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review

2011 Year in Review:
SEC and FINRA Selected Enforcement Cases and Developments Regarding Broker-Dealers

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TABLE OF CONTENTS

Page

TABLE OF CONTENTS
(continued)

Page

TABLE OF CONTENTS
(continued)

Page

This Outline highlights key U.S. Securities and Exchange Commission (the "SEC" or the "Commission") and Financial Industry Regulatory Authority ("FINRA") enforcement developments and cases regarding broker-dealers during 2011.[*]

The SEC

The SEC brought a record number of enforcement actions in FY 2011.[1] In its first complete fiscal year since the Division of Enforcement's extensive reorganization, the Commission filed 735 enforcement actions. Although senior Commission officials continue to caution that statistics alone do not tell the whole story, the measures traditionally used to assess the SEC's enforcement activity demonstrate that, in FY 2011, the Division of Enforcement vigorously pursued securities law violators. Some of the key statistics from FY 2011 are described below:

- Last year, the Commission brought 735 enforcement actions, an 8% increase from the 681 cases initiated in FY 2010.
- At the end of FY 2011, National Priority or High Impact cases represented 5.11% of the Division of Enforcement's active docket, up from 3.26% in FY 2010.
- In one of the Commission's core areas – regulation of broker-dealers – the SEC's actions increased significantly to 113 cases in FY 2011 from 70 in the prior year. This represents a 60% increase year-over-year. Also of particular note is the big jump in cases against investment advisers and

[*] This Outline was prepared by Ben A. Indek, Ivan P. Harris, Kevin T. Rover and Anne C. Flannery, partners, and of counsel Mary M. Dunbar, with substantial assistance from associates Casey P. Cohen, Alex B. Kaplan, Kerry J. Land, Nicholas J. Losurdo, Charles D. Manice, Julie A. Marcacci, John C. Matthews, Julia N. Miller, Katarzyna Mularczyk, Sarah S. Nilson, Rahul Rao, Todd Smith, E. Andrew Southerling, Shaina Stahl and David A. Snider. As noted below, certain sections of the Outline were drawn from Law Flashes published by the Firm. The authors are grateful for the outstanding administrative assistance provided by legal secretary Mary-Elizabeth Denmark. Morgan Lewis served as counsel in certain actions described herein.

[1] The SEC's fiscal year begins on October 1. References to FY 2011 are to the year that commenced on October 1, 2010 and ended on September 30, 2011.

investment companies. In FY 2011, the Commission brought 146 enforcement actions in this area. This is a single-year record and represents a 30% increase over the prior year. Cases against broker-dealers, investment advisers and investment companies represented about 35% of the SEC's total enforcement docket.

- The Division opened 578 formal investigations last year. By comparison, in FY 2010, the SEC issued 531 formal orders of investigation.

- Last year, there were 134 criminal actions relating to Commission cases, down slightly from FY 2010's 139 cases.

- The Commission also works closely with other regulators. In FY 2011, 586 SEC investigations were referred to self-regulatory organizations or other state, federal and foreign authorities for enforcement, up from FY 2010 when 492 such referrals were made. In addition, the SEC increased the number of occasions (772) when it sought assistance from foreign regulatory authorities and it received an increasing number of requests (492) for assistance from such regulators.

- Last year, almost 18.5% of the investigations opened during FY 2011 came from referrals within the Commission or other internal analysis. This represents a slight decrease from FY 2010 (21.9%).

- The Commission sought emergency relief in federal courts in 39 cases; that technique was used 37 times in FY 2010. The Commission also sought 42 asset freezes to preserve money for the benefit of harmed investors in FY 2011 versus 57 such actions in the prior year.

- In FY 2011, the Commission filed 61% of its first enforcement actions within two years of starting an investigation or inquiry, well below its target rate of 70%.

- For FY 2011, the SEC reported that it had obtained orders requiring the payment of approximately $928 million in penalties by securities law violators. This is slightly less than the $1.03 billion the SEC reported for FY 2010. It is interesting to note that, like FY 2010, a relatively small number of cases seemingly account for a substantial portion of the fines imposed last year. Specifically, it appears that ten cases represent approximately 46% of the $928 million in penalties imposed by the SEC in FY 2011.

- The Commission obtained orders requiring disgorgement of $1.878 billion in illicit gains last year, a small increase from the $1.82 billion in FY 2010.

Last year there were also a number of important enforcement developments at the Commission, including the SEC's first ever deferred prosecution agreement, the finalization of the Dodd-Frank whistleblower rules, and the continued focus on individual liability in enforcement actions. The SEC also started the process of seeking Congressional approval to enhance its penalty authority and reportedly began leaning toward filing negligence charges rather than scienter-based fraud claims in connection with certain cases.

In 2011, the SEC's long-standing settlement practice, which includes defendants neither admitting nor denying the allegations against them, came under increasing judicial attack. In March 2011, Judge Jed Rakoff of the Southern District of New York took issue with this practice in connection with his review of a proposed settlement between the SEC and a corporation and two individual defendants. Judge Rakoff ultimately approved the agreement and reserved for another time the substantial questions the SEC's settlement practices raised. That time came in November 2011, when Judge Rakoff rejected another SEC settlement with a large financial institution, finding that the proposed agreement was neither fair, reasonable, adequate nor in the public interest. That case is now on appeal to the Second Circuit.

As the calendar turned to 2012, the Commission reportedly changed its "no admit or deny" policy in cases involving parallel criminal actions. In such cases, the SEC will no longer allow a settling defendant to neither admit nor deny the Commission's allegations while at the same time admitting to a criminal violation or entering into a deferred prosecution agreement with the Department of Justice. Congress will hold hearings on the SEC's settlement policy in early 2012.

Last year, the SEC brought significant cases in several of its traditional areas, including insider trading, fraudulent trading schemes, municipal bonds, short selling, and broker-dealer supervision. In connection with its efforts to investigate misconduct during the financial crisis, the Commission continued to be active in the collateral debt obligation and mortgage-backed securities areas. Finally, the SEC instituted interesting cases against two securities exchanges, an alternative trading system and a self-regulatory organization.

These developments and cases are described in more detail on pages 6 through 74 of this Outline.

FINRA

Last year brought with it a new leadership team, new rules, revised Sanction Guidelines and a new disciplinary action database to FINRA. J. Bradley Bennett became the new Head of Enforcement, promising a "tough but fair" approach and efforts to streamline the investigation process. Several senior Enforcement officials left FINRA in 2011; Mr. Bennett internally promoted at least two enforcement staffers to new positions and recruited a new Deputy Director of Enforcement resident in FINRA's New York office.

All of the traditional statistics used to measure FINRA's enforcement program showed marked increases in 2011. FINRA brought more cases, harshly disciplined more brokers and principals, obtained significantly more money from the industry through the fines it imposed and returned substantially more money to investors than in the prior year.

- In 2011, FINRA filed 1,488 new disciplinary actions against firms and individuals, up from 1,310 cases from the prior year – an increase of 13.5%. FINRA also resolved 1,287 formal actions last year; in 2010, it had concluded 1,178 such cases.
- Last year, FINRA expelled 21 firms from its membership (compared to 14 in the prior year), barred 329 people (versus 288 in 2010) and suspended 475 individuals (an increase over the 428 such actions in the prior year).
- As of December 16, 2011, FINRA reported that it had levied fines of more than $63 million versus almost $42.2 million in all of the prior year. The 2011 figure would represent a 50% increase year-over-year.
- Again, as of December 16, 2011, FINRA ordered firms and individuals to provide more than $19 million in restitution to customers; in 2010 all such orders totaled $6.2 million.
- In line with the increased number of cases and overall fine levels, cases with significant penalties increased sharply in 2011 when compared to 2010. Last year FINRA increased the number of cases in which it imposed fines of greater than $100,000 to 70 from 53 in the prior year. That represents a 32% increase. This increase is even more pronounced at the higher levels. For example, last year FINRA imposed fines of more than $1.5 million in five times as many cases as it did in 2010 (10 such cases in 2011 compared to only 2 in 2010).

Several significant enforcement developments occurred at FINRA in 2011. After several years of operating under two regimes (i.e., NYSE Rule 351 and NASD Rule 3070), effective July 1, 2011, FINRA significantly changed its reporting requirements with the implementation of new Rule 4530. Perhaps the most important modification concerns firms' requirement to report certain internal conclusions of rule violations. New Rule 4530(b) obligates a firm to promptly report to FINRA (but in no event later than 30 calendar days) after it has concluded or reasonably should have concluded that the firm or an associated person has violated certain laws, rules, regulations or standards of conduct.

In March 2011, FINRA announced four revisions to its Sanction Guidelines. First, the Sanction Guidelines now make clear that "proximate causation" is the required standard for restitution orders in FINRA disciplinary actions. Second, the Sanction Guidelines have been revised to recognize that, where appropriate, adjudicators may order the use of disgorged funds to remedy customer harms, rather than adding those moneys as a fine payable to FINRA. Third, the Sanction Guidelines now reflect that not every factor in the Principal Considerations in Determining Sanctions section have the potential to be aggravating and mitigating considerations. Rather, the use of a factor is dependent upon the facts and circumstances of the particular case and the type of violation under consideration. Finally, the Sanction Guidelines have been amended to instruct adjudicators to also consider sanctions imposed by other regulators for the same misconduct and to determine whether that sanction was sufficiently remedial in nature.

In May 2011, FINRA announced the launch of the Disciplinary Actions on-line database, which makes disciplinary actions available through a web-based searchable system. The new database provides access to AWCs, settlements, National Adjudicatory Council decisions, Office of Hearing Officer decisions and complaints. FINRA has also linked its Monthly Disciplinary Actions case description summary to the corresponding action in its database.

Once again, FINRA was active in several customary areas last year, bringing enforcement actions against member firms for anti-money laundering, municipal securities, prospectus delivery, short selling and supervision violations. It continued its recent efforts in sanctioning firms for violations relating to auction rate securities, mortgage-backed securities, structured products, and customer confidential information. FINRA opened new enforcement fronts in other areas, including private placements, real estate investment trusts, and variable life settlements.

These developments and cases are described in more detail on pages 75 through 141 of this Outline.

Personnel Changes[2]

In 2011, there were a number of significant personnel changes in the SEC's Enforcement, Risk and Examination groups. These include the following:

- In January, SEC Chairman Mary L. Schapiro appointed Dr. Jonathan S. Sokobin as Acting Director of the SEC's Division of Risk, Strategy, and Financial Innovation ("RiskFin"). RiskFin was created in September 2009 and serves as the agency's "think tank" for policymaking, rulemaking, enforcement and examinations. Dr. Sokobin has been with the SEC since 2000 and most recently served as Director of the former Office of Risk Assessment. Before holding that position, he served as the SEC's Deputy Chief Economist from 2004 to 2008. In May, the SEC appointed Craig M. Lewis as the Chief Economist and Director of RiskFin. Dr. Lewis was a professor of finance at Vanderbilt University and, at the time of his appointment, was a visiting scholar at the SEC. In August, the Commission announced that Kathleen Weiss Hanley was named as Deputy Director and Deputy Chief Economist of RiskFin. Dr. Hanley had previously served at the Board of Governors of the Federal Reserve System and the SEC.

- On January 18, 2011, the Commission announced that Eileen Rominger had been appointed Director of Investment Management. Ms. Rominger has almost 30 years of experience in the asset management industry, most recently serving as the Global Chief Investment Officer of Goldman Sachs Asset Management. Ms. Rominger replaced Andrew J. "Buddy" Donohue, who left the agency in November 2010.

- Also in January, the agency announced that Askari Foy had been promoted to Associate Regional Director for Examinations in the SEC's Atlanta Regional Office. Mr. Foy directs a staff of approximately 40 accountants, examiners, attorneys, and support staff responsible for the examination of broker-dealers and investment advisers in Alabama, Georgia, North Carolina, South Carolina and Tennessee.

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

- On February 4, 2011, Mark D. Cahn was promoted to General Counsel in the SEC's Office of the General Counsel, replacing David M. Becker. Mr. Cahn joined the SEC in 2009 and previously served as the agency's Deputy General Counsel for Litigation and Adjudication. Also in the spring, Anne K. Small was named as Deputy General Counsel in the Office of General Counsel.

- Sean McKessy was appointed in February to oversee the new Whistleblower Office in the Division of Enforcement (an office created to administer the whistleblower provisions called for by the Dodd-Frank Wall Street Reform and Consumer Protection Act). The Office handles whistleblowers' tips and complaints and helps the SEC determine rewards made to individuals who provide the agency with information that leads to successful enforcement actions.

- In mid-April, Rose Romero left her position as Director of the SEC's Fort Worth Regional office after five years at the SEC. In August, David Woodcock was named as the Regional Director of the Fort Worth office. Mr. Woodcock had previously been a partner at Vinson & Elkins and practiced public accounting for several years at two major firms.

- Also in April, Sanjay Wadhwa was promoted to Associate Regional Director for Enforcement of the SEC's New York Regional Office. He joined the SEC in 2003 and was named as the Deputy Chief of the Enforcement Division's Market Abuse Unit in early 2010.

- Julius Leiman-Carbia joined the SEC in April as Associate Director of the SEC's National Broker-Dealer Examination Program (part of the agency's Office of Compliance Inspections and Examinations) ("OCIE"). In that capacity, he oversees 300 attorneys, examiners and accountants responsible for inspecting broker-dealers. Prior to joining the SEC in 1989, Mr. Leiman-Carbia worked in the private sector for several firms, including Citigroup Global Markets, JP Morgan and Goldman Sachs.

- On April 25, 2011, the SEC announced that Gene Gohlke, the long-time Associate Director for Examinations in OCIE, was retiring from the Commission. Dr. Gohlke had spent more than 35 years at the SEC, serving under 10 Commission Chairmen during his tenure.

- Also on April 25, 2011, the Commission announced that Cameron Elliot joined the agency as an Administrative Law Judge. These judges act as independent judicial officers who preside over public hearings involving allegations of securities law violations instituted by the Commission. Mr. Elliot had previously been an Administrative Law Judge for the Social Security Administration.

- SEC Commissioner Kathleen L. Casey left the Commission on August 5, 2011 after completing her five-year term earlier in the year. In the press release announcing her departure, the Commission noted her active engagement on international matters, particularly her role as Chair of the International Organization of Securities Commission's Technical Committee and as the SEC's representative to the Financial Stability Board.

- The SEC announced on September 19, 2011 that James Brigagliano, Deputy Director of the Division of Trading and Markets, was leaving the agency at the end of September. Mr. Brigagliano served at the SEC for 25 years, the past 13 in the Division of Trading and Markets.

- On October 4, 2011, the Commission named Michael A. Conley as Deputy General Counsel in the Office of General Counsel. Mr. Conley's portfolio includes enforcement matters, appellate cases and adjudications.

- Also in October, the Commission appointed Andrew J. Bowden as an Associate Director heading OCIE's National Investment Adviser/Investment Company examination program. Mr. Bowden succeeds Gene Gohlke; he joined the SEC from Legg Mason.

- Daniel M. Gallagher was sworn into office as an SEC Commissioner on November 7, 2011. Mr. Gallagher took the place of former Commissioner Casey. Among other things, Mr. Gallagher had previously served at the SEC in a number of senior positions, including as Deputy Director of the Division of Trading and Markets.

- In late November, Kristin Snyder was promoted to head the examinations program in the San Francisco Regional Office.

- On December 8, 2011, Louis A. Aguilar began his second term as an SEC Commissioner.

- Finally, on December 19, 2011, Michael E. Garrity was appointed to head the examination program in the Commission's Boston Regional Office.

In addition to the foregoing individual personnel changes, it is important to note that the Division of Enforcement has hired various specialists to help it in its investigations. In particular, in February 2011, it was reported that Enforcement had recently hired 10 industry specialists to assist it with investigations, training and initiative planning. The specialists include a former portfolio manager, a former trading desk head and a former municipal bond trader.[3]

Enforcement Statistics

In its first complete fiscal year since the Division of Enforcement's extensive reorganization, the Commission filed a record 735 enforcement actions in FY

[3] "Enforcement Adds Industry Specialists," Compliance Reporter (Feb. 14, 2011).

2011. The SEC has suggested that its record performance was brought about due to the Division's reorganization, the close collaboration among SEC offices and the increased use of technology to identify and stop illegal activity. For example, the SEC has stated that the Division of Enforcement has forged closer ties with OCIE, developed specialized skills and new approaches for investigating potential wrongdoing, and utilized new information technology resources to develop analytical tools and to process the large amount of data that it receives in connection with investigations.[4]

Although senior Commission officials continue to caution that statistics alone do not tell the whole story,[5] several of the measures traditionally used to assess the SEC's enforcement activity demonstrate that, in FY 2011, the Division of Enforcement actively and aggressively pursued misconduct affecting the U.S. markets.[6] The year's statistics are described below.

A Record Number of Enforcement Actions

Last year, the Commission **brought 735 enforcement actions**, an 8**%** increase from the 681 cases initiated in FY 2010. FY 2011's 735 cases is the highest number of actions ever brought by the SEC.

"National Priority" or "High Impact" Actions

The SEC is focusing on its "National Priority" or "High Impact" actions, which the Commission hopes will be widely covered by the media and affect the future conduct of market participants. At the end of FY 2011, National Priority or High Impact cases represented 5.11% of the Division of Enforcement's active docket, up from 3.26% in FY 2010. Eighty-five of the SEC's 735 enforcement actions were designated as National Priority cases last year.

