs, under which they provided favorable treatment to the funds of certain mutual fund companies in exchange for brokerage commissions and other payments. The favorable treatment included "higher visibility on the firms internal websites, increased access to the firms' sales forces, participation in 'top producer' or training meetings, and promotion of their funds on a broader basis than was available for other funds."

(b) NASD fined Quick & Reilly $570,000 and Piper Jaffray $275,000.

(iii) *Royal Alliance Associates, Inc.; H.D. Vest Investment Services; Linsco/Private Ledger Corp.; Wells Fargo Investments, LLC; SunAmerica Securities, Inc.; FSC Securities Corp.; Securities America, Inc.; RBC Dain Rauscher, Inc.; McDonald Investments Inc.; AXA Advisors, LLC; Sentra Securities Corp. and Spelman & Co., Inc.; Advantage Capital Corp.; Advest, Inc.; and AllianceBernstein Investment Research and Management, Inc.* (June 8, 2005)

(a) 14 retail firms, most of which offered funds by many different fund mutual complexes, ran "preferred partner" or "shelf space" programs that rewarded several mutual fund complexes in exchange for directed brokerage commissions.

(b) One mutual fund distributor (AllianceBernstein) was charged because it satisfied shelf space payment obligations to certain brokerage firms by having its affiliated investment adviser direct portfolio transactions to, or for the benefit of, such firms.

(c) The 15 firms were fined a total of more than $7.75 million, with fines ranging from $255,000 to $1,520,000.

(iv) *IFC Holdings, Inc. (d/b/a INVEST Financial Corp.); Commonwealth Financial Network; National Planning Corp., Inc.; Mutual Service Corp.; Lincoln Financial Advisors Corp.; SII Investments, Inc.; Investment Centers of America, Inc.; and Lord Abbett Distributor, LLC* (October 10, 2005)

(a) Seven retail broker-dealer firms received directed brokerage commissions in return for preferential treatment for certain mutual fund companies through "preferred partner" or "shelf space programs."

(b) One mutual fund distributor (Lord Abbett) was charged because it satisfied shelf space payment obligations to certain brokerage firms by having its affiliated investment adviser direct portfolio transactions to, or for the benefit of, such firms.

(c) The eight firms were fined a total of more than $7.75 million, with fines ranging from $255,000 to $1,520,000.

(v) *Ameriprise Financial Services ("Ameriprise")* (December 1, 2005)

(a) Ameriprise consented to findings that between January 2001 and December 2003, it operated two shelf space programs in which 24 mutual fund companies (of the 32 companies whose funds Ameriprise offered) paid a fee in return for preferential treatment by Ameriprise in the form of: (i) heightened access to Ameriprise's sales force, including invitations to conferences and meetings;

(ii) distribution and display of marketing materials at Ameriprise branches and on Ameriprise's intranet; and (iii) visits with Ameriprise registered representative.

(b) NASD fined Ameriprise $12.3 million.

(c) Under a settlement with the SEC for related conduct, Ameriprise agreed to a censure and a civil penalty and disgorgement of $30 million, which was to be distributed to Ameriprise's affected customers. In addition, pursuant to the SEC settlement, Ameriprise agreed to: (i) disclose on its website in multiple places and in written materials to customers specific details concerning its revenue sharing program; (ii) create and implement procedures consistent with its revenue sharing disclosure obligations to disclose requirements; (iii) create and implement procedures to review public filings of mutual funds sold by Ameriprise under revenue sharing agreements; (iv) create and implement a policy to train its financial advisers concerning disclosing to customers financial incentives that they and Ameriprise receive from its revenue sharing agreements; (v) present to its board of directors (or committee) once per year concerning its revenue sharing arrangements; and (vi) retain an independent distribution consultant to create a plan to distribute the $30 million.

2. <u>Market Timing</u>

a. "Market timing" signifies short-term purchases and sales of mutual fund shares to take advantage of inefficiencies in mutual fund pricing. While market timing is not illegal, many mutual funds attempt to prevent it (and so state in their prospectuses) to protect long-term fund shareholders.

b. In 2005, NASD settled enforcement actions involving market timing against:

(i) *ING Funds Distributor* ("IFD") (October 3, 2005)

(a) IFD and an individual respondent (an IFD supervisor) consented to findings that:

(1) IFD acquired mutual funds in 2000 that had entered into market timing agreements with three customers;

(2) IFD adopted procedures designed to prevent market timing and included language in its fund prospectuses that market timing was prohibited;

(3) despite these steps, IFD continued to permit the three customers to time the funds; and

(4) IFD failed to enforce its new procedures, which resulted in the failure to detect market timing by other customers.

(b) *NASD ordered IFD to pay a fine of $1.5 million, which was the largest NASD fine for market timing, and more than $1.4 million in restitution to the affected mutual funds. NASD also imposed a $25,000 fine and 30-day supervisory suspension on the IFD supervisor.*

(ii) *Janney Montgomery Scott* ("Janney") (October 3, 2005)

(a) Janney and two individual respondents (a former branch manager and a former branch operations manager) consented to findings that:

(1) between May 2000 and September 2003, a Janney branch manager/broker assisted two hedge fund customers to evade attempts by mutual fund companies to block or restrict their market timing transactions;

(2) the branch manager opened 19 different accounts for the customer and used multiple broker numbers and addresses, thereby assisting the customers to engage in 1,600 mutual fund exchanges (at a profit of approximately $1 million), despite receiving nearly 200 block notices from mutual fund companies;

(3) the branch manager also advised the customers on other means to avoid detection; and

(4) Janney lacked sufficient systems and procedures for responding to inquiries from regulators, which caused the firm to fail to conduct adequate due diligence before responding to regulatory inquiries. Specifically, the firm submitted an October 2003 response to the NASD stating that "no one at the firm had promoted or otherwise encouraged market timing activities and that the author of the letter was not aware of communications between mutual funds and Janney regarding market timing."

(b) NASD fined Janney $1.2 million and ordered Janney to pay nearly $1 million in restitution to the affected mutual funds. NASD also suspended the former branch manager/broker for one year and fined him $370,000, which includes disgorgement of $185,000 in commissions. NASD also barred the former branch operations manager (the branch manager's sister-in-law) for refusing to testify.

(iii) First Allied Securities ("First Allied") (October 3, 2005)

(a) First Allied and an individual respondent (a former First Allied registered representative) consented to findings that:

(1) First Allied hired the representative with the knowledge that at least some of the representative's customers were market timers;

(2) while employed by First Allied (as well as previously), the representative negotiated "sticky assets" agreements with mutual fund advisors, whereby customers agreed to invest long-term funds in one mutual fund in exchange for permission to market time other funds; and

(3) the representative also assisted another customer in evading funds' exchange limits by opening multiple accounts.

(b) NASD fined First Allied $408,000 and ordered the firm to pay approximately $326,500 to reimburse the affected funds. NASD also suspended the representative for nine months and fined him more than $136,700.

(iv) *Chase Investment Services Corporation ("CISC")* (December 13, 2005)

(a) *CISC consented to findings that:*

(1) the firm failed to "maintain, update, and enforce effective internal policies, systems, and procedures to prevent market timing" by one of its hedge fund customers;

(2) between February 2002 and August 2003, CISC received block letters from 19 mutual funds. CISC lacked internal procedures so that the block letters were enforced and opened new accounts for the hedge fund to continue to market time; and

(3) the firm did not perform any follow-up or review of the hedge fund's accounts.

(b) CISC agreed to pay a fine of $150,000 and restitution to various mutual funds of more than $140,000.

3. <u>Misleading Advertising/Sales Practices</u>

a. In 2005, NASD settled an enforcement action involving misleading advertising and sales practices against *David Lerner Associates, Inc. ("DLA"), et al*. (September 30, 2005)

(a) DLA, SSH Securities Inc. (an affiliate of DLA), and two individual respondents (DLA's president and senior vice president of sales) consented to findings that:

(1) the firm's radio advertisements and other communications contained "numerous statements and claims that were misleading, exaggerated, or unwarranted;"

(2) the advertisements boasted of "returns of 10 percent and more" to "tens of thousands" of customers and gave the impression that DLA customers would be able to preserve

their invested capital irrespective of market conditions; and

(3) similar statements were made during investment seminars conducted by DLA.

(ii) NASD fined DLA $115,000 and prohibited the firm from conducting public seminars for 30 days. DLA was also required to pre-file its sales literature and advertisements ten days before use for a period of six months. The firm's president was fined, and the firm's senior vice president of sales was fined and suspended from serving in a principal or supervisory capacity with any registered firm for 30 days. An affiliate (SSH Securities, Inc.) was fined $10,000 for preparing inaccurate fact sheets distributed by DLA.

4. Disclosure in Municipal Bond Sales

a. In 2005, NASD settled enforcement actions involving failure to disclose in municipal bond sale transactions against:

(i) *Edward D. Jones & Co., L.P. ("Edward Jones")* (September 29, 2005)

(a) MSRB rules require securities dealers to provide written confirmations to customers who have purchased or sold municipal securities. The confirmations must reveal, among other things, yield information. Between January 2003 and April 2004, Edward Jones's confirmations for customers who sold municipal bonds did not reflect yield information, and, as a result, the firm's supervisory systems and procedures were deemed inadequate.

(b) NASD censured and fined Edward Jones $300,000. Edward Jones also was required to "demonstrate that customer confirmations for municipal securities transactions contain the necessary disclosures, and to certify periodically for a two-year period that its customer confirmations comply with the MSRB Rule."

(ii) *State Street Global Markets, LLC ("State Street")* (November 22, 2005)

(a) NASD rules require brokerage firms to report price and volume data on corporate bond trades to the NASD's Trade Reporting and Compliance Engine

(TRACE) within 15 minutes (previously 75 minutes). MSRB rules require securities dealers to report municipal trades to the MSRB within 15 minutes (previously by midnight after the trade).

(b) State Street consented to findings that:

(1) between July 2003 and December 2004, State Street failed to report 89% of its self-cleared corporate bond trades to TRACE and 79% of its self cleared municipal bond trades to the MSRB;

(2) the aggregate dollar amount of unreported trades was greater than $5 billion;

(3) the firm's written procedures were deemed inadequate for proper reporting to TRACE and the MSRB because they lacked a procedure for follow-up review and monitoring; and

(4) the firm's internal inspections, which are required by NASD rule, were not sufficiently comprehensive and were not conducted by registered securities professionals.

(c) NASD fined State Street $1.4 million, which was the largest fine the NASD imposed against a firm for fixed income trade reporting violations.

5. <u>Fee-Based Accounts</u>

a. In a fee-based account, customers pay an annual fee (which can be fixed or based on a percentage of the assets in the account), rather than paying commissions on a per-transaction basis. A 1995 SEC report noted that fee-based accounts may be appropriate for customers who are building assets in their accounts and have at least moderate trading activity. According to the report, customers who conduct little or no trading activity likely would pay higher costs with a fee-based account.

b. In 2005, NASD settled enforcement actions involving fee-based accounts against:

(i) *Raymond James & Associates, Inc. and Raymond James Financial Services, Inc. (collectively, "Raymond James")* (April 27, 2005)

(a) Raymond James consented to findings that:

(1) the firm began offering fee-based accounts in April 2001, yet failed to create supervisory systems and procedures geared toward determining whether fee-based accounts were suitable for particular customers;

(2) as a result, between April 2001 and December 2004, Raymond James recommended to, and opened for, customers fee-based accounts without properly determining whether the account structure was suitable;

(3) of the nearly 3,000 Raymond James customers who opened fee-based accounts, almost 200 never traded at all, yet paid aggregate fees of $138,000; and

(4) the firm's advertising was inaccurate and misleading because it failed to adequately disclose fees and restrictions associated with fee-based accounts.

(b) NASD censured and fined Raymond James $750,000 and ordered the firm to pay $138,000 in restitution. The firm expressed an intention to cease offering fee-based accounts; however, if the firm decided to continue to offer them after July 1, 2005, the settlement required the firm to retain an independent consultant to recommend a supervisory system and written procedures relating to its fee-based brokerage rules.

c. *Morgan Stanley DW, Inc. ("Morgan Stanley")* (August 2, 2005)

(a) Morgan Stanley consented to findings that:

(1) the firm failed to create and maintain a supervisory system to ensure that fee-based accounts continued to be suitable for its customers who held such accounts; and

(2) as a result, between January 2001 and December 2003, more than 3,500 customers maintained fee-based accounts (with a minimum annual fee of $1,000), despite the fact that they conducted no trades in their accounts for two consecutive years and/or maintained assets less than $25,000 for at least one year.