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4 SEC's 2011 Performance and Accountability Report available at: http://sec.gov/about/secpar2011.shtml at pages 12 and 13.

5 Testimony of Robert Khuzami, November 16, 2011 before the United States Senate Committee on Banking, Housing and Urban Affairs Subcommittee on Securities, Insurance and Investment "Khuzami Congressional testimony", available at: http://sec.gov/news/testimony/2011/ts111611rk.htm.

6 As noted previously, the SEC's fiscal year begins on October 1st. References to FY 2011 refer to the year that began on October 1, 2010 and ended on September 30, 2011. The FY 2011 statistics in this section were taken from the Commission's Select SEC and Market Data – Fiscal 2011 report available on the SEC's website at: http://www.sec.gov/about/secstats2011.pdf and the SEC's 2011 Performance and Accountability Report.

Categories of Cases

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

Type of Case	Number of Actions	% of Total Actions
Investment Advisers/Investment Companies	146	19.9
Securities Offering Cases	123	16.7
Delinquent Filings	121	16.5
Broker-Dealer	113	15.4
Financial Fraud/Issuer Disclosure[7]	89	12.1
Insider Trading	57	7.8
Market Manipulation	35	4.8
FCPA	20	2.7

Of note, in one of the Commission's core areas – **regulation of broker-dealers** – the SEC's actions **increased significantly to 113 cases** in FY 2011 from 70 in the prior year. This represents a 60% increase year-over-year. Also of particular note is the big jump in cases against **investment advisers and investment companies**. In FY 2011, the Commission brought 146 enforcement actions in this area. This is a single-year record and represents a 30% increase over the prior year. Additionally, cases against investment advisors, investment companies and broker-dealers accounted for about 35% of the SEC's enforcement docket. Taken together, it is clear that the SEC devoted significant resources and placed regulated financial institutions under increased scrutiny in the last year.

Consistent with the SEC's aggressive stance on insider trading, the SEC brought **57 insider trading cases**, up from 53 in FY 2010 (an 8% increase). The SEC charged 124 individuals and entities in these actions versus 138 defendants charged in the prior year.

Formal Orders of Investigation

The Division opened **578 formal investigations** last year. By comparison, in FY 2010, the SEC issued 531 formal orders of investigation.

[7] Prior to FY 2011, the SEC characterized this group of cases as "Issuer Reporting and Disclosure" and included Foreign Corrupt Practices Act ("FCPA") actions in this group. Last year, FCPA actions were tracked separately.

SEC Coordination with Criminal Authorities and Referrals to Other Agencies

In the last several years, a significant amount of attention has been paid to the increasing "criminalization" of the federal securities laws. In FY 2011, the evidence reflects that the SEC continued to work closely with criminal prosecutors. Last year, there were **134 criminal actions** relating to Commission cases, down slightly from FY 2010's 139 cases.

The Commission also works closely with other regulators. In FY 2011, **586 SEC investigations were referred** to self-regulatory organizations or other state, federal and foreign authorities for enforcement, up from FY 2010 when 492 such referrals were made. In addition, the SEC increased the number of occasions (772) when it sought assistance from foreign regulatory authorities and it received an increasing number of requests (492) for assistance from such regulators. The amount of such requests to and from the SEC increased from the prior year.

Internally Generated Cases, Emergency Relief and First Time Actions

As part of its retooling efforts since 2009, the SEC has tried to enhance its ability to turn internally generated tips, audits or other prospects into investigations. Last year, **almost 18.5%** of investigations opened during FY 2011 **came from referrals within the Commission or other internal analysis**. This represents a slight decrease from FY 2010 (21.9%).

Over the last several years, the SEC leadership has indicated that a top priority is to move quickly to stop and punish misconduct affecting the securities markets. However, last year two statistics used to examine how quickly the SEC moved to stop ongoing misconduct reflected a mixed record in this area. The Commission sought **emergency relief in federal courts in 39 cases**; that technique was used 37 times in FY 2010. The Commission also sought **42 asset freezes** to preserve money for the benefit of harmed investors in FY 2011 versus 57 such actions in the prior year. Of course, these two measures may not necessarily indicate that the SEC moved more slowly than in the past, but rather can also be explained by the fact that there may have been about the same or fewer cases that required such emergency action.

On a related note, last year the Commission **filed 61% of its first enforcement actions within two years** of starting an investigation or inquiry, falling further behind its target rate of 70%. That 61% figure represents a 6% decrease year-over-year and compares even more unfavorably to the Commission's statistics in prior years.

Successful Outcomes

Last year, the Commission continued its record of "successfully" resolving the vast majority of its cases. Specifically, in FY 2011 the SEC reported that it had obtained a **"favorable" outcome**, including through litigation, settlement or a default judgment, in **93% of its cases**. (The Commission calculates this measure on a per-defendant basis.) This figure is 1% higher than the Commission achieved between FY 2007 and FY 2010.

Penalties, Disgorgement and Distributions to Injured Investors

For FY 2011, the SEC reported that it had obtained orders requiring the payment of approximately **$928 million in penalties** by securities law violators. This is slightly less than the $1.03 billion the SEC reported for FY 2010. It is interesting to note that, like FY 2010, a relatively small number of cases account for a substantial portion of the fines imposed last year. Specifically, it appears that ten cases represent approximately 46% of the $928 million in penalties imposed by the SEC in FY 2011.

The Commission also obtained orders requiring **disgorgement of $1.878 billion** in illicit gains last year, a small increase from the $1.82 billion in FY 2010.

Below is a chart reflecting fines and disgorgements between FY 2004 and FY 2011.

Fiscal Year	Civil Money Penalties	Disgorgement
2004	$1.2 billion	$1.9 billion
2005	$1.5 billion	$1.6 billion
2006	$975 million	$2.3 billion
2007	$507 million	$1.093 billion
2008	$256 million	$774 million
2009	$345 million	$2.09 billion
2010	$1.03 billion	$1.82 billion
2011	$928 million	$1.878 billion

Focus on Individuals

Over the last year, it appears that the SEC has continued to focus on the potential liability of individuals in its investigations. For example, since 2009 and through December 16, 2011, in connection with financial crisis cases alone, the Commission reported that it had charged 87 entities and individuals. This included 45 CEOs, CFOs and other senior corporate officers. It also noted that 25 officer and director bars, industry bars, and Commission suspensions had been imposed on individuals. Finally, the Commission ordered $1.2 billion in penalties in these cases over a roughly three-year period.[8]

In addition to the statistics, this trend can also be seen in several cases summarized below, including those relating to alleged fraudulent sales practices, supervision, municipal bond transactions and privacy and confidentiality of customer information.

Judicial Criticism of SEC Settlement Practices

In 2011, the SEC's long-standing settlement practices came under increasing judicial attack.

In March 2011, Judge Jed Rakoff of the Southern District of New York, took issue with the SEC's practice of accepting settlements in which the defendants neither admit nor deny the allegations against them. Writing in *SEC v. Vitesse Semiconductor Corp., et al.*, 10-Civ-9239 (S.D.N.Y. Mar. 21, 2011), Judge Rakoff questioned whether such agreements met the legal standards required for the Court to approve a settlement.

In recounting the procedural facts of the case, Judge Rakoff noted:

> Simultaneous with filing the Complaint on December 10, 2010, the S.E.C. – confident that the courts in this judicial district were no more than rubber stamps – filed proposed Consent Judgments against [certain of the defendants] without so much as a word of explanation as to why the Court should approve these Consent Judgments or how the Consent Judgments met the legal standards the Court is required to apply before granting such approval.

Unhappy with this lack of information, Judge Rakoff ordered the SEC to submit a letter brief and convened a hearing.

In its opinion, after finding the financial and injunctive portions of the settlement to be fair and reasonable, the Court went on to express its concern about the SEC's long-standing practice of allowing a defendant to settle without admitting or denying the allegations, but also requiring that the defendant not publicly deny the charges.

> The result is a stew of confusion and hypocrisy unworthy of such a proud agency as the S.E.C. The defendant is free to proclaim that he has never remotely admitted the terrible wrongs alleged by the S.E.C.; but, by gosh, he had better be careful not to deny them either (though, as one would expect

[8] *See* "SEC Enforcement Actions Addressing Misconduct that Led to or Arose from the Financial Crisis," available at: www.sec.gov.

> his supporters feel no such compunction). Only one thing is left certain: the public will never know whether the S.E.C.'s charges are true, at least not in a way that they can take as established by these proceedings.
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> The disservice to the public inherent in such a practice is palpable.

Judge Rakoff contrasted the SEC's settlement practice to the Department of Justice's policy of rarely allowing defendants to plead *nolo contendere*, clearly suggesting that this was the preferable protocol. The Court then added, "for now, however, the S.E.C.'s practice of permitting defendants to neither admit not deny the charges against them remains pervasive, presumably for no better reason than it makes the settling of cases easier."

Judge Rakoff ultimately approved the Consent Judgments in this matter because the two individual defendants had pleaded guilty in parallel criminal cases and the company had, despite its financial difficulties, paid $2.4 million to a class action settlement fund and would pay an additional $3 million under the settlement. As Judge Rakoff stated: "No reasonable observer of these events could doubt that the company had effectively admitted the allegations of the complaint in the way that, for a company, is particularly appropriate: by letting its money do the talking."

Judge Rakoff reserved for another time the "substantial questions" of whether it was permissible to approve other settlements in which the defendant neither admits nor denies the allegations against it.

That time came only six months later. On October 29, 2011 the SEC announced that Citigroup had agreed to pay $285 million in penalties, disgorgement and prejudgment interest to settle charges that it had negligently misled investors in connection with its 2007 structuring and sale of a CDO tied to the housing market. Like the SEC's well publicized case against Goldman Sachs in 2010, the SEC alleged that Citigroup failed to disclose that it had bet against the CDO's mortgage collateral. The proposed settlement included the usual provision that Citigroup neither admitted nor denied the allegations in the SEC's complaint, which was filed on the same day in the U.S. District Court for the Southern District of New York.[9]

Like the *Vitesse* case, the *Citigroup* action was assigned to Judge Rakoff.[10] In the *Citigroup* case, Judge Rakoff responded to the proposed settlement by

[9] *SEC v. Citigroup Global Markets Inc.*, Case No. 1:11-cv-07387-JSR.

[10] Interestingly, in 2009, Judge Rakoff had raised significant objections to the fine in a proposed SEC settlement with Bank of America over disclosures relating to its purchase of Merrill Lynch.

issuing an Order setting a hearing to determine whether the settlement was "fair, reasonable, adequate, and in the public interest." Judge Rakoff also asked the SEC and Citigroup to answer at least nine questions at the hearing that addressed such topics as the "no admit or deny" language in the settlement, the manner in which the penalty amount was determined, how the SEC enforces injunctions and treats recidivist financial institutions, and why, given the facts cited in the Complaint, the SEC charged Citigroup with negligence instead of fraud.

The SEC responded to Judge Rakoff's questions with a forceful submission, arguing, among other things, that the proposed settlement "reflects the scope of relief likely to be obtained by the Commission under the applicable law if successful at a trial on the merits, also taking into account the litigation risks likely to be presented, the benefits of avoiding those risks, the willingness of Citigroup to consent to a judgment and not deny liability, and the opportunity to detail publicly in this forum the facts that led the Commission to pursue this action." The SEC also strongly defended its "no admit or deny" policy, noting that such settlements had long been endorsed by the U.S. Supreme Court and observing that Justice Department civil settlements, as well as settlements by other federal agencies such as the Federal Trade Commission, include similar provisions. Finally, the SEC argued that Judge Rakoff should base his analysis of the proposed settlement solely on the allegations in the Complaint, should not seek information about the SEC's investigation or its settlement negotiations, and should give substantial deference to the Commission.

Despite the SEC's arguments, as well as similar arguments raised by Citigroup, Judge Rakoff rejected the Citigroup settlement in a 15-page opinion issued on November 28, 2011. Although he noted that the SEC's views about the appropriateness of the settlement are entitled to substantial deference, Judge Rakoff determined that he "must still exercise a modicum of independent judgment" in evaluating whether the settlement serves the public interest. According to Judge Rakoff, this was particularly true when the Court is asked to employ its injunctive and contempt powers in support of a settlement.

Applying that judgment to the proposed settlement, Judge Rakoff found it to be neither fair, reasonable, adequate, nor in the public interest because, among other things, it allowed Citigroup to neither admit nor deny the Complaint's allegations. Referring to this policy as "hallowed by history, but not by reason," Judge Rakoff complained that such settlements "deprive[] the Court of even the most minimal assurance that the substantial injunctive relief it is being asked to impose has any basis in fact." He further opined that such settlements, and the comparatively modest penalties they impose, are viewed "as a cost of doing business" by the business community. In a not-so-subtly veiled criticism of the SEC, Judge Rakoff further wrote that the settlement offers little to the public, and

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Ultimately, after the parties renegotiated the settlement, which called for an increased penalty, Judge Rakoff approved the agreement.

nothing to the SEC besides "a quick headline." He concluded his opinion by stating that the "application of judicial power that does not rest on facts is worse than mindless, it is inherently dangerous," and that only admissions or trials can establish such facts. Judge Rakoff ordered the parties to proceed to trial in the summer of 2012.

On December 15, 2011, Enforcement Director Robert Khuzami announced that the SEC would appeal Judge Rakoff's ruling to the U.S. Court of Appeals for the Second Circuit.[11] Calling the ruling "unprecedented" and harmful to investors, Mr. Khuzami stated that requiring defendants to admit facts or go to trial "is at odds with decades of court decisions that have upheld similar settlements by federal and state agencies across the country." He also warned that a broader application of Judge Rakoff's standard would mean "that other frauds might never be investigated or be investigated more slowly because limited agency resources are tied up in litigating a case that could have been resolved."

While the case makes its way through the appellate process, another federal court took note of Judge Rakoff's decision and has questioned the SEC's proposed settlement with Koss Corporation and its CEO and CFO.[12] On December 20, 2011, Judge Rudolph Randa of the U.S. District Court for the Eastern District of Wisconsin issued a letter to the SEC asking it to provide a "written factual predicate" for why it should approve the settlement. Judge Randa's letter cited to Judge Rakoff's November 28, 2011 opinion and questioned both the injunctive relief he was being asked to enter and the basis on which the SEC had determined the disgorgement amount. The SEC has until January 24, 2012 to submit a brief to Judge Randa addressing these issues.

In early January 2012, furthermore, Mr. Khuzami announced a significant change in the SEC's "no admit or deny" policy in cases involving parallel criminal actions. In such cases, the SEC will no longer allow a settling defendant to neither admit nor deny the SEC's allegations while at the same time admitting to a criminal violation or entering into a deferred prosecution agreement with the Justice Department. Rather, under the new policy, the SEC's action will cite the admissions made in the parallel criminal case. SEC critics had noted the inconsistency between the Commission's approach and that of the Department of Justice in such recent cases as the Wachovia Bank, N.A. municipal securities bid-rigging matter. In that case, Wachovia settled the SEC's action without

[11] The level of discord between the SEC and Judge Rakoff even flowed over to the initial stages of the appeal. Just before the Christmas holiday, the SEC asked Judge Rakoff to stay the district court proceedings while the appeal is pending. Anticipating that Judge Rakoff might deny its motion, the SEC sought an emergency order from the Second Circuit staying the lower court action. The SEC apparently did not inform Judge Rakoff of its application for an emergency order, which resulted in him issuing an Order on December 27, 2011 denying the SEC's motion at virtually the same time that the Second Circuit issued an Order granting the SEC's motion for an emergency stay. Judge Rakoff shot back at the SEC on December 29 by issuing a Supplemental Order accusing the SEC of misleading both him and the Second Circuit.

[12] *SEC v. Koss Corp. et al*., Case No. 11-C-991 (E.D. Wisc.)

admitting or denying the allegations leveled against it but, at the same time, settled with the Justice Department by admitting, acknowledging and accepting responsibility for the same conduct.[13] However, the new SEC policy will not affect the majority of its cases – those in which it alone is resolving a case against a company.

Finally, Congress has indicated that it will hold a hearing to examine this issue in early 2012.[14]

Insider Trading and Parallel Proceedings

Although federal criminal prosecutors have made major headlines in the insider trading area over the last two years, the SEC also continues to be active and aggressive in pursuing such cases. To support this view, Mr. Khuzami stated, in late March 2011, that the SEC "continue[s] to vigorously enforce insider trading laws."[15] Indeed, a total of 57 actions were brought in FY 2011 alleging insider trading violations, an 8% increase from the prior year. Defendants included individuals from hedge funds, broker-dealers, corporate boards, and even a former Nasdaq managing director. High profile cases were brought against a former board member of Goldman Sachs and involving a new product – exchange traded funds.

Many insider trading cases involve both criminal and SEC charges. Speaking generally about the close collaboration between the DOJ and the SEC, Deputy Director of the Division of Enforcement Lorin Reisner commented in June 2011 that, of the Commission's highest priority cases, approximately 55-65% have "some type" of parallel criminal investigation.[16]

The Rajaratnam Criminal Conviction and SEC Judgment

The most widely followed securities-related case of 2011 was the criminal trial of hedge fund manager Raj Rajaratnam. As we reported in 2009, the United States Attorney's Office for the Southern District of New York charged Rajaratnam with perpetrating an insider trading scheme that involved extensive and recurring insider trading ahead of various corporate announcements. Prosecutors alleged that Rajaratnam orchestrated a scheme that resulted in over $50 million in illicit profits. The case, along with a companion civil action filed by the SEC against Rajaratnam and dozens of other individuals, has reportedly led to additional inquiries involving employees at major Wall Street investment banks, expert networks, law firms and other professionals. In something of a departure from

13 "SEC Changes Policy on Firms' Admissions of Guilt," Edward Wyatt, New York Times (Jan. 7, 2012).

14 *Id*.

15 Remarks at SIFMA's Compliance & Legal Society Annual Seminar, March 23, 2011.

16 "Interaction of SEC's Bounty Program, Cooperation Initiative Remains to be Seen," BNA Securities Regulation and Law Report (June 13, 2011).

prior practice, the government made extensive use of write taps made during its investigation, the validity of which was sustained in the cases brought to trial.

Although most of the defendants in these civil and criminal actions settled, Rajaratnam elected to take his criminal case to trial. Following a two-month trial, Rajaratnam was convicted on May 11, 2011 on all 14 counts of conspiracy and securities fraud leveled against him. While his conviction is on appeal, Rajaratnam began serving an 11-year prison sentence in December 2011. Rajaratnam was also ordered to pay more than $53.8 million to forfeit illegal gains and $10 million in criminal fines.

As for the SEC, in November 2011, the Commission announced that it had obtained a record monetary penalty of $92.8 million from Rajaratnam in its own civil action. In its press release, the SEC stated that the case "marks the largest penalty ever assessed against an individual in an SEC insider trading case."[17]

SEC Efforts to Enhance its Penalty Authority

In late November 2011, SEC Chairman Schapiro delivered a letter to top members of the Securities Subcommittee of the Senate Finance Committee asking for statutory changes that would substantially increase the monetary penalties that the SEC can seek in enforcement actions.

First, the SEC asked that the top tier of its penalty scale increase to $1 million per violation for individuals and $10 million per violation for entities.

Second, the SEC's proposal would increase the alternative maximum tier three penalty to three times the gross amount of pecuniary gain to the defendant, as opposed to the current one time, and make a calculation method based on the gross amount of pecuniary gain available in SEC administrative proceedings for all violations. This latter change would align the penalties available in federal district court actions with SEC administrative proceedings.

Third, the SEC asked the Senators to consider allowing a third alternative for tier three penalties that would be based on investor losses incurred as a result of a defendant's violations. As noted in Chairman Schapiro's letter, this methodology would require SEC actions to determine the amount of investor losses in particular cases through event studies or expert witnesses testimony. This methodology would also create a dichotomy in that the SEC is not required to prove loss causation to establish liability in its enforcement actions, yet would need to establish causation for purposes of calculating penalties.

To address recent criticism that the SEC is not aggressive enough on recidivists, the fourth proposed change in Chairman Schapiro's letter would authorize the SEC to seek a three-times penalty if, within the preceding five years, a defendant has been sanctioned by the SEC or criminally convicted of securities fraud.

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17 "SEC Obtains Record $92.8 Million Penalty Against Raj Rajaratnam" (Nov. 8, 2011).

The fifth, and related, proposal would allow the SEC to seek a civil penalty for violations of a federal court injunction or an industry bar obtained by the SEC in a federal court action or administrative proceeding.

These changes would, in the Chairman's view, provide the SEC with greater flexibility regarding monetary penalties in cases where the misconduct is very serious, repeated or involves substantial losses, but current statutes do not allow for an appropriately significant penalty.

The Commission's Use of Negligence Rather Than Scienter-Based Fraud Charges

A fall 2011 Wall Street Journal article reported that the Commission had changed its enforcement strategy to make it easier for the SEC to hold individuals accountable for misconduct that occurred during the financial crisis.[18] Specifically, the SEC was reportedly leaning toward filing negligence charges rather than scienter-based fraud claims in such cases.[19] Of course, the standard for proving negligence is much lower than that needed to demonstrate that an individual acted with intent.

A review of several FY 2011 cases against both firms and individuals appears to support the notion that the Commission is looking to use this tactic. Specifically, several cases described in more detail below contain charges under Sections 17(a)(2) and (3) of the Securities Act of 1933 rather than under Section 10(b) and Rule 10b-5 of the Securities and Exchange Act of 1934.

This development bears watching in the coming year.

Cooperation Initiatives[20]

In 2010, the Commission announced a series of new measures designed to encourage individuals and companies to cooperate in Enforcement Division investigations and enforcement actions. As we summarized in our 2010 Year in Review, these initiatives include formal guidelines to evaluate and potentially reward cooperation by individuals, and incentives for individuals and companies to cooperate with the Division such as cooperation agreements, deferred prosecution agreements and nonprosecution agreements. These tools seek to provide the SEC with some of the same methods available to federal prosecutors in fighting white collar crime, and are consistent with the philosophy that Enforcement Director Robert Khuzami and Deputy Enforcement Director Loren

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18 "At SEC, Strategy Changes Course," Gene Eaglesham, Wall Street Journal (Sept. 30, 2011).

19 *See also* "The SEC's Recent Interest in Negligence-Based Charges," Audrey Strauss, New York Law Journal (Nov. 3, 2011). This article provides an excellent analysis of this issue.

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

Reisner, both former federal prosecutors, have brought to the Division. Below are the developments in these areas that occurred in 2011.

Cooperation Agreements

The Enforcement Division has trumpeted its use of these cooperation tools in 2011. According to the most recently available statistics that we have seen, the SEC has entered into approximately 25 cooperation agreements with individuals since its program began, and officials expect that number to increase as the program becomes more established.[21]

Deferred Prosecution Agreements

In May 2011, the SEC announced its first ever deferred prosecution agreement ("DPA") in connection with a Foreign Corrupt Practices Act ("FCPA") investigation involving Tenaris S.A., a global steel pipe manufacturer and supplier. DPAs are formal written agreements in which the Commission agrees to forego an enforcement action against a cooperator. These agreements are executed only if the individual or company agrees, among other things, to cooperate fully and truthfully, including producing all potentially relevant nonprivileged documents and materials, and to comply with express prohibitions and undertakings during a period of deferred prosecution, which generally should not exceed five years.

In announcing the Tenaris DPA, Mr. Khuzami stated in the SEC's press release that the Commission agreed to a deferred prosecution agreement because Tenaris' "immediate self reporting, thorough internal investigation, full cooperation with SEC staff, enhanced anti-corruption procedures, and enhanced training made it an appropriate candidate for the Enforcement Division's first deferred prosecution agreement."

Pursuant to the terms of the agreement, the SEC agreed not to bring any enforcement action against Tenaris arising from the alleged FCPA violations in exchange for Tenaris' agreement to, among other things, pay $5.4 million in disgorgement and prejudgment interest and to perform certain express undertakings. The Tenaris deferred prosecution agreement contains notable provisions, many of which mimic the Department of Justice's ("DOJ") deferred prosecution program, including:

- *Acceptance of responsibility*. The Tenaris DPA includes an introductory paragraph that states that "[p]rior to a public enforcement action being brought by the Commission against it, without admitting or denying these allegations, [Tenaris] has offered to accept responsibility for its conduct…."

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21 This figure comes from the remarks of Robert Khuzami at a late June 2011 SIFMA Compliance & Legal Society luncheon.

- *Term*. The Tenaris DPA, as is typical of DOJ DPAs, contains a term for the agreement – in this case, two years.

- *Statute of limitations*. The Tenaris DPA, like many DOJ DPAs, includes a provision that the statute of limitations is tolled during the term of the DPA.

- *Statement of Facts*. Similar to DOJ DPAs, the Tenaris DPA includes a detailed statement of facts. In contrast to typical DOJ DPAs, however, Tenaris does not admit these facts. Instead, the DPA includes a footnote stating that the recitation of facts arose out of settlement negotiations and are not binding against Tenaris in any other legal proceeding.

- *Prohibitions*. The Tenaris DPA includes a set of prohibitions that are reminiscent of standard DOJ DPAs, including that Tenaris agrees to refrain from: 1) violating the federal and state securities laws; 2) seeking a federal or state tax credit or deduction for any monies paid pursuant to the DPA; and 3) seeking or accepting reimbursement or indemnification from any source with respect to monies paid pursuant to the DPA.

- *Undertakings*. Standard DOJ DPAs usually include requirements to disclose any later investigations or misconduct to DOJ and to enhance existing compliance programs. Tenaris agreed to similar requirements here.

Nonprosecution Agreements

In December 2010, the SEC announced its first nonprosecution agreement involving a company called Carters Inc. About a year later, the Commission entered into highly publicized nonprosecution agreements with Fannie Mae and Freddie Mac, while at the same time charging several former executives of those entities with securities fraud.

Dodd-Frank Whistleblower Provisions[22]

On May 25, 2011, the Commission voted to approve final rules to implement the SEC whistleblower provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), enacted by Congress on July 21, 2010. The vote was split, with three Commissioners voting in favor of implementation and two voting against. According to the majority of the Commissioners, the final rules attempt to balance the tension between encouraging whistleblowers to come forward to the SEC while simultaneously discouraging them from bypassing internal company compliance programs. The

[22] This section of the Outline was drawn from "SEC's Final Rules for Implementing Dodd-Frank Whistleblower Provisions: Important Implications for Covered Entities," by Firm partners Sarah Bouchard and Thomas Linthorst, published May 25, 2011, available at: http://www.morganlewis.com/pubs/FRR_LEPG_LF_SECFinalRulesForDodd-FrankWhistleblowerProvisions_25may11.pdf.

dissenting Commissioners disagreed, taking the position that the failure to require mandatory internal reporting would have a detrimental effect on internal compliance and spur whistleblowers to bypass those internal mechanisms in favor of directly reporting to the SEC.

The Commission's whistleblower program officially became effective on August 12, 2011.

Whistleblowers Protected from Retaliation

A key component of the final rules is the definition of "whistleblower," which reflects the SEC's view that the antiretaliation protections of the Dodd-Frank Act do not depend on a finding of an actual violation of securities laws. The final rules provide that "[y]ou are a whistleblower if, alone or jointly with others, you provide the Commission . . . and the information relates to a possible violation of the federal securities laws (including any rules or regulations thereunder) that has occurred, is ongoing, or is about to occur." This definition tracks the statutory definition, but adds the "possible violation" language, a standard that does not require an actual violation for the antiretaliation protections to apply. In its proposed rules, the SEC had included the phrase "potential violation;" it replaced that phrase with "possible violation" in the final rules.

However, the final rules also require that, to be afforded protection from retaliation, the whistleblower must possess a "reasonable belief" that the employer is violating the securities laws. The SEC has defined "reasonable belief" in three ways: (1) specific, credible and timely information; (2) information related to a matter already under investigation by the SEC, but that makes a "significant contribution" to the investigation; or (3) information that was provided through the employer's internal compliance mechanisms, which is subsequently reported to the SEC by the employer, and which satisfies the first or second prong of the definition. This standard is a significant change from the proposed rules (which included no such requirement), and the final rules echo and cite to specific comments and proposals that Morgan Lewis submitted to the Commission on December 17, 2010.

Finally, the SEC makes clear that the antiretaliation provisions do not depend on whether the whistleblower ultimately qualifies for an award (see below). An otherwise-eligible whistleblower is protected from retaliation even if the award requirements are not met.

Rules Relating to Eligibility for an Award

To be considered for an award, the whistleblower must (1) voluntarily provide the SEC (2) with original information (3) that leads to the successful enforcement by the SEC of a federal court or administrative action (4) in which the SEC obtains monetary sanctions totaling more than $1 million.

The final rules provide that an individual whistleblower may be eligible for an award of 10% to 30% of the recovery, depending on a number of factors. This range reflects the SEC's attempt to balance competing interests: receiving high-quality information directly from whistleblowers and encouraging whistleblowers to utilize internal compliance procedures.

Reporting Through Internal Compliance Procedures

As an initial matter, a whistleblower need not report information through an employer's internal compliance procedures in order to be eligible for an award. This issue was left undecided under the proposed rules. In the final rules, however, the SEC has left the decision of whether to use internal compliance up to the individual whistleblower. This reflects the SEC's belief that whistleblowers will utilize robust internal compliance measures if they exist, despite having no requirement that they do so.

The SEC has set up financial incentives as a further effort to encourage the use of internal compliance measures. In determining the amount of an award, voluntary participation in corporate internal reporting programs can increase the reward, while interference with corporate internal reporting programs can decrease the reward. These incentives had not been included in the proposed rules.

Moreover, if any individual reports information to the company's internal compliance team or other similar department, the individual has 120 days from the original date of submission to report the information to the SEC. The individual will receive credit as if he or she had reported "original" information to the SEC on the date he or she disclosed it internally. This provision is also designed to promote internal compliance measures.

Similarly, the final rules provide that if a whistleblower reports information through the employer's internal compliance systems, and if the company subsequently self-reports to the SEC, the original whistleblower is credited with the report and any resulting award.

Original and Voluntary Information

Further, to obtain an award, the final rules require that the whistleblower come forward voluntarily. The SEC has defined "voluntarily" to exclude information provided pursuant to a subpoena, judicial order, demand from government authority or the Public Company Accounting Oversight Board, or preexisting legal obligation (such as those of certain corporate officers). The whistleblower must also provide "original information" to qualify for an award. "Original information" must be derived from the whistleblower's "independent knowledge or independent analysis."

The final rules exclude certain categories of information from the definition of "original information." For example, the SEC would not generally consider information obtained through an attorney-client privileged communication to be derived from independent knowledge or analysis. The carveout for attorneys reflects the SEC's concern that the monetary incentives of the SEC whistleblower program may deter companies from consulting with attorneys about potential securities laws violations. The final rules also exclude any information gained through the performance of an engagement required under the securities laws by an independent public accountant if the information relates to a violation by the engagement client or its directors, officers or other employees. This exception reflects the SEC's recognition of the role of independent public accountants and their pre-existing duty under securities laws to detect illegal acts. The SEC also excludes from "original information" any information the whistleblower obtained as a person with legal, compliance, audit, supervisory or governance responsibilities for an entity, such as an officer, director or partner, if the information was communicated to the whistleblower through the company's internal compliance mechanisms. However, this exclusion is not absolute, and several exceptions allow such individuals to still be whistleblowers (e.g., if the person believes that disclosure is needed because the company is engaging in conduct likely to cause substantial injury to the financial interest or property of the entity or investors). Here, the SEC attempts to reconcile the tension between the potential bounty available to whistleblowers and its recognition that effective internal compliance programs can promote the goals of federal securities laws.

Misconduct and Aggregation

Finally, the final rules do not necessarily disqualify a whistleblower who has engaged in fraud or misconduct, even if it is the same fraud or misconduct the whistleblower is reporting. The degree and nature of the misconduct is simply a factor the SEC will consider in determining the award to a whistleblower. In determining whether the $1 million in monetary sanctions threshold has been satisfied (a necessary precondition for award eligibility), the SEC will aggregate awards from separate proceedings if the proceedings were based on the same nucleus of operative facts.

Impact on FCPA Investigations

The whistleblower provisions of the Dodd-Frank Act will almost certainly result in a significant increase in the number of Foreign Corrupt Practices Act ("FCPA") investigations initiated by current and former employees through allegations related to bribery of foreign officials. In recent years, some of the highest SEC recoveries have been in FCPA books and records cases including actions involving sanctions of $77 million, $137 million and $218 million. Whistleblowers, who stand to obtain awards of 10% to 30% of those staggering amounts, will be highly incentivized to report allegations of the books and records provision of the FCPA, which the SEC enforces through civil enforcement proceedings.

Impact on Covered Entities

According to the SEC, through these final rules it has attempted to "incentivize" whistleblowers to use company internal compliance programs while simultaneously offering whistleblowers the right to contact the SEC directly. Although this compromise may dissuade some from reporting internally, having robust internal mechanisms is still of utmost importance. In light of these rules, companies should undertake a thorough review of their internal compliance programs and assess their effectiveness. The quality of these programs may significantly impact whether (1) a whistleblower approaches the SEC in the first instance, or (2) the employee complains internally and waits to see how effectively the company handles the internal complaint. Further, the availability and quality of these programs will have a significant effect on whether the SEC decides to initiate an investigation, or whether it believes that the company has cured any problematic conduct such that no investigation or enforcement action is necessary.

Whistleblower Statistics

In November 2011, the Office of the Whistleblower issued its first annual report to Congress.[23] Although the report only addresses the Office's activities during the seven weeks between August 12 (the effective date of the new rules) and September 30, 2011, it contains several statistics of interest to broker-dealers and other financial industry participants. Of the 334 whistleblower tips that the SEC received during this time period, 16.2% related to market manipulation, 7.5% related to insider trading, 5.1% related to trading and pricing, and 2.7% related to municipal securities and public pensions. Most U.S.-based tips originated from California (10%) and New York (7%). Surprisingly, 10% of all tips (32 in total) came from overseas, mostly from China and the UK. The report noted that the SEC has yet to pay out its first whistleblower award.

Developments in Administrative Proceedings

Penalties in Cease-and-Desist Proceedings

As part of the Dodd-Frank Act, Congress provided the SEC with the authority to seek penalties and other relief in cease-and-desist proceedings that were previously available only in federal court actions. Section 929P of the Dodd-Frank Act grants the SEC the authority to impose civil monetary penalties in administrative cease-and-desist proceedings, even against entities that are not registered with the SEC. The SEC brought the first such administrative cease-and-desist proceeding in an insider trading case against Rajat K. Gupta in March, 2011. The Gupta action arose from the SEC's ongoing investigation of insider trading involving Galleon Management LP. Gupta was a former member of the Board of Directors of The Goldman Sachs Group, Inc. The Commission's action against Gupta, his aggressive response to the filing of that administrative

[23] Available at: http://www.sec.gov/about/offices/owb/whistleblower-annual-report-2011.pdf.

proceeding, and the SEC's decision to drop that proceeding while reserving the right to file an action in federal court are discussed in the case summaries below.