(b) NASD fined Morgan Stanley $1.5 million and ordered the firm to pay more than $4.6 million in restitution.

6. Variable Annuity Switching

a. In 2005, NASD settled an enforcement action involving variable annuity switching against *Waddell & Reed, Inc. ("Waddell & Reed")*(April 29, 2005)

(i) Waddell & Reed and two individual respondents (the firm's president and its national sales manager) consented to findings that:

(a) the firm engaged in "an aggressive campaign" to switch customers from contracts issued by one company (UILIC) to similar annuity contracts issued by a company (Nationwide Insurance) that agreed to share its fees with Waddell & Reed;

(b) once the fee sharing agreement had been reached, Waddell & Reed's president and senior managers encouraged the sales force to switch customers to Nationwide and failed to respond to requests from the sales force and supervisors for guidance for determining the suitability of switching customers; and

(c) as a result of the switches, many customers incurred surrender charges and/or switched to annuities that offered fewer benefits and less flexibility than other available annuities, the selection of which would not have been as profitable for Waddell & Reed's sales force.

(ii) Waddell & Reed agreed to pay fines to the NASD and state regulators of $5 million and $2 million, respectively. In addition, the firm agreed to make restitution of up to $11 million to more than 5,000 customers and retain an independent consultant to implement the repayment plan. Waddell & Reed's former president and national sales manager were each fined $150,000 and suspended for six months.

7. Overcharge in Proceeds Transactions

a. NASD's Proceeds Rule requires that "if a customer sells securities through a broker and uses the proceeds to pay for other securities purchased at or about the same time, the broker must calculate his commission in the same way as if the customer had purchased for cash." (NASD April 14, 2005 press release announcing settlement with Ladenberg Thalmann & Co.)

b. In 2005, NASD settled an enforcement action involving overcharge in proceeds transactions against *Ladenburg Thalmann & Co. ("Ladenberg")* (April 14, 2005)

(i) Ladenberg consented to findings that it misinterpreted the NASD's Proceeds Rule to apply only to same-day sales and re-investments and established its procedures accordingly. As a result, the firm overcharged 3,300 customers whose sales and re-investments were one day apart a total of approximately $1.2 million.

(ii) Ladenberg agreed to a fine of $275,000 and to refund $1.2 million to overcharged customers. The firm also agreed to retain a consultant to recommend changes to bring its policies in compliance with the Proceeds Rule.

8. Mutual Fund Class B and Class C Shares

a. Differences in Mutual Fund Share Classes

(i) Class A shares typically charge a high front-end sales load and a low 12b-1 (annual distribution) charge.

(ii) Class B shares typically do not have a front-end sales load, but instead have a combination of a high 12b-1 fee and a back-end load in the form of a contingent deferred sales charge (CDSC), which the investor may pay at the time the investor sells the shares. The amount of the CDSC declines over time, and if the investor holds the shares for a sufficient period of time, the CDSC typically is eliminated entirely. Once the CDSC is eliminated, Class B shares may be converted into Class A shares.

(iii) Class C shares typically do not have a front-end sales load, but they often charge a high 12b-1 fee and a modest CDSC. Class C shares typically do not convert to Class A shares, so the 12b-1 fee tends to be higher for the life of the investment.

b. In 2005, NASD settled enforcement actions involving mutual fund class B and class C shares against:

(i) *Citigroup Global Markets, Inc.; American Express Financial Advisors; and Chase Investment Services Corporation* (March 23, 2005)

(a) Each of the three firms consented to findings that it recommended and sold to customers Class B and/or Class C mutual funds without considering or disclosing that customers would have achieved a higher overall rate of return had they purchased Class A shares. The firms did not disclose that the customers may have been entitled to breakpoint discounts on sales charges for Class A shares (based on the size of the purchase) that were not available for shares of other fund classes.

(b) NASD censured and fined the three firms a total of $21.25 million. The firms also agreed to notify affected customers, offer them an opportunity to convert their shares to Class A shares, and make restitution to shareholders who have sold some or all of their shares.

(ii) *Merrill Lynch, Pierce, Fenner & Smith ("Merrill Lynch"); Wells Fargo Investments ("Wells Fargo"), and Linsco/Private Ledger Corporation ("Linsco")* (December 19, 2005)

(a) Each of the three firms consented to findings that:

(1) between January 2002 and July 2003, it recommended and sold to customers Class B and/or Class C mutual funds without considering or disclosing that, taking account of all relevant factors, including fees, Class A shares represented a better option for the customers; and

(2) the firms lacked adequate supervisory and compliance procedures to guide the firms'

sales forces in recommending the appropriate classes of mutual funds.

(b) Merrill Lynch was fined $14 million, Wells Fargo $3 million, and Linsco $2.4 million, which approximate the additional commissions the three firms received by selling Class B shares instead of Class A shares. In addition, the firms agreed to notify certain affected customers, offer them an opportunity to convert their shares to Class A shares, and make restitution if necessary.

9. <u>Corporate Bonds and Trade Reporting</u>

a. Pursuant to NASD rules, firms are required to sell securities, including corporate high yield debt, at fair prices. NASD markup policy states that markups and markdowns generally should not exceed five percent. The NASD believes that for most debt transactions, the markups and markdowns should be even lower.

b. In 2005, NASD settled enforcement actions involving corporate bonds and trade reporting against:

(i) *SG Americas Securities, LLC ("SG"); RBC Capital Markets Corp. ("RBC CM"); RBC Dain Rauscher, Inc. ("RBC Dain"); DebtTraders, Inc. ("DebtTraders")* (October 31, 2005)

(a) The four firms consented to findings that they charged excessive markups or markdowns in corporate high yield bond trades, ranging as high in some cases as forty percent. Each firm's supervision was deemed inadequate because its supervisory procedures were not designed to comply with legal requirements and NASD guidelines concerning markups.

(b) SG, RBC CM, and RBC Dain were fined a total of more than $7.7 million and ordered to pay a total of nearly $1 million in restitution. DebtTraders was expelled from the industry and ordered to pay a restitution figure of $120,000.

10. <u>529 Plans</u>

a. 529 college savings plans, which are named after the section of the U.S. federal tax code that addresses them, are tax-advantaged investment programs designed to pay for qualified higher education costs.

b. In 2005, NASD settled an enforcement action involving a 529 plan against *Ameriprise Financial Services, Inc. (“Ameriprise”)* (October 26, 2005). This action marked the first settlement from the NASD’s sweep examining 529 plans.