Collateral Bars

In April, an SEC administrative law judge held that certain of the collateral bar provisions in Dodd-Frank could not be applied retroactively to conduct that preceded the passage of the Act.[24] In an administrative proceeding involving John W. Lawton, who had pled guilty to mail and wire fraud, the SEC sought a collateral bar based on Lawton's conduct while associated with an unregistered investment adviser that occurred before Dodd-Frank was signed into law. Before Dodd-Frank, Section 203(f) of the Advisers Act only permitted the SEC to suspend or bar a person from association with an investment adviser. Dodd-Frank amended Section 203(f) to authorize the Commission to suspend or bar a person from association with an investment adviser, broker, dealer, municipal securities dealer, municipal advisor, transfer agent or Nationally Recognized Statistical Rating Organization ("NRSRO").

In the Lawton case, Chief Administrative Law Judge Brenda P. Murray held that she could bar Lawton from association with a broker, dealer, municipal securities dealer and transfer agent for his pre-Dodd-Frank conduct, because such sanctions were effectively imposed by the statutory disqualification that flowed from his criminal conviction. However, Judge Murray found that amended Section 203(f) of the Advisers Act included two newly-created associational bars, municipal advisors and NRSROs, which could not be applied retroactively. Because those bars did not exist at the time of Lawton's conduct and would attach "new legal consequences" to his conduct, Judge Murray found them to be impermissibly retroactive.

Immunity Requests

In addition to the cooperation tools announced in 2010, the SEC amended its rules in June 2011 and delegated authority to the Enforcement Director to submit witness immunity requests to the U.S. Attorney General and, upon approval, grant immunity to witnesses in SEC investigations in order to compel those individuals to give testimony.[25] In its order amending the rules, the SEC stated that the delegation is intended to "enhance the Division's ability to detect violations of the federal securities laws, increase the effectiveness and efficiency of the Division's investigations, and improve the success of the Commission's enforcement actions." The amendment to the SEC's rules will last for 18 months, at which time the Commission will evaluate whether to extend the delegation to issue immunity orders.

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[24] *In the Matter of John W. Lawton*, Initial Decision, Administrative Proceeding File No. 3-14162 (Apr. 29, 2011).

[25] Available at: http://www.sec.gov/rules/final/2011/34-64649.pdf.

Commissioner Paredes Sounds a Cautionary Note Regarding SEC Enforcement

Although the SEC continues to tout its new enforcement tools, at least one Commissioner has observed that the Enforcement staff must not forget that "sometimes the best choice is not to bring a particular case or advance a particular charge." In a May 2011 speech, Commissioner Troy A. Paredes cautioned that Enforcement cannot pursue each and every possible violation of the securities laws, and proposed several "guideposts" for the Enforcement staff to follow in deciding how to allocate its limited resources. These guideposts include:

- How and to what extent did the misconduct harm investors?
- Have certain enforcement-related objectives already been satisfied? The staff should consider, for example, whether a party has already undertaken appropriate remedial steps.
- Has the alleged wrongdoer been, or will the individual or entity be, meaningfully sanctioned through means other than an SEC enforcement action, thus reducing the marginal value of our bringing a case?
- What is the impact of bringing one more case of a particular type? Is there any appreciable general deterrence benefit of bringing another case of this type or have diminishing returns already set in?

Commissioner Paredes also observed that the SEC should give "meaningful credit" to those who cooperate with its investigations. In elaborating on what constitutes "meaningful" credit, Commissioner Paredes opined that the SEC "cannot be stingy" and that parties should receive "enough credit to make cooperating worth it."[26]

Criticism of Defense Counsel Tactics and Multiple Representations

In a June 1, 2011 speech to the Criminal Law Group of the UJA-Federation of New York, Mr. Khuzami addressed a number of defense counsel tactics that he deems to be of concern.[27] As he has in the past, Mr. Khuzami focused part of his speech on multiple representations and the potential conflicts they present. Although he made clear that multiple representations are permissible, Mr. Khuzami noted that he finds it troubling when multiple witnesses represented by the same counsel give highly consistent and not so obvious interpretations of the same events and documents. Although the SEC's means of addressing these concerns may be limited, Mr. Khuzami stated that the staff intends to raise its concerns more frequently with counsel, and may question witnesses about their awareness of potential conflicts inherent in multiple representations. He also

26 Available at: http://www.sec.gov/news/speech/2011/spch050611tap.htm.

27 *See* "Remarks to Criminal Law Group of the UJA-Federation of New York" (June 1, 2011), available at: http://www.sec.gov/news/speech/2011/spch060111rk.htm.

indicated that the staff may be less willing to grant extensions of time in cases where counsel represented multiple witnesses, only to have separate counsel engaged at the Wells stage.

In his speech, Mr. Khuzami highlighted other defense tactics he deems troubling. Among other things, he highlighted instances of witnesses answering "I don't recall" dozens or hundreds of times in testimony, including in response to basic questions. Mr. Khuzami noted that one is "left to wonder" whether witnesses are "under instructions" from defense counsel to testify about only those events that they recall with near certainty. He further cited instances of counsel signaling to clients during testimony.

Mr. Khuzami also focused his speech on questionable tactics in document productions and internal investigations. He criticized the production of documents on the eve of testimony, withholding too many documents from production on the grounds that they may be privileged, without ever determining whether the documents are actually privileged, and delaying the production of a privilege log.

Finally, he noted what he deemed questionable tactics in internal investigations, including interviewing multiple witnesses at once, ignoring clear and identifiable red flags, casting blame on lower-level employees in order to protect senior management who have long-standing relationships with the counsel in question, and failing to acknowledge constraints placed on the scope of their inquiry.

The Enforcement Division's focus on defense counsel behavior comes at the same time that the SEC has instituted proceedings against defense counsel for unprofessional conduct. In November 2010, the SEC issued an opinion barring Steven Altman, an attorney who represented a witness in an SEC proceeding, from appearing or practicing before the SEC.[28] According to the opinion, during the course of several telephone calls, Altman told counsel representing two respondents in an SEC administrative proceeding that Altman's client would avoid service of an SEC subpoena in return for a monetary payment and other benefits from the respondents. Unknown to Altman, the respondents' counsel recorded the telephone calls and provided the recordings to the SEC.

Cooperation with Foreign Regulators

As in the past, in 2011 the SEC enhanced its cooperation and collaboration with foreign regulators. Specifically, in July 2011 the SEC and the Capital Markets Board of Turkey announced the signing of an agreement aimed at promoting investor protection, fostering market integrity and making cross-border securities activities easier between the United States and Turkey. Among other things, the

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[28] Available at: http://www.sec.gov/litigation/opinions/2010/34-63306.pdf.

agreement calls for enhanced cooperation and the exchange of information in connection with cross-border securities enforcement cases.[29]

SEC Office of Inspector General Investigations and Reports

The Office of Inspector General ("OIG") is an independent office within the SEC that performs audits of Commissions activities and investigations into allegations of misconduct by staff or contractors.

While not all of its inquiries have been made public to date, in FY 2011, OIG issued several reports of some its investigations and audits and provided Congressional testimony on several issues affecting the SEC's Enforcement mission.[30] The inquiries and reports included scrutiny of actions relating to an alleged conflict of interest arising from the SEC's former General Counsel's participation in Madoff-related matters, alleged misconduct in an insider trading case, allegations of improper preferential treatment and access affecting the settlement of an investigation, improper destruction of records relating to matters under inquiry, the leasing of office space, implementation of the SEC's employee recognition program and recruitment, relocation and retention incentives, and the SEC staff's handling of various investigations and examinations that failed timely to detect the Ponzi schemes conducted by Bernard Madoff and R. Allen Stanford and the fraud and misappropriations committed by principals of Westridge Capital Management.[31]

The OIG also frequently is asked to testify before Congress on the results of its investigations, audits and various Congressional inquiries it may receive.

While playing an important role, OIG's investigations can be grueling and time intensive for current and former employees, as well as third parties whose testimony and records may be sought in a manner similar to Enforcement's own investigative practices. The constant scrutiny and potential for criticism or reprisal may also impact how the staff conducts its own investigations.

SEC Enforcement Priorities Regarding Broker-Dealers

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

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[29] "SEC and Turkey Securities Regulator Announce Terms of Reference for Enhanced Cooperation and Collaboration," available at: http://ww.sec.gov/news/press/2011/2011-153.hmtl.

[30] Further information about OIG and copies of its publicly issued reports and Congressional testimony are available on the SEC's website at http://www.sec-oig.gov/index.html

[31] Further information about the outcome of the OIG's investigations and other efforts can be found in its semi-annual reports to Congress for the six months ended March 31,2011 and September 30, 2011, available at http://www.sec-oig.gov/Reports/Semiannual/2011/SAR_fall_2011_FINAL.pdf (Mar. 31, 2011); http://www.sec-oig.gov/Reports/Semiannual/2011/SAR_fall_2011_FINAL.pdf (Sep. 30, 2011).

- The marketing and sale of CDOs and mortgage-backed securities
- The valuation of and disclosures relating to subprime securities
- IPO valuations and allocations
- High frequency/electronic trading activities, including spoofing and layering
- Structured products, including principal protected notes, reverse convertible notes, and ETFs and the pricing and conflicts related to these products
- Sales of unsuitable securities to retail investors
- Municipal securities and political contributions
- Insider trading by Wall Street professionals
- Failure to supervise registered representatives
- Microcap fraud
- The setting of the London Interbank Offer Rate ("Libor")
- Insider trading regarding ETFs
- Insider trading ahead of S&P's downgrade of the U.S.'s debt rating

Enforcement Actions[32]

Auction Rate Securities

Since the auction rate securities ("ARS") market froze in 2008, the SEC, FINRA and state regulators have brought numerous enforcement actions. Below is a summary of a settled case and a litigated action.[33]

[32] Unless otherwise apparent from the context of the descriptions of the actions, the cases described herein are settlements in which respondents neither admitted nor denied the allegations against them. Certain cases fall outside of the SEC's FY 2011, but are included here for completeness.

[33] The vast majority of SEC and FINRA actions in the ARS space have been settled. In this Outline, however, we report on two litigated cases involving Morgan Keegan and Thomas Weisel. Moreover, it should be noted that Charles Schwab & Co., Inc. contested the New York State Attorney General's charges that it fraudulently marketed and sold auction rate securities as a safe, liquid and short-term investment. In October 2011, a New York Supreme Court Judge dismissed the Attorney General's claims. *See* "NYAG Suit Over Schwab ARS Practices Felled By Failure to Allege False Statements," Phylis Diamond, Broker-Dealer Compliance Report, (Nov. 9, 2011).

A. *SEC v. Morgan Keegan & Company, Inc.* ("Morgan Keegan"), 2011 WL 2559362 (N.D. Ga.) (June 28, 2011)

1. As noted above, regulators have instituted many enforcement actions involving the sale of ARS to investors. The overwhelming majority of these cases were settled by firms. Here, the SEC and Morgan Keegan are litigating such an action. In an opinion issued on June 28, 2011, U.S. District Judge William Duffey granted Morgan Keegan's motion for summary judgment in this case.

2. In its ruling, the Court found that Morgan Keegan adequately disclosed the risks of investing in ARS, and that the total mix of information Morgan Keegan provided to its customers "clearly and repeatedly" illustrated the liquidity risks. For example, the Court noted that many of Morgan Keegan's disclosures followed best practices developed by the Securities Industry Financial Markets Association.

3. Notably, the Court also gave little weight to the handful of investor statements that the SEC submitted in which Morgan Keegan customers claimed that their brokers misrepresented the risks of investing in ARS. In holding in Morgan Keegan's favor, the Court held that the four investor statements were insufficient to establish liability against Morgan Keegan, absent some evidence that, among other things, "Morgan Keegan encouraged or instructed its brokers generally to issue misleading statements."

4. In response to the SEC's allegations that Morgan Keegan failed adequately to disclose the possibility that the ARS market could freeze, the Court stated: "Failure to predict the market does not constitute securities fraud."

5. The SEC has appealed this decision to the Court of Appeals for the Eleventh Circuit.

B. *In the Matter of Raymond James & Associates, Inc. and Raymond James Financial Services, Inc.,* Admin. Proc. File No. 3-14445 (June 29, 2011)

1. The SEC filed a settled administrative proceeding against Raymond James & Associates, Inc. and Raymond James Financial Services, Inc. (collectively, "Raymond James") alleging that Raymond James made inaccurate statements when selling ARS to customers.

2. Specifically, the SEC alleged that some registered representatives and financial advisers at Raymond James told customers that ARS were safe, liquid alternatives to money-market funds and other cash-like investments. In fact, ARS were very different types of investments.

3. The SEC also alleged that representatives at Raymond James did not provide customers with adequate and complete disclosures regarding the complexity and risks of ARS, including their dependence on successful auctions for liquidity.

4. The Commission censured Raymond James, ordered it to cease-and-desist from future violations, and reserved the right to seek a financial penalty against the firm.

5. Raymond James also agreed to: purchase eligible ARS from its eligible current and former customers; use its best efforts to provide liquidity solutions to customers who acted as institutional money managers who were not otherwise eligible customers; reimburse excess interest costs to eligible ARS customers who took out loans from Raymond James after February 13, 2008; compensate eligible customers who sold their ARS below par by paying the difference between par and the sale price of the ARS, plus reasonable interest; and at the customer's election, participate in a special arbitration process with those eligible customers who claim additional damages.

Fraudulent Trading Schemes

The Commission has historically aggressively pursued fraudulent trading schemes. In 2011, the SEC repeatedly showed that it will continue to do so.

A. *SEC v. Todd M. Ficeto, Florian Homm, Colin Heatherington, Hunter World Markets, Inc., and Hunter Advisors, LLC, et al.,* CV-11-1637 (C.D. Cal. Feb. 24, 2011)

1. The SEC filed a civil action against two securities professionals, a hedge fund trader, and two firms involved in a pump-and-dump scheme that allegedly manipulated several U.S. microcap stocks and generated over $63 million in illicit profits.

2. The SEC alleged that from September 2005 to September 2007, Florian Homm and Todd Ficeto conducted the scheme through their broker-dealer Hunter World Markets, Inc. ("HWM"), with the assistance of Colin Heatherington (a

trader), by taking microcap companies public through reverse mergers and manipulating upwards the stock prices of these thinly-traded stocks before selling their shares at inflated prices to eight offshore hedge funds controlled by Homm. Allegedly, the defendants used a number of classic manipulative techniques such as placing matched orders, placing orders that marked the close or otherwise set the closing price for the day, and conducting wash sales.

3. The SEC further alleged that their manipulation of the stock prices allowed Homm to materially overstate by at least $440 million the hedge funds' performance and net asset values in a fraudulent practice known as "portfolio pumping."

4. The SEC seeks permanent injunctive relief, disgorgement of profits, and other monetary penalties. The SEC also seeks an administrative order permanently barring Ficeto from participating in any penny stock offering, or from serving as an officer or director of a public company.

B. *In the Matter of Tony Ahn*, Admin. Proc. File No. 3-14272 (Feb. 24, 2011)

1. In a case related to the above matter, the SEC settled an administrative proceeding against Tony Ahn alleging that Ahn and others manipulated the price of certain microcap stocks between September 2005 and September 2007.

2. The SEC alleged that Ahn, as primary trader for HWM and at the instruction of HWM's co-owners, executed numerous trades aimed at manipulating upwards the price of certain stocks which resulted in improper transaction fees for HWM and profits for HWM principals and related entities.

3. Specifically, the SEC alleged that Ahn manipulated stock prices by executing numerous matched orders through accounts and funds affiliated with HWM, marked the close of certain microcap stocks by executing purchases or sales at or near the close of the market with the intent to influence the stock's closing price, and backdated certain trades to hide HWM's scheme to manipulate stock prices. The SEC's order concluded that these practices resulted in "portfolio pumping" that materially overstated net asset values of client portfolios.

4. The SEC also alleged that Ahn aided and abetted HWM's failure to preserve instant-message transcripts as required by Section 17(a) of the Exchange Act and Rule 17a-4(b)(4).

5. In his settlement with the SEC, Ahn consented to a cease-and-desist order, a bar from association with any broker or dealer (with the right to reapply for association in five years), certain undertakings, and a $40,000 civil penalty.

6. In a related matter, the SEC settled a failure to supervise case against HWM's Chief Compliance Officer.

C. *SEC v. Jose O. Vianna and Creswell Equities, Inc.*, 10-Civ-1842 (S.D.N.Y. March 25, 2011)

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

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

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

4. To settle the charges, Creswell agreed to an entry of judgment ordering it to pay $1,661,650 in disgorgement. Vianna also settled the charges, and a final judgment on consent was entered against him on March 25, 2011. In addition to a permanent injunction, Vianna was ordered to disgorge $306,412 in ill-gotten gains plus $47,442 in prejudgment interest, and pay a $130,000 civil penalty.

D. *In the Matter of Melhado, Flynn & Associates, Inc., George M. Motz and Jeanne McCarthy*, Admin. Proc. File No. 3-12574 (May 11, 2011)

1. On May 11, 2011, the SEC settled an administrative proceeding that it had initiated in 2007 against Melhado, Flynn & Associates, Inc. ("MFA"), a registered broker-dealer and investment adviser, George M. Motz (MFA's President and CEO), and Jeanne McCarthy (MFA's Comptroller and FINOP), for engaging in fraudulent trade allocations, or cherry-picking.

2. The SEC alleged that from 2001 through September 2003, Motz (MFA's only trader) engaged in a cherry-picking scheme that generated risk-free profits for the firm's trading account at the expense of the firm's advisory clients. From 2003 through 2005, Motz expanded the scheme to boost the returns of the Third Millennium Fund, LP, an advisory client hedge fund affiliated with MFA.

3. As alleged, Motz effected the scheme by placing orders with his trading desk early in the day, and then deciding later in the day (often just before the closing bell) whether to sell the position – if profitable – and book the gains in MFA's proprietary account or, instead, to allocate the securities – if trading at a loss by the end of the trading day – to MFA's advisory client account. As a result of this scheme, day-trades allocated to MFA's proprietary account were profitable 98% of the time and yielded a net gain of close to $1.4 million over 18 months for MFA; day-trading in the Third Millennium account was 100% profitable from 2003 through 2005.

4. Motz also admitted to altering certain order tickets in a failed attempt to hide the fraudulent scheme from regulators.

5. The settled order against MFA, among other things, revoked MFA's registrations as a broker-dealer and an investment adviser.

6. In October 2009, MFA pled guilty to one count of securities fraud relating to the cherry-picking alleged in these proceedings. For his involvement in the scheme, Motz is currently serving an eight-year prison sentence imposed. (*United States v. Motz*, 08-CR-598 (E.D.N.Y. Apr. 28, 2010).

E. *SEC v. Richard A. Finger, Jr. and Black Diamond Securities LLC*, 11-CV-01479 (W.D.Wash. Sept. 8, 2011).

1. The SEC filed a civil action against securities broker Richard A. Finger, Jr. ("Finger") and his firm, Black Diamond Securities LLC ("Black Diamond"), alleging fraud in connection with undisclosed high-risk options trading and concealed commissions.

2. The SEC alleges that in February 2011, Black Diamond's customers – many of whom were friends and family of Finger – deposited roughly $4.9 million into Black Diamond accounts for Finger to manage. From February to August 2011, the customer accounts suffered $1.9 million in losses due to an undisclosed high-frequency, high-risk options trading strategy. During that same period, despite the losses, the accounts paid $2.1 million in commissions to Black Diamond.

3. Of the $2.1 million in commissions paid to Black Diamond since February 2011, Finger transferred $1.1 million to his own customer account and subsequently transferred $870,000 to his personal bank account.

4. The SEC alleges that Finger and Black Diamond concealed the losses and commissions from customers by providing false account statements that showed higher account balances, lower commissions and lower trading activity and losses.

5. The SEC further alleges that Finger also attempted to hide the losses from Black Diamond's clearing broker. When asked for documentation showing customer approval for the significant trading losses and high commissions, Finger allegedly provided the clearing broker with forged letters.

6. The case against Finger and Black Diamond is ongoing and the SEC seeks a permanent injunction, an accounting, an asset freeze, disgorgement with prejudgment interest and civil penalties.

F. *In the Matter of Gilford Securities, Incorporated, Ralph Worthington, IV, David S. Kaplan, and Richard W. Granahan*, Admin. Proc. File No. 3-14574 (Sept. 30, 2011)

1. The SEC filed settled administrative proceedings against Gilford Securities, Incorporated ("Gilford"), a New York-based broker-dealer, as well as Ralph

Worthington, IV (Gilford's Chief Executive Officer and Chairman of the Board), David S. Kaplan (Sales Manager at Gilford's New York office), and Richard W. Granahan (Gilford's Chief Compliance Officer).

2. According to the SEC, from January 2005 to December 2007, Gilford broker M.S. Gregg Berger ("Berger") participated in a series of fraudulent pump-and-dump schemes involving the sale of microcap stocks resulting in proceeds in excess of $33 million. Berger facilitated the trading of over 30 million shares of low-priced, thinly traded microcap stocks, which coincided with spam e-mail campaigns and the release of corporate news for stocks that previously had little or no trading volume. Berger generated approximately $1.1 million in sales commissions from these unregistered sales. Berger was indicted in February 2011 for conspiracy to commit securities fraud and wire fraud, and has pled guilty to the conspiracy charge.

3. The SEC alleges that Gilford facilitated Berger's unregistered, non-exempt resale of over 30 million shares in more than 20 customer accounts, in willful violation of Sections 5(a) and 5(c) of the Securities Act. Gilford allegedly made no inquiries and ignored obvious red flags concerning the unregistered sales. The SEC also charged Gilford with failing to adequately supervise Berger because it did not have a system to implement its policies and procedures regarding the prevention and detection of sales of unregistered stock and the review of unusual order tickets.

4. The SEC further alleges that Worthington, as founder, CEO, and Chairman, had ultimate responsibility for Gilford's supervisory policies, procedures, and implementation of these policies and procedures, yet failed to adequately supervise Berger's trading activity. Kaplan, as the sales manager, allegedly failed to follow Gilford's policies and procedures relating to review of internal e-mail correspondence. Both Worthington and Kaplan purportedly ignored obvious red flags, including Berger's selling of large volumes of low-priced, little-known securities on behalf of overseas customers (often the only securities sold in the account). Granahan, Gilford's CCO and AML officer, failed to file SARs in response to Berger's suspicious trading activities.

5. All respondents consented to the entry of cease-and-desist orders against them. Gilford and its CCO, Granahan, were censured, while Worthington and Kaplan were suspended

from association in a supervisory capacity with any broker or dealer for one year. Gilford was ordered to pay disgorgement of $275,000, prejudgment interest of $77,113, and a civil penalty of $260,000. Kaplan was ordered to pay $225,000, with prejudgment interest of $63,092, and a civil penalty of $30,000. Worthington and Granahan, the CCO, were ordered to pay civil penalties of $45,000 and $20,000, respectively.

G. *In the Matter of FTN Financial Securities Corp.,* Admin. Proc. File No. 3-14632 (November 17, 2011); *SEC v. Stephen M. Folan*, Case No. 1:11-cv-8905 (N.D. Ill. Dec. 15, 2011)

1. The SEC filed settled administrative proceedings against FTN Financial Securities Corp. ("FTN"), a Tennessee-based broker-dealer, which is a wholly owned subsidiary of First Tennessee Bank.

2. The order alleges that FTN engaged in certain transactions with Sentinel Management Group ("Sentinel"), an Illinois-based investment advisor, that caused Sentinel to fail to maintain true, accurate, and current financial statements, and which FTN should have known would be used by Sentinel to perpetrate a fraud against its advisory clients.

3. In or around 2000, FTN developed a security referred to as a Preferred Term Securities Ltd. ("PreTSL"). PreTSLs were collateralized debt obligations created by pooling and securitizing trust preferred securities issued by regional banks and thrifts, insurance companies or REITS. PreTSL securities were sold in tranches, each with its own risk and liquidity profile.

4. Sentinel, which managed investments of short-term cash for advisory clients, purported to invest its clients' assets primarily in highly liquid cash management products. In reality, however, Sentinel invested a substantial amount of its clients' funds in illiquid securities, including nearly $85 million in PreTSL securities from FTN, and used client assets to collateralize a bank loan used to finance the investments. Sentinel also drew on the bank loan to finance a portion of its undisclosed leveraging strategy.

5. The SEC's order alleged that on two occasions in 2006, including at year end, Sentinel told FTN that it was having "balance sheet" issues and needed to get some PreTSL securities "off" Sentinel's books. Although FTN's compliance team expressed concern that the proposed transactions

might be viewed as illegal “parking” of securities, FTN approved the transactions. In one instance at the end of December 2006, FTN repurchased $35 million in PreSTLs from Sentinel for approximately $25 million. On January 2, 2007, FTN resold the PreSTLs back to Sentinel.

6. Sentinel’s year-end financial statements, however, failed to include as a liability Sentinel’s obligation to repurchase the PreSTLs from FTN, nor did they disclose any of the other short-term transactions that Sentinel engaged in to temporarily reduce the bank loan balance. The SEC concluded that, based on FTN’s unresolved concerns about the transactions, FTN should have known that Sentinel would use the transactions for an improper purpose.

7. FTN consented to the entry of a cease-and-desist order and agreed to pay disgorgement of $1,495,878 and prejudgment interest of $377,758.

8. In a related proceeding, on December 15, 2011, the SEC filed a civil injunctive action against Stephen M. Folan, a former registered representative in FTN’s Chicago office alleging that he assisted Sentinel commit fraud against its advisory clients. The complaint alleges that Folan acted as the primary advocate within FTN for the 2006 year-end repurchase transaction with Sentinel. The SEC further alleges that recorded telephone calls show that, although Folan had information indicating that Sentinel would use the year-end transaction for an improper purpose, he did not share this information with his superiors at FTN. The case is ongoing.

Insider Trading

As we have reported in previous Outlines, the SEC has brought civil charges against 29 individuals and entities in connection with a wide-ranging insider trading probe over the last several years. Those charged included hedge fund advisers, Wall Street employees, and corporate insiders. Many of these cases were in connection with the insider trading scheme involving Galleon Management LP.

The most significant SEC development in these cases occurred in November 2011, when the SEC obtained a final judgment against Raj Rajaratnam, the founder and a managing general partner of Galleon, in which Rajaratnam was found liable for a $92.8 million civil penalty. This is the largest penalty ever obtained against an individual in a SEC insider trading case.

In a separate criminal trial, Rajaratnam was found guilty of securities fraud and conspiracy to commit fraud. He was sentenced to prison for 11 years and was ordered to pay $53.8 million in forfeiture and $10 million in fines. Rajaratnam is appealing his conviction.

Two non-Galleon and one Galleon-related insider trading cases are described below.

A. *SEC v. Donald L. Johnson and Dalila Lopez*, 11-Civ-3618 (S.D.N.Y. May 26, 2011)

1. On May 26, 2011, the SEC filed a civil injunctive action against defendant Donald L. Johnson and his wife, relief defendant Dalila Lopez, alleging that Johnson – a former managing director of The NASDAQ Stock Market ("Nasdaq") – engaged in multiple instances of insider trading over a three-year period.

2. Specifically, the SEC alleged that between 2000 and 2006, Johnson – through his positions in Nasdaq's Corporate Client Group and Market Intelligence Desk – had significant interactions with senior executives of Nasdaq-listed issuers, during which those executives regularly shared confidential information regarding pending public announcements that could affect the price of their companies' stock. The executives shared this information based on their understanding that the information would be kept confidential and that Johnson could not use the information for personal benefit.

3. The SEC also alleged that Johnson traded unlawfully in advance of nine announcements of material information between August 2006 and July 2009, earning in excess of $750,000 in illicit profits. Johnson often placed the trades directly from his work computer at Nasdaq using an on-line brokerage account in his wife's name.

4. Lopez was named as a relief defendant for the purpose of recovering any illicit profits still in her possession.

5. On July 13, 2011, a judgment on consent was entered against Johnson, which ordered a permanent injunction. Disgorgement and/or a civil penalty will be determined by the Court at a later date.

6. Johnson pled guilty in a parallel criminal action. *United States v. Donald Johnson*, 11-CR-254 (E.D.V.A. May 26, 2011). He was sentenced to 42 months in prison.

B. *In the Matter of Spencer D. Mindlin and Alfred C. Mindlin, CPA*, Proc. File 3-14557 (Sept. 21, 2011)

1. The SEC instituted administrative proceedings against Spencer Mindlin ("Spencer") and his father Alfred Mindlin. The SEC alleged that while Spencer was an employee on Goldman Sachs's Exchange Traded Funds ("ETF") desk, he obtained inside information concerning Goldman's plans to make market-moving trades in certain ETFs, including specifically the SPDR S&P Retail ETF ("XRT"). The Mindlins created an account in a relative's name and made $57,000 trading off of Spencer's inside XRT information in December 2007 and March 2008.

2. This is the first insider-trading action brought by the SEC for trades involving ETFs. The SEC charged the Mindlins with violations of Section 17(a) of the Securities Act and Section 10(b) of the Securities Exchange Act and Rule 10(b) thereunder.

3. The SEC seeks disgorgement of the Mindlins' profits and civil penalties.

C. *In the Matter of Rajat K. Gupta,* Admin. Proc. File No. 3-14279 (March 1, 2011), *Rajat K. Gupta v. SEC*, 11 Civ. 1900 (S.D.N.Y Mar. 18, 2011) and *SEC v. Rajat Gupta and Raj Rajaratnam,* 11-Civ-07566 (S.D.N.Y. Oct. 26, 2011)

1. In another case related to the Galleon matter, the SEC instituted public administrative cease-and-desist proceedings against Rajat K. Gupta, a member of the Boards of Directors of the Goldman Sachs Group, Inc. ("Goldman Sachs") and the Procter & Gamble Company ("P&G"), for allegedly providing material, nonpublic information he obtained during the course of his duties as a member of the Boards to Raj Rajaratnam, founder and Managing General Partner of Galleon Management L.P. As noted above, this was the SEC's first administrative cease-and-desist proceeding seeking civil money penalties against an individual or entity not registered with the Commission after the passage of Section 929P of the Dodd-Frank Act. It is also a rare example of an administrative proceeding in an insider trading case, which led to a countersuit by Gupta against the SEC, which dropped the administrative case and later filed an injunctive action in the federal court. Also, the DOJ has filed criminal charges against Gupta.

2. The SEC alleged that Rajaratnam caused the various Galleon hedge funds to trade based on material, nonpublic information provided to him by Gupta regarding Berkshire Hathaway Inc.'s $5 billion investment in Goldman Sachs, as well as Goldman Sach's financial results from the second and fourth quarters of 2008. Because of the disclosure of this material, nonpublic information, the Galleon hedge funds are alleged to have made trades resulting in profits or loss avoidance in excess of $17 million.

3. The SEC also alleged that Rajaratnam caused the various Galleon hedge funds to trade based on material, nonpublic information provided to him by Gupta regarding P&G's financial results for the quarter ending December 2008. Because of the disclosure of this material, nonpublic information, the Galleon hedge funds are alleged to have made trades generating profits in excess of $570,000.

4. The SEC alleged that Gupta willfully violated Section 17(a) of the Securities Act of 1933, and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. As remedies, the SEC sought disgorgement, civil penalties, and a cease-and-desist order.

5. In March 2011, Gupta filed a Complaint against the SEC seeking declaratory and injunctive relief to prevent the SEC from retroactively applying the Dodd-Frank Act to seek civil penalties from Gupta in an administrative proceeding rather than a federal court action. Gupta's complaint sought to move the administrative case to federal court, and alleges that the SEC administrative proceeding denies him his constitutional right to a jury and treated him differently than the more than two dozen other Galleon-related defendants sued in federal court. In July 2011, the district court, sympathizing with Gupta's equal protection argument, rejected the SEC's motion to dismiss and allowed Gupta to proceed on his Complaint seeking injunctive relief. The court, however, narrowed Gupta's Complaint to the equal protection issue.

6. On August 4, 2011, the SEC dismissed its administrative proceeding, deciding "that it is in the public interest to dismiss these proceedings." The SEC reserved the right to re-file the case in federal district court, which it did on October 26, 2011.

7. In the federal court complaint, the SEC charged former Gupta with insider trading for tipping off Raj Rajaratnam

while serving on the boards of Goldman Sachs and P&G. The SEC also filed new charges against Rajaratnam concerning these trades.

8. The SEC alleged that Gupta gave Rajaratnam inside information on Berkshire Hathaway's pending $5 billion investment in Goldman and related earnings information for Goldman and P&G. Rajaratnam then traded on this information for a profit of, per the SEC's complaint, $23 million. For instance, the SEC alleges that on June 10, 2008 Gupta learned from Goldman's CEO that Goldman's quarterly results would significantly beat analysts' estimates and that Gupta immediately relayed the information to Rajaratnam. Rajaratnam then built a position in Goldman shares and liquidated the position post-announcement for a profit of $18.5 million.

9. The SEC seeks disgorgement of profits - Gupta was a director and investor in Rajaratnam's Galleon funds - and a permanent injunction barring Gupta from acting as an officer or director of any public company.

10. The action is pending before Judge Jed Rakoff, who has set an October 1, 2012 trial date. Certain discovery has been stayed pending the resolution of the criminal action brought by the U.S. Attorneys' office against Gupta, also before Judge Rakoff, which is set for trial on April 9, 2012. The criminal action is *United States v. Gupta*, 11 Cr. 907 (JSR).

Marketing and Sales of Collateralized Debt Obligations

The SEC has been investigating the marketing and sales of a number of complex derivative products since the start of the economic crisis in late 2008. Described below are five cases from last year.

A. *SEC v. Stifel, Nicolaus & Co., Inc. and David W. Noack*, 11-cv-00755 (E.D. Wisc. Aug. 10, 2011)

1. The SEC charged brokerage firm Stifel Nicolaus & Co., Inc. and Senior Vice President David Noack with abusing Stifel's long-standing trust relationships with five Wisconsin school districts by selling risky synthetic collateralized debt obligations (CDOs) without adequate disclosure of material facts and risks.