(i) Ameriprise consented to findings that:

(a) between May 2001 and December 2004, Ameriprise’s procedures were inadequate so that the firm’s customers enrolled in suitable 529 plans;

(b) many customers who were eligible to receive state tax deductions for their contributions to in-state 529 plans were instead enrolled in an out-of-state plan, which eliminated the customers’ ability to claim the deductions;

(c) during much of the period under investigation, Ameriprise offered and sold only one 529 plan, which was sponsored by the state of Wisconsin; and

(d) throughout the period, Ameriprise’s procedures were inadequate for its registered representatives to consider state income tax benefits when determining the suitability of 529 plans for particular customers.

(ii) Ameriprise agreed to pay a fine of $500,000 and make restitution of approximately $750,000 to more than 500 accounts.

II. NEW YORK STOCK EXCHANGE

A. Background

1. In 2005 the NYSE initiated approximately 125 disciplinary actions; in 2004 the NYSE bought 195 cases. However, because of recent delays in issuing decisions, it is difficult to do a year over year comparison at this point in time.

2. While the final figures for 2005 are not yet in, last year the NYSE imposed significant fines in a number of its cases. In 2004, the NYSE collected fines totaling $25.6 million.

3. Much like the NASD, in 2005 the NYSE appears to have begun to look at the use of creative sanctions.

4. In 2005, the NYSE issued 2 significant information memoranda relating to enforcement actions (Information Memo concerning cooperation 05-65 and Information Memo regarding sanctions 05-77).

B. Enforcement Matters

1. <u>Prospectus Delivery, Registration of Employees and Operational Issues</u>

   a. Section 5(b)(2) of the Securities Act of 1933 requires that a prospectus be delivered with, or in advance of, delivery of certain securities.

   b. In 2005, the NYSE settled an enforcement action involving failure to deliver prospectuses, among other violations, against *Merrill Lynch, Pierce, Fenner & Smith, Incorporated* ("Merrill Lynch") (HPD 05-87; July 21, 2005).

      (i) Merrill Lynch consented to findings that:

         (a) in two unrelated instances in 2002 and 2004 (two days in one instance and seven months in the other), issues with Merrill Lynch's operating systems caused the firm to fail to deliver prospectuses to customers who purchased certain securities. Merrill Lynch discovered both of these issues in 2004, and later that year, made rescission offers to affected customers;

         (b) due to the absence of certain codes in its securities master database, certain customers who purchased exchange-traded funds did not received product descriptions required by Exchange Rule 1100(b), and certain customers who made after-market purchases in equity offerings did not receive prospectuses;

         (c) Merrill Lynch also failed to, among other things: (i) transfer or properly complete employee registrations; (ii) maintain proper registrations for certain employees; (iii) comply with an undertaking agreed to in a pervious settlement relating to filing promptly Forms U-4 and amendments thereto; (iv) timely register for use of the NYSE's electronic filing platform relating to preliminary investigations; and (v) comply with other rules relating to reporting to the NYSE customer complaints and arbitration awards.

(ii) Merrill Lynch consented to a censure and a $10 million fine. In addition, Merrill Lynch agreed to retain an independent consultant to review the firm's policies, procedures, and supervisory systems concerning reporting to the NYSE certain information on Form RE-3 and certain information concerning customer complaints and take steps to implement the recommendations or alternatives designed to achieve the same purpose.

2. Preservation of Electronic Communications and Reporting Deficiencies

a. NYSE Rule 440, Section 17(a) of the Securities Exchange Act of 1934, and Rule 17a-4 promulgated thereunder require broker-dealers to preserve for a period of three years, the first two of which must be kept in an accessible place, electronic communications relating to their business.

b. In 2005, the NYSE settled enforcement actions involving failure to preserve and retain electronic communications against:

(i) *J.P. Morgan Securities. Inc. ("J.P. Morgan")* (HPD 05-1; January 5, 2005).

(a) During a joint investigation among the SEC, NYSE, and NASD of conflicts of interest involving institutions' research and investment banking divisions, the regulators discovered that J.P. Morgan had failed to comply with federal securities laws and NYSE rules that require firms to preserve and retain electronic communications sent or received by its employees relating to its business. Specifically, the firm was unable to locate and/or produce back-up tapes that contained e-mails requested by regulators during their investigations. The firm's systems and procedures were inadequate regarding compliance with the retention requirements

(b) J.P. Morgan consented to a censure, a $2.1 million fine ($700,000 to SEC, $700,000 to NYSE, and $700,000 to NASD), and a requirement that the firm review its procedures regarding the preservation of electronic communications.

c. *UBS Securities LLC ("UBS")* (HPD 05-62; May 19, 2005).

(i) During a joint investigation among the SEC, NYSE, and NASD of conflicts of interest involving institutions' research and investment banking divisions, the regulators discovered that UBS had failed to comply with federal securities laws and NYSE rules that require firms to preserve and retain electronic communications sent or received by its employees relating to its business. Specifically, the firm was unable to locate and/or produce back-up tapes that contained e-mails requested by regulators during their investigations. The firm's systems and procedures were inadequate regarding compliance with the retention requirements.

(ii) UBS consented to a censure, a $2.1 million fine ($700,000 to SEC, $700,000 to NYSE, and $700,000 to NASD), and a requirement that the firm review its procedures regarding the preservation of electronic communications.

3. <u>Supervision and Control of Disbursement of Customer Accounts</u>

a. In 2005, the NYSE settled an enforcement action involving failure to supervise and control disbursement of customer accounts against *Charles Schwab & Co., Inc. ("Schwab")* (HPD 05-110; October 17, 2005)

(i) Schwab consented to findings that:

(a) the firm provided certain investment advisors and their clients with clearing and related support, including a dedicated website providing access to client accounts, which were custodied at Schwab. Customers authorized the investment advisors to trade securities on their behalf at Schwab, for which Schwab charges commissions and/or fees;

(b) between 1998 and the first quarter of 2003, some of the investment advisers misappropriated their clients' funds without any involvement by Schwab employees; and

(c) however, Schwab's procedures for, and follow-up monitoring and review of, transferring assets from customer accounts managed by the investment advisors were not reasonable to supervise and control money movements, and to protect adequately the account holders' assets. For example, Schwab did not routinely compare signatures in a letter of authorization or wire transfer request with the signature in the account opening documents. Eventually, the firm began to compare signatures, but only for transfers above a dollar threshold that was deemed too high;

(ii) Schwab consented to a censure and a fine of $1,000,000. In addition, Schwab agreed to retain an independent consultant to review the firm's policies and procedures relating to disbursement of customer assets from accounts managed by non-employee investment advisors to third parties.