2. The SEC alleged that Noack convinced the school district to invest $200 million ($162.7 million of which was borrowed) in a portfolio of approximately 100 credit default swaps on

corporate bonds. Noack purportedly made sweeping assurances that, for the investment to fail, it would take "15 Enrons," or the failure of 100 of the world's top 800 corporations.

3. Stifel and Noack allegedly knew that the districts were risk averse but failed to disclose, among other things, that the portfolio performed poorly from the outset, credit agencies placed negative warnings on 10 percent of the portfolio in the first 36 days, and CDO providers declined to participate in Stifel's funds because of the type of investor and the risk involved. The school districts lost their entire investment due to exposure to catastrophic risk and received a credit rating downgrade for failing to put additional funds in the failing trusts.

4. The SEC charged the defendants with violations of Section 17(a) of the Securities Act and Section 10(b) of the Securities Exchange Act and seeks the disgorgement of fees, civil penalties, and permanent injunctions. The action is pending.

B. *In the Matter of RBC Capital Markets LLC,* Admin. Proc. File 3-14564 (Sept. 27, 2011)

1. In a separate action arising from the same transactions in the Stifel matter, the SEC filed a settled administrative order against RBC Capital Markets LCC for its own alleged failure to adequately disclose the risks to the school districts. Through Stifel, RBC Capital Markets marketed the $200 million in CDO investments to the school districts in three separate transactions.

2. According to the SEC, RBC Capital Markets allowed the investments despite internal assessment memos and communications doubting Stifel's projected revenues and the school districts' ability to appreciate the risks. Indeed, some communications focused on attempting to insulate RBC Capital Markets if the CDO investments failed.

3. The SEC alleged that RBC Capital Markets' presentations to the school districts were materially misleading including, for instance, inaccurate risk models and assurances that quality investments were handpicked on "strong selection criteria" when, in fact, investments were picked on spread rather than quality.

4. Without admitting or denying any of the findings, RBC Capital Markets consented to the SEC's order of censure and payment of $30.4 million to the school districts. RBC Capital Markets also agreed to cease and desist from committing any future violations of Sections 17(a)(2) and (3) of the Securities Act.

C. *SEC v. Citigroup Global Markets, Inc.,* 11-Civ.-7387 (S.D.N.Y. Oct. 19, 2011) (Rakoff, J.)

1. On October 19, 2011, the SEC charged Citgroup Global Markets, Inc. ("Citigroup"), with misleading investors about Citigroup's role in structuring a $1 billion synthetic CDO called Class V Funding III ("Class V III").

2. The SEC's complaint against Citigroup alleges that at a time when the U.S. housing market was showing signs of distress, Citigroup structured and marketed Class V III and exercised significant influence over the selection of $500 million of the assets included in the CDO. The collateral consisted primarily of credit default swaps referencing other CDOs whose collateral consisted primarily of subprime mortgage-backed securities.

3. According to the complaint, Citigroup's marketing materials for Class V Funding III stated that the collateral manager for the CDO, Credit Suisse Alternative Capital, Inc. ("CSAC"), selected the CDO's investment portfolio using a rigorous approach to collateral analysis. The Complaint alleged that the marketing materials did not reference Citigroup's role in the selection of a substantial portion of Class V III's investment portfolio.

4. The SEC's complaint further alleges that, while Citigroup was structuring the CDO and selecting a substantial portion of its collateral, Citigroup arranged with CSAC to buy protection on CDOs referenced in the Class V III investment portfolio that had a notional amount of $500 million. This protection, which the SEC alleges was the equivalent of a short position on the underlying CDOs, provided Citigroup with a financial interest in the negative performance of the Class V III collateral. The Complaint alleges that Citigroup did not disclose the extent of this purported conflict with investors in the Class V III CDO.

5. According to the SEC's Complaint, within a year of the closing of Class V III, over a third of its assets had been downgraded, and the collateral selected by Citigroup had

performed significantly worse than the collateral selected by CSAC. As a result of this poor performance, investors in the subordinate tranches of Class V III lost most, if not all, of their principal, while owners of the super senior tranches suffered additional losses. The SEC alleges that, in contrast, Citigroup earned net profits of approximately $160 million from its structuring fees and profits on its short position in those same downgraded assets.

6. Based on this conduct, the SEC filed a Complaint in the United States District Court for the Southern District of New York charging Citigroup with violating Sections 17(a)(2) and (3) of the Securities Act of 1933, which only require a showing of negligent conduct. In addition to the case against Citigroup, the SEC charged Citigroup employee Brian Stoker ("Stoker") for his role in structuring the Class V III transaction. Further, the SEC instituted settled administrative proceedings against CSAC, Credit Suisse Asset Management, LLC and a CSAC portfolio manager, Samir H. Bhatt, based on their conduct in the Class V III transaction.

7. When the SEC announced these actions, it also announced that Citigroup had agreed to settle the case by agreeing, without admitting or denying the SEC's allegations, to the entry of a proposed consent judgment that would impose a permanent injunction, order disgorgement of $160 million in profits, plus $30 million in interest, and impose a civil penalty of $95 million.

8. Subsequently, Judge Jed S. Rakoff, in a widely publicized decision, refused to approve the proposed consent judgment, finding that it was not fair, reasonable, adequate, nor in the public interest to allow Citigroup to settle without admitting to any of the allegations in the complaint. As a result, the case against Citigroup has been consolidated with the case against Stoker and, as of this writing, is set for trial on July 16, 2012.

9. This matter is on appeal to the Second Circuit.

D. *In the Matter of Wells Fargo Securities LLC (f/k/a Wachovia Capital Markets LLC)*, Admin. Proc. File No. 3-14320 (Apr. 5, 2011)

1. The SEC commenced an administrative proceeding against Wells Fargo Securities LLC (f/k/a Wachovia Capital Market LLC) ("Wachovia") which alleged that Wachovia violated the antifraud provisions of the Securities Act in connection with

its offering of two collateralized debt obligations (“CDOs”) tied to the performance of residential mortgage-backed securities (“RMBS”).

2. The SEC alleged that Wachovia represented to investors that it acquired the underlying assets from affiliates on an arm’s-length basis and at fair market prices when certain assets were in fact acquired from a Wachovia affiliate at above-market prices.

3. The SEC further alleged that Wachovia charged undisclosed and excessive markups in the sale of the securities to an institutional investor and an individual investor. According to the SEC’s order, the prices paid by these customers were at least 70% higher than the price at which Wachovia marked the securities for accounting purposes.

4. In announcing the case, the SEC noted that Wachovia did not act improperly in structuring the CDOs or in the way it described the roles played by those involved in the structuring process.

5. Wachovia consented to an order prohibiting future violations of the securities laws, disgorgement of $6.75 million and a civil fine of $4.45 million.

E. *SEC v. J.P. Morgan Securities LLC* (f/k/a J.P. Morgan Securities Inc.), 11-Civ-4206 (S.D.N.Y. June 21, 2011), and *SEC v. Edward S. Steffelin,* 11-Civ-4204 (S.D.N.Y. June 21, 2011)

1. The SEC brought civil actions against J.P. Morgan Securities LLC (“J.P. Morgan Securities”) and an employee of GSCP (NJ) L.P. (“GSCP”), a registered investment adviser, alleging fraud in connection with the structuring and marketing of a synthetic CDO.

2. The SEC alleged that J.P. Morgan Securities structured and marketed a synthetic CDO, Squared CDO 2007-1 (“Squared”), which was tied to the performance of the residential housing market and was structured and marketed in early 2007 when the United States housing market was beginning to show signs of distress.

3. The SEC alleged that the marketing materials for Squared represented that its investment portfolio was selected by GSCP, which had experience analyzing credit risk in CDOs. Not included in the marketing materials, and not disclosed to investors, was the fact that the Magnetar Capital LLC

("Magnetar") hedge fund, which was poised to benefit if the CDOs defaulted, played a significant role in selecting which CDOs should make up the portfolio.

4. The SEC also alleged that while participating in the selection of the investment portfolio, Magnetar shorted a large portion of the assets it helped to choose. The CDO securities Magnetar shorted had a notional value of approximately $600 million, which represented more than half of Squared's investment portfolio.

5. J.P. Morgan Securities sold approximately $150 million of "mezzanine" notes of Squared's liabilities to a group of approximately 15 institutional investors. The mezzanine investors lost virtually their entire principal.

6. J.P. Morgan Securities consented to a permanent injunction, and payment of $18.6 million in disgorgement, $2 million in prejudgment interest and a $133 million penalty, for a total of $153.6 million. Of that amount, $125,869,721 will be returned to the mezzanine investors through a Fair Fund distribution, and $27,730,279 will be paid to the U.S. Treasury.

7. In a separate complaint, the SEC brought fraud charges against Edward S. Steffelin, the GSCP employee who was in charge of the team responsible for selecting the portfolio for Squared.

8. The case against Steffelin is ongoing, and the SEC seeks injunctive relief, disgorgement of profits, prejudgment interest, and civil penalties.

Misappropriation of Fund Assets

A. *SEC v. Steven T. Kobayashi,* CV-11-0981 (N.D. Cal. Mar. 3, 2011)

1. On March 3, 2011, the SEC filed an action against Steven T. Kobayashi, a broker at UBS Financial Services, Inc. ("UBS FS"), alleging fraud in connection with the operation of a private pooled life insurance investment fund he established.

2. The SEC alleged that between 2006 and 2007, Kobayashi siphoned approximately $4 million from this fund for luxury cars, prostitutes and paying off large gambling debts. This fund was created by Kobayashi in response to a stated desire by some of his UBS FS customers to invest in life insurance policies. Kobayashi did not disclose his role as

manager and advisor of this fund to UBS FS, placing it outside the scope of his UBS FS employment.

3. The fund had an initial investment of $1.4 million. Kobayashi later established a $3 million line of credit, most of which he improperly drew down. When the initial investors began asking for returns, Kobayashi convinced several other UBS FS customers to liquidate $1.9 million in securities, some of which he transferred to the initial investors as purported returns.

4. Kobayashi settled the charges without admitting or denying the allegations, agreed to enjoinment of further violations, and consented to be permanently barred from associating with entities in the securities industry. The Court will determine the amount to be disgorged upon the motion of the Commission.

Municipal Bond Actions

The Commission has called for greater scrutiny of the municipal securities market. The four cases below involve alleged bid rigging in this market. The SEC brought a similar case in 2010.

A. *SEC v. UBS Financial Services, Inc.*, 11-CV-2885 (D.N.J. May 4, 2011); *In the Matter of Mark Zaino,* Admin. Proc. File No. 3-14369 (May 4, 2011)

1. The SEC filed a settled action in New Jersey federal court against UBS Financial Services, Inc. ("UBS FS") charging it with fraudulently rigging at least 100 municipal reinvestment transactions in 36 states and generating millions of dollars in ill-gotten gains.

2. The allegations involve UBS FS's participation in the bidding process through which municipalities invest proceeds from the sale of municipal securities. When investors purchase municipal securities, the municipalities generally temporarily invest the proceeds of the sales in reinvestment products before the money is used for its intended purposes. For tax purposes, and to ensure a competitive bidding process and fair market value transactions, these temporary investments generally are made via independent bidding agents who search for the appropriate investment vehicle for a municipality's funds.

3. The complaint alleged that between 2000 and 2004, UBS FS facilitated improper payments to other bidding agents and

improperly steered business to favored providers of reinvestment products. In some cases, UBS FS is alleged to have given favored providers information on competing bids in a practice known as “last looks.” In other instances, UBS FS allegedly obtained off-market “courtesy” bids or pre-arranged “set-ups” by purposefully obtaining noncompetitive bids from others so that the favored provider would win the business.

4. The SEC alleged that UBS FS’s practices undermined the competitive bidding process, affected the prices that municipalities paid for the reinvestment products, and jeopardized, at that point in time, the tax-exempt status of billions of dollars in municipal securities.

5. UBS FS consented to pay $47.2 million in penalties, disgorgement, and prejudgment interest, which will be returned to the affected municipalities. UBS FS and its affiliates have also agreed to pay $113 million to settle parallel charges brought by other federal and state authorities.

6. In a related enforcement action, the SEC barred former UBS FS officer Mark Zaino from associating with any broker, dealer, or investment adviser, based upon his guilty plea last year in a criminal case charging him with two counts of conspiracy and one count of wire fraud.

B. *SEC v. J.P. Morgan Securities, LLC*, 11-CV-03877 (D.N.J. July 7, 2011)

1. The SEC filed a settled action against J.P. Morgan Securities LLC (“JPMS”) charging JPMS with fraudulently rigging municipal bond reinvestment transactions in 31 states.

2. The SEC’s action related to the investment of bond proceeds by municipalities before those proceeds were spent on their intended use. According to the SEC’s complaint against JPMS, municipalities typically purchase financial instruments such as guaranteed investment contracts (“GICs”), repurchase agreements (“Repos”) and forward purchase agreements (“FPAs”) that are tailored to meet the municipalities’ specific collateral and spend-down needs. In order to maintain the tax-exempt status of the municipal securities, municipalities must purchase the GICs, Repos or FPAs at fair market value, which is typically established through a competitive bidding process.

3. The SEC alleged that JPMS undermined the competitive bidding process for municipal reinvestment products it sold to various municipalities by improperly obtaining information from bidding agents about competing bids, conspiring with bidding agents to create "set-ups," whereby the bidding agent would deliberately obtain non-winning bids from other providers, and facilitating bid rigging by intentionally submitting non-winning bids. For example, the SEC alleged that the bidding agents provided JPMS with "last looks" that allowed JPMS to view competing bids in order to ensure that its own bid would prevail. In exchange, JPMS provided the bidding agents who participated in the scheme with additional business, and agreed to submit non-winning bids to allow other GIG, Repo or FPA providers to win other bids.

4. The SEC alleged that, in certain instances, JPMS provided municipalities with false certifications that, among other things, its bids were arms length and made without regard to any other agreement that JPMS had with the municipality or any other person. The SEC further alleged that these practices caused municipalities to purchase reinvestment products at non-market values and jeopardized the tax-exempt status of municipal securities.

5. Without admitting or denying the allegations in the complaint, JPMS agreed to pay a penalty of $32.5 million, disgorgement of $11,065,969, prejudgment interest of $7,620,380, and consented to an injunction prohibiting future violations of the securities laws.

6. In a related action, the SEC barred former JPMS vice president James L. Hertz ("Hertz") from association with any broker, dealer or investment adviser and from participating in a penny stock offering. This bar stemmed from Hertz's guilty pleas to conspiracy and wire fraud in connection with his misconduct during the bidding process for the investment of proceeds from certain municipal bonds.

C. *SEC v. Wachovia Bank, N.A.*, 11-CV-07135 (D.N.J. Dec. 8, 2011)

1. The SEC filed a settled action against Wachovia Bank N.A. ("Wachovia") charging Wachovia with fraudulently rigging municipal bond reinvestment transactions in 25 states and Puerto Rico.

2. The SEC's action related to the investment of bond proceeds by municipalities before the proceeds were spent on their intended use. According to the SEC's complaint against

Wachovia, municipalities typically purchase financial instruments such as guaranteed investment contracts ("GICs"), repurchase agreements ("Repos") and forward purchase agreements ("FPAs") that are tailored to meet the municipalities' specific collateral and spend-down needs. In order to maintain the tax-exempt status of the municipal securities, municipalities must purchase the GICs, Repos or FPAs at fair market value, which is typically established through a competitive bidding process.

3. The SEC alleged that Wachovia undermined the competitive bidding process for municipal reinvestment products it sold to various municipalities by: (1) improperly obtaining information from bidding agents about competing bids; (2) conspiring with bidding agents to create "set-ups" whereby the bidding agent would deliberately obtain non-winning bids from other providers; and (3) facilitating bid rigging by intentionally submitting non-winning bids. For example, the SEC alleged that the bidding agents provided Wachovia with "Last Looks" that allowed Wachovia to view competing bids in order to ensure that its own bid would prevail. In exchange, Wachovia provided the bidding agents who participated in the scheme with additional business, and agreed to submit non-winning bids to allow other GIG, Repo or FPA providers to win other ostensibly competitive bidding processes.

4. The SEC alleged that Wachovia provided municipalities with false certifications that its bids were arms length and made without regard to any other agreement that Wachovia had with the municipality or any other person. The SEC further alleged that these practices caused municipalities to purchase reinvestment products at non-market values and jeopardized the tax-exempt status of municipal securities.

5. Without admitting or denying the allegations in the complaint, Wachovia agreed to pay a penalty of $25 million, disgorgement of $13,802,984, prejudgment interest of $7,275,607, and consented to an injunction prohibiting future violations of the securities laws.

6. Wachovia also entered into agreements with the Justice Department, the Office of the Comptroller of the Currency, the Internal Revenue Service, and 26 state attorneys general that included the payment of an additional $102 million. Those settlements arose out of long-standing parallel investigations into widespread corruption in the municipal securities reinvestment industry in which 18 individuals were

criminally charged by the Justice Department's Antitrust Division.

D. *In the Matter of Dean Zenon Pinard*, Admin. Proc. File. No. 3-14655 (Dec. 8, 2011)

1. In this settled administrative proceeding, the SEC alleged that Dean Zenon Pinard, a dual officer of Banc of America Securities LLC ("BAS") and Bank of America, N.A. ("BANA") participated in fraudulently rigged municipal bond reinvestment transactions.

2. Notably, Pinard is the beneficiary of a grant of conditional amnesty from criminal prosecutions by the Department of Justice provided to BAS.