4. <u>Annuity Switching/CCO/GC</u>

a. In 2005, the NYSE settled an enforcement action involving annuity switching against *Robert Lynn Cram* (HPD 05-94; August 24, 2005)

(i) Cram, the Director of Compliance and General Counsel of David A. Noyes & Co., Inc. consented to findings that:

(a) he was aware of 1998-1999 NYSE and 1999 SEC examinations that found improper annuity switches occurring at a Wisconsin branch office and that the firm was inadequately supervising such switches;

(b) following the review, in March 2000, the firm established written procedures concerning annuity switches.

(c) in 2001, the SEC sent a letter to the firm stating that improper annuity switches continued to occur and that the firm was not supervising the issue adequately. The NYSE and NASD then conducted a joint examination and found that the firm was not following its own annuity procedures and that improper annuity switches continued at the Wisconsin branch. The majority of the annuity switches executed by the Wisconsin branch was inappropriate and caused customers substantial unnecessary surrender fees, charges and expenses.

(d) Cram was aware of the regulatory activity and was responsible for coordinating and supervising the firm's March 2000 policy. He also received memoranda from, and had conversations with, the firm's national insurance manager, who voiced concerns that the policy was not being followed by the Wisconsin branch office. Cram also failed to create a master list of annuities, which would have enabled the creation of an exception report. Also, the firm's compliance audits of the branch failed to detect the Wisconsin branch's failure to comply with the March 2000 policy.

(ii) Cram consented to a censure and a six month supervisory suspension.

(iii) The Hearing Panel specifically noted that Cram "was not disciplined simply because he held the title of Compliance Director or General Counsel. Holding such a title does not automatically make one a supervisor under Exchange Rule 342. Rather he was named and properly disciplined because he had lapses of personal responsibility. Whether a Compliance Director or General Counsel is or becomes a supervisor is a fact based analysis. Here Enforcement and the Hearing Panel are convinced that the Respondent undertook certain specific responsibilities concerning [the branch office manager] and failed to perform them. He also was personally and specifically put on notice by [the national insurance manager] of problems for which he had undertaken an oversight relationship."

5. <u>Market Timing</u>

a. In 2005, the NYSE settled an enforcement action involving market timing against *Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch")* (HPD 05-27; March 7, 2005).

(i) Merrill Lynch consented to findings that:

(a) between January and April of 2002, a team of its brokers executed over 3,700 short-term mutual fund transactions in multiple accounts held for a hedge fund client;

(b) after certain mutual funds objected to the market timing activity, Merrill Lynch instructed the brokers to cease market timing;

(c) thereafter, in August 2002, the brokers moved the hedge fund's mutual fund positions held at Merrill Lynch to new accounts held outside Merrill Lynch (at the recommendation of one of the firm's managing directors). The brokers identified themselves as the brokers of record on the outside accounts (which resulted in the firm's receipt of trailing commission fees that were reported on the firm's monthly reports) and continued to execute frequent trades on the hedge fund's behalf in the accounts. Subsequently, the brokers returned the positions to the hedge fund's Merrill Lynch accounts; and

(d) when Merrill Lynch managers became aware of the brokers' trading in the outside accounts in November 2002, they instructed the brokers to cease trading in the outside accounts. However, Merrill Lynch did not verify that its instructions were being followed, and, in fact, the brokers ignored that instruction for at least another five or six months. Merrill Lynch was deemed to have ignored numerous red flags throughout the relevant period.

(ii) Merrill Lynch consented to a censure and a $13.5 million fine, which was deemed paid in light of the firm's settlements with two state regulators. In addition, the firm agreed the following undertakings: (i) issuing a Global Compliance Alert relating to review and retention of correspondence and fax transmissions; (ii) implementation of policies and procedures addressing how FAs should handle instructions from clients who seek to trade mutual funds in accounts held outside of Merrill Lynch; (iii) begin developing technology to permit recording client reallocation requests for underlying sub-accounts of non-proprietary variable annuity products when relayed from a client to an affiliated insurance carrier through a Merrill Lynch employee; and (iv) implementation of procedures to permit an affiliate to provide client tax ID numbers to NSCC when transmitting clients' mutual fund orders.

6. <u>Anti-Money Laundering ("AML")</u>

a. Since April 2002, NYSE member broker-dealers have been obligated to create and implement an anti-money laundering program to detect and report suspicious activity, comply with the Bank Secrecy Act, and undergo independent testing for review of compliance with these provisions.

b. In 2005, the NYSE settled an enforcement action involving anti-money laundering rules against *Oppenheimer & Co., Inc. ("Oppenheimer")* (HPD-181; December 29, 2005). This case was brought jointly by the NYSE and the U.S. Department of the Treasury's Financial Crimes Enforcement Network ("FinCEN").

(i) Oppenheimer consented to findings that:

(a) the firm was one of many firms subject to a 2001 sweep by the SEC, NYSE, and NASD concerning compliance with regulatory AML rules and was informed by the NYSE's Member Firm Regulation that the firm's compliance system was not sufficiently set up to prevent and/or detect money laundering activity;

(b) despite the adoption by the NYSE of its April 2002 AML rule (and requirements under the Bank Secrecy Act to report suspicious activity), a 2003 NYSE examination revealed that Oppenheimer had not enhanced its procedures to prevent and detect money laundering; and

(c) specifically, Oppenheimer: (i) had not implemented sufficient systems to review foreign wire transfers and journal transactions for suspicious activity, some of which did not appear economically-motivated; (ii) did not aggregate wire transfers or journal transactions by a customer in the firm's reports; (iii) did not review accounts for which the address in the firm's records was a post office box; (iv) did not adequately staff its AML department; and (v) did not adequately train its employees concerning AML duties; and (v) failed to report certain customer activity that should have triggered a suspicious activity report.

c. Oppenheimer consented to a censure and a fine of $2.8 million, to be split equally between the NYSE and FinCEN. In addition, the firm agreed to submit a report concerning a completed review of the firm's AML policies and procedures, and then implement the policies and procedures recommended in the report.

7. General Operational Violations

a. In 2005, the NYSE settled an enforcement action involving general operational violations against *Oppenheimer & Co., Inc. ("Oppenheimer")* (HPD-05-190; December 29, 2005)

(i) Oppenheimer consented to findings that:

(a) in January 2003, Fahnestock & Co. ("Fahnestock") purchased retail brokerage businesses, including Oppenheimer entities;

(b) in May 2003, Fahnestock began an effort to transfer Oppenheimer's retail customers onto Fahnestock's books and records; and

(c) in the course of that transfer, operational difficulties led to, among others, the following lapses: (i) issuance of inaccurate monthly account statements; (ii) "failure to prepare accurate net capital commitments;" (iii) failure to disclose to customers revenue sharing agreements; (iv) failure to transfer customer assets in a timely manner to other broker-dealers; and (v) failure to notify the NYSE as to the operational difficulties when the firm knew or should have known about them.

(ii) Oppenheimer agreed to a censure and a fine of $1.35 million.

C. During 2005, the NYSE issued two significant Information Memoranda relating to enforcement actions.

1. Information Memo Concerning Cooperation (IM No. 05-65; September 14, 2005)

a. The NYSE issued an Information Memorandum in which the Division of Enforcement articulated its views on the meaning and virtues of corporate cooperation with regulators.

b. The Exchange believes that membership in the NYSE imposes affirmative duties upon a regulated person or entity, including self-policing, self-reporting, remediation, and cooperation. As examples of mandatory cooperation, the NYSE's Information Memorandum cites to rules that: (i) mandate the timely disclosure of reportable matters; (ii) require prompt, accurate responses to inquiry and investigation requests; and (iii) set forth the

Exchange's ability (and a member organization's inability) to dictate the order, direction, and scope of an investigation.

c. To identify how a member organization might go beyond what is required and thereby cause the NYSE to consider a reduced sanction, lesser charges, or even no charges, the NYSE created the concept of "extraordinary cooperation." According to the Information Memorandum, "extraordinary cooperation" involves adherence to the following eight standards:

   (i) prompt, full disclosure coupled with thorough internal review;

   (ii) prompt, full disclosure coupled with thorough internal review;

   (iii) candor with the NYSE;

   (iv) waiver of attorney-client privilege;

   (v) breadth, depth and timeliness of remedial action;

   (vi) responses to investigative requests;

   (vii) aiding the jurisdiction of the NYSE;

   (viii) a culture of compliance; and

   (ix) partnering with the NYSE to uncover wrongdoing

d. For a member organization (or individual) that successfully convinces the NYSE that its cooperation warrants extraordinary cooperation credit, favorable treatment may include:

   (i) a reduced number of charges;

   (ii) a reduced sanction;

   (iii) obviating the need for an undertaking or impacting the type of undertaking required;

   (iv) adding language to the documents that resolve enforcement proceedings to mitigate the severity of the charges and/or credit the level of cooperation;

   (v) publicly acknowledging the level of cooperation in a press release; and

(vi) in the “exceptional” case (of “exceptional” cooperation), no enforcement action.

e. The NYSE noted, however, that its cooperation factors will not always determine whether enforcement action will be taken, and acknowledged the existence of other matters to be considered, such as the nature of the violation, the extent of customer harm, the duration of the misconduct, and the existence of prior related discipline.

2. Information Memo Regarding Factors Considered By the NYSE Division of Enforcement In Determining Sanctions (IM 05-77, October 7, 2005)

a. During 2005, the NYSE Enforcement Division reviewed its sanctions program and published an Information Memorandum listing the factors considered by the Division when determining an appropriate sanction in a given matter “to provide greater transparency, predictability and consistency to the sanction process.”

b. These factors include:

(i) nature of the misconduct/degree of scienter (i.e., intentional or knowing conduct or reckless or deliberate indifference to misconduct vs. negligence);

(ii) harm caused by the misconduct;

(iii) extent of misconduct;

(iv) prior disciplinary record;

(v) acceptance of responsibility;

(vi) implementation of corrective measures and restitution;

(vii) enrichment and/or deceptive conduct;

(viii) neglect or disregard of “red flags;”

(ix) effectiveness of operational, supervisory, and compliance controls;

(x) respondent’s size and financial resources;

(xi) training and education (in addressing the misconduct);

(xii) reliance on professional advice;

(xiii) other discipline (by another regulator, or, in the case of an individual respondent, by the respondent's employer); and

(xiv) "pro-active and exceptional" cooperation (and conversely, failure to cooperate fully and completely may increase the sanction).

III. SEC

A. Enforcement Statistics

1. In the SEC's fiscal year 2005 (which began on October 1, 2004 and ended on September 30, 2005), the SEC commenced 947 investigations, 335 civil proceedings, and 294 administrative proceedings. Areas investigated included: fraud involving mutual funds, investment advisers, and accounting issues, as well as SRO lapses. The SEC claimed to have "prevailed in the great majority of the enforcement actions decided by district courts or administrative law judges, and [that] a total of more than $3 billion in disgorgement and penalties was ordered in SEC enforcement cases."

B. Enforcement Matters

1. <u>Revenue Sharing and/or Class B shares</u>

a. In late 2004 or 2005, the SEC settled an enforcement action involving revenue sharing and Class B shares against:[2]

(i) *Edward Jones & Co., L.P. ("Edward Jones")* (33-8520; December 22, 2004)

(a) Edward Jones consented to findings that:

(1) during the 1990s, Edward Jones entered into revenue sharing agreements with mutual funds. One of the primary factors considered by Edward Jones in determining whether to add a fund company to its "Preferred Family" list was whether the fund company was a party to a revenue sharing agreement with Edward Jones. In fact, of the approximately 240 mutual fund complexes whose funds were sold by Edward Jones, 95 – 98% of mutual fund shares sold by Edward Jones were shares of

[2] The SEC also settled a revenue sharing matter with Ameriprise, which is discussed *supra* in connection with a related NASD investigation.

the seven mutual fund companies that were parties to revenue sharing agreements;

(2) internally, Edward Jones promoted to its representatives the "Preferred Family" funds and held sales contests for its representatives that only rewarded them for sales of "Preferred Family" funds;

(3) Edward Jones also provided favorable treatment to "Preferred Family" fund companies, including higher visibility on the firms websites and in sales, research, and training literature;

(4) similarly, Edward Jones sold 529 plans of fourteen mutual fund companies, but the firm only promoted the 529 plans sponsored by "Preferred Family" mutual fund companies; and

(5) Edward Jones failed to adequately disclose the revenue sharing agreements.