3. The proceeding relates to the investment of bond proceeds by municipalities before the proceeds were spent on their intended use. According to the SEC's Order, municipalities typically purchase financial instruments such as guaranteed investment contracts ("GICs"), repurchase agreements ("Repos") and forward purchase agreements ("FPAs") that are tailored to meet the municipalities' specific collateral and spend-down needs. In order to maintain the tax-exempt status of the municipal securities, municipalities must purchase the GICs, Repos or FPAs at fair market value, which is typically established through a competitive bidding process.

4. The SEC alleged that Pinard, in conjunction with other employees of BAS, undermined the competitive bidding process for municipal reinvestment products BAS sold to various municipalities by improperly obtaining information from bidding agents about competing bids, conspiring with bidding agents to create "set-ups" whereby the bidding agent would deliberately obtain non-winning bids from other providers, and facilitating bid rigging by intentionally submitting non-winning bids. For example, the SEC alleged that the bidding agents provided Pinard, and others at BAS, with "Last Looks" that allowed Pinard, and others at BAS, to view competing bids in order to ensure that BAS's own bid would prevail. In exchange, Pinard and other BAS employees, provided the bidding agents who participated in the scheme with additional business, and agreed to submit non-winning bids to allow other GIG, Repo or FPA providers to win other ostensibly competitive bidding processes.

5. The SEC alleged that Pinard and other BAS employees provided municipalities with false certifications that BAS's bids were arms length and made without regard to any other agreement that BAS had with the municipality or any other person. The SEC further alleged that these practices caused municipalities to purchase reinvestment products at non-market values and jeopardized the tax-exempt status of municipal securities.

6. Without admitting or denying the allegations in the complaint, Pinard agreed to pay disgorgement of $32,489 and prejudgment interest, accepted a bar from association with a broker, dealer or investment advisor, and consented to an injunction prohibiting future violations of the securities laws.

Mutual Fund Pricing

Outlined below is a case against two affiliated entities and two executives.

A. *In the Matter of Morgan Asset Management, Inc.* ("Morgan Asset"); *Morgan Keegan & Company, Inc.* ("Morgan Keegan"); *James C. Kelsoe, Jr., and Joseph Thompson Weller, CPA,* Admin Proc. File No. 3-13847 (June 22, 2011)

1. The SEC, FINRA, and state regulators in Alabama, Kentucky, Mississippi, South Carolina and Tennessee settled actions against Morgan Keegan, an affiliated entity and two individuals concerning deficiencies in fund pricing, sales and marketing in connection with seven affiliated funds.

2. During the period November 2004 through July 29, 2008, Morgan Keegan was the principal underwriter and distributor of certain open-ended mutual funds that were managed by Morgan Asset through Kelsoe, a portfolio manager. The funds' prospectuses stated that Morgan Asset would price the securities in the funds, but the boards of directors of each of the funds delegated this responsibility to Morgan Keegan. Morgan Keegan priced the securities and calculated the funds' NAV through its Fund Accounting Department, which was overseen by a Valuation Committee, of which Weller, Morgan Keegan's Controller and an officer and treasurer of the funds, was part.

3. The SEC alleged that Morgan Keegan and Weller failed to price the funds in accordance with the funds' policies and procedures. For example, Fund Accounting often sought broker-dealer price confirmations for certain securities.

Kelsoe reviewed the price confirmations and convinced one broker-dealer to change the price confirmations obtained by Fund Accounting and the independent auditor, who were unaware of this practice. Kelsoe also allegedly did not inform Fund Accounting or the funds' boards of directors when he received price-changing information regarding the funds' securities.

4. The SEC also alleged that: (i) low-level employees with little experience were responsible for pricing decisions; (ii) Fund Accounting accepted price adjustments from Kelsoe without any supporting documents or reasonable bases; (iii) Kelsoe was allowed to determine the broker-dealer price confirmations to use, which was beyond the scope permitted by the valuation procedures; and (iv) Fund Accounting and the Valuation Committee allowed securities to be assigned stale prices by not making sure that such prices were re evaluated.

5. As a result of such practices, the SEC alleged that Morgan Keegan published daily NAVs that it did not know were accurate and sold and redeemed shares of the funds based on those NAVs. Moreover, documents filed with the Commission included untrue statements of material fact regarding the funds' performance.

6. FINRA's action alleged that during the period January 1, 2006 through September 30, 2007, sales materials for the Regions Morgan Keegan Select Intermediate Fund were not fair and balanced, contained exaggerated claims and did not appropriately disclose the impact market conditions in the summer of 2007 had on the value of the fund. Although the fund was marketed as a fairly safe, fixed income mutual fund, FINRA alleged that, in fact, the fund carried with it the potential for higher risk, especially with respect to its investments in asset-backed and mortgage-backed securities.

7. Morgan Keegan agreed to pay restitution of $200 million to settle all of the foregoing actions. Specifically, $20.5 million in disgorgement, $4.5 million in prejudgment interest, and $75 million in civil penalties will be paid to the SEC, to be distributed to harmed customers through a Fair Fund. The firm will pay $100 million into a state fund for customers. Additionally, as part of the settlement with the SEC, Morgan Keegan and Morgan Asset are barred from being involved in the pricing of securities for investment companies for three years. Kelsoe consented to pay a civil penalty of $250,000

and to an industry bar and a bar from participating in any penny stock offering. Weller agreed to a penalty of $50,000 and a 12-month suspension from acting in a supervisory capacity and participating in the offering of a penny stock. He was also prohibited from appearing or practicing before the Commission as an accountant.

8. As part of the settlement in the state proceedings, Morgan Keegan agreed to retain an Independent Consultant to review certain policies and protocols and to provide training to its registered representatives. These items were incorporated into the firm's settlement with FINRA.

Privacy and Confidentiality of Client Information

Below are two interesting cases involving the alleged misuse of customer information.

A. *In the Matter of Merrill Lynch, Pierce, Fenner & Smith Incorporated* ("Merrill Lynch"), Admin. Proc. File No. 3-14204 (Jan. 25, 2011)

1. The SEC settled fraud charges brought against Merrill Lynch concerning the misuse of confidential client information and improper mark-ups and mark-downs on certain riskless principal trades.

2. The SEC alleged that between February 2003 and February 2005, a firm proprietary desk used information regarding institutional customer orders from traders on Merrill Lynch's market making desk to place proprietary orders. The firm had represented to its customers that such information would remain confidential.

3. In another aspect of the case, according to the SEC Merrill Lynch had agreements with certain customers that it would charge a commission equivalent for executing riskless principal trades. The SEC charged, however, that between 2002 and 2007 and contrary to those agreements, the firm also charged those customers undisclosed mark-downs and mark-ups by filling customer orders at lower or higher prices than it paid for the securities in the market.

4. Merrill Lynch was also charged with failing to supervise its proprietary and market-making desks. The SEC also alleged that the firm failed to keep records of price guarantees that were part of certain customer orders.

5. In considering the settlement, the SEC took into account "significant" remedial actions the firm voluntarily undertook.

6. Merrill Lynch consented to a censure and a fine of $10 million.

B. *In the Matter of Frederick O. Kraus,* Admin. Proc. File No. 3-314326 (Apr. 7, 2011); *In the Matter of David C. Levine,* Admin. Proc. File No. 3-314327 (Apr. 7, 2011); *In the Matter of Marc A. Ellis,* Admin. Proc. File No. 3-314328 (Apr. 7, 2011)

1. The SEC filed settled administrative proceedings against three former brokerage executives of Tampa-based GunnAllen Financial Inc. ("GunnAllen") for failing to protect confidential information about their customers.

2. The SEC's order alleged that, as GunnAllen was winding down its business operations in 2010, its former president, Frederick O. Kraus, and former national sales manager, David C. Levine, violated customer privacy rules by improperly transferring customer records to another firm. Kraus allegedly authorized Levine to take customer information from more than 16,000 GunnAllen accounts, including customer names, addresses, account numbers, and asset values, to Levine's new employer. The SEC's order charged Kraus and Levine with violating Regulation S-P, an SEC rule that requires firms to protect confidential customer information from unauthorized release to unaffiliated third parties.

3. The SEC also charged Marc A. Ellis, GunnAllen's former chief compliance officer, with failing to ensure that the firm's policies and procedures were reasonably designed to safeguard confidential customer information. Among other things, Ellis allegedly failed to revise or supplement GunnAllen's policies and procedures for safeguarding information despite several serious security breaches at the firm between 2005 and 2009, including the theft of three laptop computers and unlawful access to its e-mail system by a terminated employee.

4. Kraus, Levine, and Ellis each consented to the entry of cease-and-desist orders, as well as monetary penalties in the amount of $20,000 (for both Kraus and Levine) and $15,000 (for Ellis).

Record Keeping

The two cases below both involve allegations regarding the submission of false records to the SEC's examination staff.

A. *In the Matter of Legend Securities, Inc. and Salvatore Caruso*, Admin. Proc. File No. 3-14389 (May 16, 2011)

1. In an enforcement action arising out of the production of documents and information during an examination, the SEC charged a broker-dealer and its chief compliance officer with providing false documents to the examination staff.

2. In 2009, the SEC examination staff commenced an examination of Legend Securities, Inc. ("Legend"). As part of its examination, the staff requested that Legend produce various employment records for its associated persons. When Legend discovered that it did not have certain forms, including compliance-related documents, concerning one of its associated persons, Legend's chief compliance officer, Salvatore Caruso, asked the associated person to sign forms that were backdated to appear as though they were signed when the associated person began his employment at Legend. Caruso then provided these backdated forms to the examination staff.

3. The Commission entered an order directing Legend and Caruso to cease-and-desist from committing violations of Section 17(a) of the Exchange Act and Rules 17a-3 and 17a-4 thereunder and imposing a civil penalty of $50,000 on Legend and $25,000 on Caruso.

B. *SEC v. Kurt S. Hovan, Lisa B. Hovan, Edward J. Hovan, Jr. and Hovan Capital Management, LLC*, 11-Civ-4795 (N.D.Cal. Sept. 28, 2011)

1. The SEC filed a civil action against Hovan Capital Management LLC ("HCM"), an investment adviser, and its principals in connection with an alleged scheme to misappropriate client assets and for production of fictitious documents to cover up the fraud during SEC examination.

2. The SEC alleged that Kurt S. Hovan, the President of HCM, with the assistance of his wife, Lisa B. Hovan, Chief Financial Officer of HCM, and his brother Edward J. Hovan, Executive Vice President of HCM, misappropriated over $178,000 in brokerage commission fees, known as "soft dollars," by misusing the funds for the benefit of HCM. Soft

dollars, if appropriately disclosed, may be used by investment advisers for a limited category of brokerage and research services. According to the SEC, defendants mislead HCM clients and the SEC to believe that soft dollars would be used for research services. In reality the money was used to pay HCM rent, Edward Hovan's salary and kick backs to Kurt and Lisa Hovan. In numerous disclosure documents to clients and ADV forms filed with the Commission, defendants misrepresented the true use of soft dollars.

3. The SEC alleged that to cover up their scheme, defendants created a shell research company, controlled by Edward Hovan, through which they issued invoices to HCM for research services. Once the invoices were paid with soft dollars from HCM, Edward Hovan kicked back approximately 40% of the payment to Kurt and Lisa Hovan.

4. Additionally, during the Commission's examination in 2010, defendants provided the SEC with doctored documents to create the impression of legitimate research reports for which HCM paid with soft dollars. The SEC alleged that Kurt Hovan testified to creating the documents during the Commission's examination.

5. The SEC seeks injunctive relief, disgorgement of wrongfully obtained benefits, including prejudgment interest and civil penalties.

6. On September 28, 2011, federal criminal charges were also brought against Kurt Hovan by the DOJ. On January 17, 2012 Hovan pled guilty to mail fraud and is awaiting sentencing.

Registration

Below is a case involving the broker-dealer and investment adviser registration provisions of the securities laws.

A. *In the Matter of Banco Espirito Santa S.A.,* Admin. Proc. File No. 3-14599 (Oct. 24, 2011)

1. The SEC filed a settled administrative proceeding against Banco Espirito Santo S.A. ("BES"), a commercial bank headquartered in Portugal with over 700 branches throughout the world, alleging that BES violated broker-dealer and investment advisor registration provisions

– as well as the securities transaction registration provisions – of the federal securities laws.

2. The SEC alleged that BES acted as a broker-dealer and investment adviser, even though it was not a registered broker-dealer or investment advisor and did not utilize a registered broker-dealer as an intermediary, and thus willfully violated Sections 5(a) and 5(c) of the Securities Act, Section 15(a) of the Exchange Act, and Section 203 (a) of the Advisers Act.

3. Specifically, the SEC alleged that BES maintained relationships with approximately 3,800 U.S. residents, who were largely Portuguese immigrants, that held securities in their brokerage and advisory accounts with BES between 2004 and 2009.

4. The SEC further alleged that, from 2005 until 2009, BES dedicated a relationship manager to the U.S. market and that relationship manager provided services to approximately 225 U.S. clients.

5. The SEC also alleged that BES retained a third party to operate a customer service call center, that had two Portugal-based employees dedicated to servicing BES's U.S. customers, and those two employees offered various financial products, including securities, to those customers over the phone.

6. In addition, the SEC alleged that BES charged its U.S.-based customers and clients commissions and fees on their accounts and for securities transactions.

7. BES consented to a cease-and-desist order, disgorgement of $1.65 million plus prejudgment interest and a civil penalty of $4.5 million.

Regulation SHO

Late last year, the SEC brought another Reg SHO case against a broker-dealer.

A. *In the Matter of UBS Securities LLC* ("UBS"), Admin. Proc. File No. 3-14620 (Nov. 10, 2011)

1. The SEC settled a case with UBS in which it alleged that the firm violated Rule 203(b) of Reg SHO in connection with the method by which it granted and documented locates.

2. According to the SEC, since at least 2007, in circumstances where UBS's Securities Lending Desk employed a manual locate process, its documentation practices created an inaccurate record regarding the basis upon which locates had been granted, and caused locates to be granted without UBS documenting a reasonable basis for locates.

3. Specifically, when granting a locate, a lending desk trader would note the source of the shares for the locate on the firm's locate log. Each entry included either the name of an employee at the lending source or an indication that the trader was relying on an electronic availability feed. This method of notation appeared to distinguish between locates granted based on information for a lender's employee and those granted based on the electronic availability feed. The SEC alleged that in practice, however, lending desk traders regularly noted the name of a lender employee even when no one at UBS had actually contacted that person with respect to the locate.

4. The SEC also charged that UBS's inaccurate logs failed to comply with the books and records requirements of Section 17(a) of the Exchange Act that brokers maintain accurate records. For example, the locate log indicated that thousands of locates were sourced to lender employees who were out of the office on the relevant days and so could not have provided a locate to UBS. The SEC alleged that the firm's documentation practices meant that the basis upon which locates were granted could not be determined.

5. The SEC order notes that the effect of UBS's documentation practices was mitigated because: (1) some of the clients for whom UBS gave locates did not execute short sales using those locates or did so for amounts smaller than the locate approval; (2) some lenders may have been able to lend UBS the securities so that the firm could meet its settlement obligations, despite the inaccuracies in the locate documentation; and (3) UBS was generally able to meet its settlement obligations through sources other than those indicated in the locate log.

6. UBS agreed to a censure and an $8 million fine. The firm also agreed to an undertaking to retain an independent consultant to conduct a review of its Securities Lending Desk policies, procedures and practices with respect to granting locate requests and UBS's procedures to monitor compliance therewith, to satisfy its Reg SHO obligations.

Securities Exchanges, Alternative Trading Systems and SROs

Last year the SEC brought disciplinary actions against two exchanges, an alternative trading system and an SRO.

A. *In the Matter of EDGX Exchange, Inc., EDGA Exchange, Inc., and Direct Edge ECN LLC,* Admin. Proc. File No. 3-14586 (Oct. 13, 2011)

1. The Commission entered a settled order instituting administrative and cease-and-desist proceedings against two electronic securities exchanges, EDGX Exchange, Inc. ("EDGX") and EDGA Exchange, Inc. ("EDGA"), and their associated routing broker, Direct Edge ECN LLC ("DE"), (collective "Respondents"), alleging that Respondents violated sections 19(b) and 19(g) of the 1934 Act, and Regulations SHO and NMS as a result of weak internal controls that lead to system outages and investor losses.

2. The SEC alleged that in one incident, Respondents failed to test newly implemented codes used in processing customer orders, which led to orders of at least three members being overfilled. To correct this error, the exchanges engaged DE to liquidate the positions through DE's error account and assume positions in other securities, all in violation of internal rules which limited DE's role, and resulting in $2.1 million loss to the exchanges.

3. In an attempt to unwind the overfilled trades, DE violated Reg SHO by failing to accurately mark orders as short and obtain and document locates.

4. The SEC further alleged that in another incident, EDGX's database administrator inadvertently disabled EDGX's database resulting in the exchanges' inability to process incoming orders, modifications and cancellations. After receiving several internal warnings and external notifications from clients whose orders were not being filled, EDGX waited approximately twenty-four minutes before identifying its quotations as manual in violation of Regulation NMS. The incident resulted in over $668,000 in losses sustained by members of the exchanges.

5. Respondents settled the matter by agreeing to a censure and undertaking, among other things, to enhance policies and procedures with respect to system maintenance and testing, outsourcing internal audit functions and developing procedures to compensate members for losses incurred.