(b) Edward Jones agreed to a censure, a fine of $37.5 million, and disgorgement of $37.5 million. In addition, Edward Jones agreed to: (i) disclose on its website and in written materials to customers specific details concerning its revenue sharing program; and (ii) create and implement procedures consistent with its revenue sharing disclosure obligations to disclose requirements. The firm also agreed to create and implement procedures concerning: (a) disclosure requirements, (b) review of public filings of mutual funds sold by Edward Jones under revenue sharing agreements, (c) moving funds onto or off its preferred list, and (d) training its financial advisers concerning disclosing to customers financial incentives that they and Edward Jones receive from its revenue sharing agreements. Finally, the firm agreed to retain an independent consultant to review changes to the firm's procedures and to review the firm's plan to distribute the $75 million.

(ii) *Citigroup Global Markets, Inc.* ("CGMI") (33-8557; March 23, 2005)

(a) CGMI consented to findings that:

(1) the firm conducted a revenue sharing program with mutual funds, under which it provided favorable treatment to the funds of certain mutual fund companies in exchange for brokerage, including selling only mutual funds of companies that participated. Funds that made higher revenue sharing payments received greater access to the firm's branches, increased agenda space at sales meetings, and appeared in CGMI's internal publications and broadcasts. None of these facts was disclosed to customers.

(2) CGMI also recommended and sold Class B shares of mutual funds to certain customers without disclosing that the customers may have been entitled to breakpoint discounts on sales charges and reduced expenses for Class A shares that were not available for Class B share purchases. CGMI also did not disclose that CGMI received higher commissions for Class B shares than Class A shares of the same mutual funds.

(b) CGMI agreed to a censure and a $20 million civil penalty. In addition, CGMI agreed to: (i) disclose on its website details concerning its revenue sharing program; (ii) retain an independent consultant to review the firm's revenue sharing disclosures; and (iii) offer a defined group of customers who purchased Class B shares the option to convert the shares to Class A shares and/or a cash payment.

b. In 2005, the SEC also litigated before an administrative law judge a matter that involved Class B shares: *In re IFG Network Securities, et al ("IFG") (Initial Decision Rel. No. 273; February 10, 2005)*

(i) The Division of Enforcement alleged that:

(a) IFG registered representatives recommended and sold Class B shares ($250,000 or more) of mutual funds to certain customers without disclosing that the customers' Class A shares would have been financially more advantageous for the customers; and

(b) IFG representatives also did not disclose to customers that they received higher commissions for Class B shares than Class A shares of the same mutual funds.

(ii) The ALJ dismissed the charges, agreeing with the respondents that:

(a) it was unproven that a $250,000 investment in Class A shares outperformed the same investment in Class B shares under all circumstances. Accordingly, the registered representatives' did not omit to disclose material information to their customers; and

(b) it was not clear that the registered representatives had a duty to disclose to their customers that they received greater compensation from the sale of one type of fund shares versus another. The ALJ noted that a rule addressing this topic was pending before the Commission, and for the ALJ to hold that such a duty existed "would be to usurp the Commission's policy and rule making function."

2. <u>Market Timing and/or Late Trading or Late Processing</u>

a. Rule 22c-1(a) of the Investment Company Act of 1940 requires registered investment companies that issue redeemable securities (or others parties designated in the prospectus) to consummate transactions in its securities to sell and redeem fund shares at a price based on the net asset value ("NAV") next computed after receipt of the order to purchase or redeem shares. Orders received by these investment companies prior to 4 PM Eastern Time receive the NAV as of 4 PM that day. Orders received after 4 PM receive the next trading day's 4 PM NAV. Late trading refers to a practice whereby orders are received after 4 PM but are given the same-day NAV.

b. In 2005, the SEC settled enforcement actions involving market timing and/or late trading against:

(i) *Southwest Securities, Inc. ("Southwest"), et al* (34-51002; January 10, 2005)

(a) Southwest and three individual respondents (the firm's president and CEO, its senior vice president and director, and its vice president and branch manager) consented to the following findings:

(1) three Southwest registered representatives engaged in market timing on behalf of two hedge fund customers by using multiple accounts and multiple representative ID numbers to circumvent blocks that mutual fund companies placed on trading by the hedge funds. In addition, the representatives engaged in late trading on behalf of the same hedge fund customers; and

(2) Southwest failed to supervise the representatives because the firm had no policies and procedures for monitoring market timing or late trading by representatives, and the firm's systems permitted representatives to place trades until 6:30 PM. The three respondent supervisors failed to supervise because they knew of the market timing trading (even before the representatives were hired) and failed to stop it or follow up on other red flags.

(b) Southwest agreed to a fine of $8 million and disgorgement of $2 million. In addition, Southwest agreed to retain an independent consultant to review Southwest's policies and procedures concerning market timing, late trading, and retention of records and implement the recommendations of the consultant. The three individual respondents agreed to fines ranging between $50,000 and $200,000. The NYSE conducted a joint investigation and agreed to the same penalties (although the fines by the NYSE were deemed paid upon payment to the SEC).

(ii) *Canadian Imperial Holdings, Inc. ("CIHI") and CIBC World Markets Corp. ("World Markets") (collectively, "CIBC")* (33-8592; July 20, 2005)

(a) CIBC consented to the following findings:

(1) CIHI financed hedge fund clients that it knew were using the leverage provided by CIHI to market time mutual funds. CIHI opened accounts for hedge fund customers at World Markets. When World Markets could "no longer hide the market timing transactions in with normal business flow," CIHI began to open accounts with other broker-dealers. CIHI also established two subsidiaries to reduce the developing perception that equated CIBC with market timing;

(2) World Markets brokers also assisted customers to evade attempts by mutual fund companies to block or restrict their market timing transactions;

(3) the brokers opened many different accounts for the customers and used multiple broker numbers and broker-dealers, despite receiving nearly 1,000 block notices from mutual fund companies;

(4) the World Markets brokers' activity was known to upper management and the firm's mutual fund operations department;

(5) World Markets' selling agreements included representations that the firm did not provide market timing services to customers; and

(6) the World Markets brokers also accepted orders from customers after 4 PM with an understanding that those orders would receive that day's NAV. To do so, the World Markets brokers accepted and time stamped trade instructions from customers before 4 PM but only processed those tickets that corresponded to trades that the

customers ultimately decided after 4 PM to execute.

(b) CIBC agreed to pay a $25 million fine and disgorge $100 million for fair fund distribution. In addition, CIBC agreed to retain an independent distribution consultant to develop a plan to distribute the $125 million.

(iii) *Legg Mason Wood Walker, Inc. ("LMWW")* (34-52478, September 21, 2005)

(a) LMWW, a broker-dealer, consented to the following findings:

(1) LMWW purchased an order entry system for processing non-proprietary mutual funds that, beginning in 1998, was capable of establishing a 4 PM cutoff for processing orders at the same day's NAV;

(2) LMWW never upgraded its system to include that capability, and, as a result, until October 2003, automatically, processed mutual fund orders received by 5:30 PM at the same day's NAV; and

(3) LMWW failed to supervise adequately the processing of non-proprietary mutual funds because, among other reasons, it never tested its systems to ensure a 4 PM cutoff was in place.

(b) LMWW agreed to pay a fine of $1 million. In addition, the firm agreed to retain an independent consultant to determine whether changes to LMWW's policies and procedures to correct these deficiencies were reasonably designed to prevent future late processing.

(c) This late processing violation differed from late trading violations committed by other firms, whereby those firms entered into agreements to permit late trading in violation of securities laws.

3. IPO Allocation

a. In 2005, the SEC settled enforcement actions involving IPO allocation against:

(i) *Morgan Stanley & Co. Incorporated ("Morgan Stanley") and Goldman, Sachs & Co. ("Goldman Sachs")*, (SEC Lit. Release 2005-10; January 25, 2005)

(a) Morgan Stanley and Goldman Sachs consented to findings that they attempted to induce customers who received IPO allocations to purchase additional shares in the aftermarket. For example, Morgan Stanley solicited aftermarket interest from customers during the restricted period, and Goldman Sachs communicated to customers who wanted IPO allocations (including those who only wanted the IPO shares to immediately flip them for a profit) that indications of intentions to purchase shares in the immediate aftermarket, and/or aftermarket orders themselves, would increase their chances of obtaining favorable IPO allocations.

(b) A judgment was to be entered requiring each firm to pay a $40 million civil penalty.

4. Fraud, Supervision, and Retention of Electronic Communications

a. In 2005, the Division of Enforcement litigated before an administrative law judge a matter that involved allegations of fraud, failure to supervise registered representatives and retention of electronic communications against *Raymond James Financial Services Inc. ("Raymond James"), et al (*SEC, Admin. Proc. File No. 3-11692; September 15, 2005).

(a) In 2004, a former Raymond James registered representative pleaded guilty to criminal wire fraud charges based on his role in a fraudulent offering. The Division of Enforcement brought charges in an administrative proceeding against Raymond James, the firm's president, chief operating officer, and a director, and the firm's branch manager (who settled with the Commission prior to the ALJ's decision).

(b) The ALJ held Raymond James responsible for the fraudulent acts of its representative under the common law doctrine of respondeat superior, which holds an employer liable for its employee’s fraud if the employee committed the fraud while acting within the scope of his or her employment duties.

(c) The ALJ also held that Raymond James failed to supervise the representative’s conduct, because during the relevant period, Raymond James: (i) lacked adequate procedures and systems to detect fraud perpetrated by its registered representatives; (ii) lacked adequate information about work locations of its registered representatives; (iii) failed to alert the compliance department as to potential violations; and (iv) ignored red flags that could have alerted the firm to the fraud of its registered representative.

(d) The ALJ found that Raymond James did not willfully violate books and records provisions of the federal securities laws, including the provisions that require broker-dealers to retain all electronic communications for a period of three years. At the hearing, a former officer of member firm regulation at the New York Stock Exchange testified that "in 1999 and 2000, senior staff members of the SEC represented to the broker-dealer industry generally and openly that the Commission would likely modify and make less stringent the requirements [for e-mail retention in a] ... 1997 [SEC] release. In these circumstances, it would be patently unfair and unacceptable in view of the senior staff's actions and representations to find that Raymond James did not take steps to comply with Rule 17a-4(b)(4)."

(e) The ALJ fined Raymond James $6.9 million dollars and ordered the firm to disgorge approximately $5,000 in commissions and fees that it received as a result of the fraudulent offering. She also fined Raymond James' president, chief operating officer, and a director at the time $200,000 and suspended him for 90 days from the broker-dealer and investment advisory businesses. The ALJ denied the Division’s requests for: (i) a cease-and-desist order (because Raymond James’s “corporate culture” had changed, reducing the likelihood of future violations); and (ii) an order that Raymond James retain an outside consultant.

(f) The ALJ's decision became final in November 2005.

5. <u>Best Execution</u>

a. In late 2004, the SEC settled an enforcement action involving best execution for institutional customers against:

(i) *Knight Securities L.P. ("Knight")* (34-50867; December 16, 2004)

(a) Knight consented to findings that:

(1) between January 1999 and November 2000, when Knight received an institutional "not held" (i.e., brokers were given discretion as to price and time of execution) buy order from a customer, Knight's traders acquired shares of the requested security for the firm's proprietary account before filling the customer's order;

(2) Knight then waited to see how the security performed in the market during the day. If the stock went up in price during the day, Knight executed the customer's order from the market, locking in a profit in Knight's proprietary account. If the stock price dropped during the day, Knight would fill the customer's orders from the firm's proprietary position at prices that nevertheless provided a profit to Knight;

(3) Knight engaged in the same behavior with respect to customers' sell orders by selling short shares of the security in the firm's proprietary account;

(4) this conduct violated the firm's duty to seek best execution for its customers; and

(5) Knight also misused trade modifiers when reporting to ACT trades more than 90 seconds after they were executed. The firm failed to supervise this reporting because it lacked written procedures, systems, and supervisory personnel that would have

prevented its sales trades from misusing the modifiers.

(b) Knight agreed to a censure, a fine of $12.5 million, and disgorgement of more than $41 million. In addition, Knight agreed to retain an independent consultant to prepare a plan to distribute the fine and disgorgement amount to affected investors.