6. In considering the terms of settlement, the SEC took into account extensive remedial actions already taken by Respondents, including, but not limited to, retaining consultants, purchasing new hardware and software, and engaging outside counsel to conduct a review of compliance and operational policies.

B. *In the Matter of Pipeline Trading Systems LLC, Fred J. Federspiel, and Alfred R. Berkely III*, Admin. Proc. File No. 3-13877 (Oct. 24, 2011)

1. The SEC instituted a settled administrative proceeding against Pipeline Trading Systems LLC ("Pipeline"), Fred J. Federspiel, the firm's chief executive officer and a supervisory principal, and Alfred R. Berkeley III, the firm's chairman and also a supervisory principal.

2. According to the Commission's Order, Pipeline operated an alternative trading system ("ATS") that it held out to its customers and the public as a crossing network that anonymously matched customers' interests in trading large blocks of stock and protected institutional investors from the market impact associated with predatory trading. According to the Order, Pipeline promised that all customers would be treated equally and without preferential treatment, that customer trading information would be maintained confidential, and that its platform prevented the leakage of pre-trade information.

3. The SEC alleged that Pipeline did not disclose to its customers that the overwhelming majority of the shares traded on the ATS were bought or sold by a wholly owned affiliate of Pipeline, which was created specifically to provide liquidity to Pipeline's customers. The SEC further alleged that, contrary to Pipeline's public statements that all customers would be treated equally and without preferential treatment, Pipeline provided its affiliate with access and information that improved its ability to trade advantageously. For example, Pipeline provided the affiliate with enhanced connectivity and receipt of trading and pricing data that was not available to all customers, and adjusted mandatory trade block sizes to help reduce the risk of the affiliate's trading and increase its profitability. In addition, the affiliate's trading created a conflict of interest in any given trade as the better price the customer received, the worse price the affiliate received (and vice versa), and often the affiliate's participation in a trade negatively impacted customer execution.

4. Pipeline settled the matter by paying a civil monetary penalty of $1 million, and Federspiel and Berkeley each paid a civil monetary penalty of $100,000.

C. *In the Matter of Financial Industry Regulatory Authority, Inc.*, Admin. Proc. File No. 3-14605 (Oct. 27, 2011)

1. The SEC filed a settled administrative proceeding against the FINRA concerning FINRA's production of altered records to the SEC's inspection staff.

2. According to the Order Instituting Proceedings, in August 2008, the Director of FINRA's Kansas City District Office "caused the alteration of three records of staff meeting minutes just hours before producing them to the Commission inspection staff, making [the minutes] inaccurate and incomplete." This was the third time in the 2006-2008 time period that FINRA (or the NASD) had provided altered or misleading documents to the SEC in violation of Section 17(a)(1) of the Exchange Act and Rule 17a-1.

3. FINRA first learned of the altered documents through a whistleblower complaint in June 2010. Within days, FINRA's Internal Audit staff conducted an internal investigation of the matter; Internal Audit verbally advised FINRA's Audit Committee of the whistleblower's allegations in July 2010. In September 2010, the District Director resigned and FINRA self-reported Internal Audit's finding to the SEC's Chicago Regional Office and the Enforcement Division.

4. FINRA consented to the entry of a cease-and-desist order and has undertaken to provide training to all of its employees concerning document integrity issues. FINRA also agreed to engage an independent consultant to review its policies and procedures and training relating to document integrity. In determining to accept the settlement, the Commission considered the remedial actions promptly undertaken by FINRA and the cooperation it provided to the SEC's staff.

5. In response to the case, FINRA's Chairman and CEO, Richard Ketchum, issued a press release stating that "we have zero tolerance for actions that could compromise the integrity of our organization."

Securities Offerings

A. *In the Matter of Johnny Clifton,* Admin. Proc. File No. 3-14266 (Feb. 17, 2011)

1. On February 17, 2011, the SEC instituted public administrative and cease-and-desist proceedings against Johnny Clifton, the former president and principal of MPG Financial, LLC ("MPG"), for his purported role in offering limited partnership interests in a six-well oil and gas drilling project (the "Osage Project") and supervising the sale of those interests.

2. The SEC alleged that the Osage Project's drilling efforts met with a series of mishaps and pitfalls: drilling a well with lower-than-expected oil flows; drilling a second well that produced excessive amounts of water and was later converted into a non-producing "salt water disposal well," drilling three dry wells consecutively, and running behind schedule for much of the project's existence. Ultimately, before drilling began on the sixth well, the entire project was abandoned, and MPG returned 25% of the investors' principal.

3. Clifton supervised MPG's sales representatives and sales practices. The SEC alleged he held weekly meetings in which he encouraged the sales force to use the Osage Project's Private Placement Memorandum, as well as oral information that he shared with the representatives, in order to sell interests in the project. As MPG's president, Clifton was informed of each of the Osage Project's setbacks, yet he allegedly did not adequately communicate information regarding those setbacks to MPG's sales force.

4. The SEC also alleged Clifton provided false and misleading statements or omitted material information in at least one sales presentation and – through his own selective disclosures – caused his sales representatives to provide false and misleading statements regarding the Osage Project.

5. Further, Clifton allegedly failed reasonably to supervise MPG's sales representatives and failed to draft and approve adequate Written Supervisory Procedures regarding (a) the supervision of outgoing correspondence and (b) the need to provide material information to investors regarding recommended investments.

6. The SEC alleged that as a result of Clifton's failure to supervise MPG's registered representatives and his failure to provide material information to his sales force, investors in the Osage Project were not adequately informed of the risks inherent in the project.

7. An Administrative Law Judge ("ALJ") determined that Clifton had violated federal securities fraud provisions and had failed to supervise MPG's sales representatives. The ALJ imposed a cease-and-desist order and Clifton was barred from the industry and ordered to pay a $130,000 penalty.

Suitability

Although FINRA has taken the lead on cases involving brokers' sale of structured products to their retail clients, below is an example of the SEC doing so.

A. *In the Matter of David G. Brouwer*, Admin. Proc. File No. 3-14516 (Aug. 26, 2011)

1. The SEC filed a settled administrative proceedings against David G. Brouwer, a former registered representative associated with broker-dealer and investment adviser Great American Advisors, Inc.

2. The order alleges that Brouwer made material representations about and failed to disclose certain material risks associated with equity-linked notes that he recommended as investments to certain customers in 2007 and 2008. The order further alleges that Brouwer's recommendation of equity-linked notes to at least two of his customers was unsuitable based on their investment objectives and stated risk tolerance.

3. Brouwer is charged with telling customers that the equity-linked notes, which were structured notes in which there was a derivatives exposure to the note holder due to the reverse convertible nature of the note, were safe when in fact there was the possibility that the notes would convert to securities at a value less than the invested principal. Brouwer failed to adequately disclose this risk to the investors. According to the SEC, Brouwer committed fraud in this case.

4. Brouwer consented to the entry of a cease-and-desist order and the payment of $33,000 in disgorgement plus prejudgment interest and a civil fine of the same amount. Brouwer was also barred from the industry.

Supervision

The SEC routinely brings supervisory cases against broker-dealers. Below are several actions against firms and individual supervisors.

A. *In the Matter of BNY Mellon Securities*, Admin. Proc. File No. 3-14191 (Jan. 14, 2011)

1. The SEC filed a settled administrative proceeding against BNY Mellon Securities ("BNY") alleging that during a more than eight-year period from 1999 to 2008, BNY failed reasonably to supervise the manager of the institutional order desk and traders under the manager's supervision. The institutional order desk executed trades for a BNY affiliate, Mellon Investor Services LLC ("MIS"), which served as administrator for employee stock purchase plans, stock option plans and direct purchase and sale plans (collectively, the "Plan Customers").

2. According to the SEC, the desk manager failed to meet his duty of best execution to the Plan Customers. This failure occurred because the order desk manager directed the traders to execute the trades for the Plan Customers through cross trades with favored accounts of hedge funds and individuals at prices that favored the hedge funds.

3. The cross trades were all executed on a regional stock exchange which had a functionality in its order management system called the "validated cross window" which allowed a trader a several minute window for entering trade details, including the price of the trade. Using this delay feature, traders used the validated cross window to favor the counter-parties for the Plan Customers' trades in the trade.

4. For example, traders had the ability to execute trades at stale prices that favored the hedge funds and the individuals to the detriment of the Plan Customers who were the counter-parties to the trade. The SEC studied more than 8,500 trades and concluded that the desk used the validated cross window to obtain better prices for the hedge funds more than 80 percent of the time.

5. The SEC alleged that BNY failed to supervise the desk in two respects. First, BNY failed to establish reasonable procedures for following up on red flags raised in best execution exception reports. Second, BNY did not have procedures in order to determine whether the order desk

manager was fulfilling his responsibility to conduct a daily best execution review of executions on regional exchanges

6. BNY settled the matter by consenting to a censure, to pay disgorgement of $19,297,016 and a $1 million civil penalty, and to pay for an Independent Distribution Consultant to distribute the disgorgement and penalty funds to the Plan Customers.

7. The SEC settled a related administrative proceeding against Mark Shaw, the supervisor of the institutional order desk from November 1999 through March 31, 2008. Shaw consented to a bar from association with any broker-dealer, to pay disgorgement of $195,300, prejudgment interest of $23,291, and a civil money penalty of $150,000.

B. *In the Matter of TD Ameritrade, Inc.*, Admin. Proc. File No. 3-14225 (Feb. 3, 2011)

1. This case concerns TD Ameritrade's ("Ameritrade") alleged supervisory failures with respect to the offer and sale of shares of a short-term bond fund, the Reserve Yield Plus Fund (the "Fund"), that "broke the buck" when Lehman Brothers, Inc. failed in September 2008 and the value of Lehman's commercial paper owned by the Fund dropped significantly.

2. The SEC filed a settled administrative proceeding against Ameritrade in which it alleged that Ameritrade failed to establish policies and procedures and a system to implement the procedures to prevent and detect misleading representations to customers by Ameritrade's registered representatives concerning the nature of the Fund and the risks associated with the Fund.

3. According to the SEC, Ameritrade's registered representatives mischaracterized the Fund as a money-market fund, failed to disclose the risks of the fund, and described the Fund as an investment with guaranteed liquidity or as safe as cash. The SEC further alleged that Ameritrade lacked a system to ensure that registered representatives were adequately trained regarding the Fund and lacked any system to provide refresher courses or continuing education regarding the Fund.

4. Ameritrade settled the matter by agreeing to a censure. In light of the fact that Ameritrade undertook voluntarily to pay

$10 million to customers who owned the Fund, the SEC did not seek to impose a civil penalty on Ameritrade.

C. *In the Matter of Torrey Pines Securities, Inc.*, Admin. Proc. File No. 3-14230 (Feb. 3, 2011)

1. In this settled administrative proceeding, the SEC alleged that Torrey Pines, a small broker-dealer, failed to establish reasonable policies and procedures to supervise a registered representative, who was also a part owner of Torrey Pines. This failure allegedly resulted in the registered representative supervising himself.

2. Additionally, though Torrey Pines had a policy prohibiting selling securities outside of the firm, the firm failed to develop systems to monitor adherence with the firm's ban on selling away. Finally, the SEC alleged that the supervisors and compliance staff at Torrey Pines failed to follow up on alleged "red flags" concerning the registered representative's outside business activities.

3. Torrey Pines settled the matter by agreeing to a censure and to an undertaking to retain an independent consultant to review its policies, procedures and systems concerning supervision of registered representatives and the outside business activities of associated persons. A civil money penalty was not imposed based upon Torrey Pines' representations of its inability to pay.

D. *In the Matter of Jack C. Smith, Jr.*, Admin. Proc. File No. 3-14229 (Feb. 3, 2011)

1. In this settled administrative proceeding, which is related to the Torrey Pines matter discussed above, the SEC alleged that Smith, a part-owner of Torrey Pines and its president and chief executive officer, failed reasonably to supervise a registered representative of Torrey Pines who was selling away and conducting an unregistered private securities offering outside Torrey Pines.

2. The registered representative raised over $17 million in the private securities offering.

3. Smith settled the matter by agreeing to a censure, a nine month suspension from supervision and a $25,000 civil penalty.

E. *In the Matter of Elizabeth Pagliarini,* Admin. Proc. File No. 3-14273 (Feb. 24, 2011)

1. In a case related to the Hunter World Markets Inc. ("HWM") and Tony Ahn matters (see above), the SEC settled an administrative proceeding against Elizabeth Pagliarini alleging that, in her role as compliance officer, she failed to review and flag certain improper trades and money transfers, failed to detect certain trades and wire transfers and file suspicious activity reports ("SARs"), and failed to supervise Tony Ahn, HWM's primary trader, and to detect certain improper trades and wire transfers and file the appropriate reports. During the time period in question, Pagliarini was the chief compliance officer of HWM, a registered broker-dealer.

2. Specifically, the SEC contended that Pagliarini failed to review and approve order tickets generated from Ahn's trading activities and failed to discover or follow up on suspicious trades executed by Ahn such as matched orders and wash trades.

3. The SEC further alleged that Pagliarini should have determined that certain trades and wire transfers executed by HWM were potentially fraudulent and accordingly filed SARs for those transactions.

4. In her settlement with the SEC, Pagliarini consented to a cease-and-desist order, a one-year suspension from association with any broker or dealer, certain undertakings, and a $20,000 civil penalty.

F. *In the Matter of Janney Montgomery Scott LLC,* Admin. Proc. File No. 3-14459 (July 11, 2011)

1. The SEC filed a settled administrative proceeding against a broker-dealer and investment adviser, Janney Montgomery Scott LLC ("JMS"), alleging that it failed to establish, maintain and enforce policies and procedures to prevent the misuse of material, nonpublic information in violation of §15(g) of the Securities Exchange Act of 1934. The SEC alleged that JMS's implementation of its policies and procedures was deficient. First, in some cases, JMS did not enforce its protocols. As such, the SEC alleged that employees did not understand their responsibilities. Second, in other instances, JMS did not follow its policies and procedures as they were written.

2. The SEC alleged that JMS failed to prevent and monitor communications between investment banking and research personnel, and to adequately monitor employee trading in securities of companies on JMS's watch list. Specifically, the SEC alleged that JMS did not follow its policy to adequately "chaperone" conversations between investment banking and research, which on at least one occasion led to a research analyst recommending stock of a company advised by JMS in a pending merger and acquisition to at least three institutional clients. A public announcement of the merger just a few days later resulted in an increase in the price of the stock.

3. The SEC also alleged that between 2005 and 2009, the firm's firewall procedures allowed for direct e-mail communications between the investment banking and research department.

4. The SEC entered a cease-and-desist order and ordered JMS to pay a civil penalty of $850,000. In addition, JMS agreed to, among other things, engage an independent consultant to review and make recommendations about its policies and procedures to prevent the misuse of material, nonpublic information, and to certify JMS's continued compliance with improved policies and procedures.

Swaps Trading

Below are two cases related to swaps trading: one against a trader and another against her supervisor.

A. I*n the Matter of Larry Feinblum,* Admin. Proc. File No. 3-14407 (May 21, 2011)

1. The SEC entered an administrative order against Larry Feinblum, a former Executive Director and supervisor of the Equity Financing Products Swaps Desk at Morgan Stanley & Co., Inc. ("Morgan Stanley"). From October through December 2009, Feinblum and a trader on his desk, Jennifer Kim, implemented and executed an arbitrage strategy that sought to profit from the differences between the prices of American Depositary Receipts and common stock of two emerging market securities.

2. The SEC alleged that by October 2009, Morgan Stanley's net risk position in one of the securities exceeded the $50 million limit the firm placed on any single emerging market security. As such, Morgan Stanley notified Feinblum

that he needed to reduce the net risk position to bring it within the firm's limit. Despite this warning, on at least 32 separate occasions between October and December 2009 Feinblum entered swap orders into Morgan Stanley's risk management system, and then almost immediately cancelled the orders. The effect of this strategy was to temporarily and artificially reduce the net risk positions in the securities. During this time, Feinblum allegedly represented to the firm that he continued to reduce the desk's net risk position to bring it within the firm's limit, when, in fact, he continued to increase the net risk position.

3. The SEC also alleged that Morgan Stanley discovered the trading strategy in December 2009 when the market moved against Feinblum's position and he recorded a $7 million loss. Following this loss, Feinblum admitted to his supervisor that he repeatedly exceeded the firm's risk limits and concealed his actions. Morgan Stanley subsequently terminated Feinblum based on this conduct.

4. The SEC alleged that Feinblum violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

5. The Commission entered a settled order which barred Feinblum from association with a broker, dealer or investment adviser, with a right to reapply for association after two years, and imposed a civil penalty of $150,000.

B. *In the Matter of Jennifer Kim,* Admin. Proc. File No. 3-14460 (July 12, 2011)

1. The Commission entered a settled order instituting administrative and cease-and-desist proceedings against Kim regarding the same allegations as those above against Feinblum.

2. Interestingly, and in contrast to its charges against Feinblum, in this case the Commission alleged that Kim violated Section 13(b)(5) of the Exchange Act, which prohibits persons from knowingly circumventing or knowingly failing to implement a system of internal accounting controls or knowingly falsifying any book, record or account.

3. Kim was barred from association with any broker-dealer with the right to reapply after three years and was ordered to pay a fine of $25,000.

4. In an unusual action, Commissioner Aguilar dissented from the SEC's order accepting the settlement of Kim. Commissioner Aguilar noted that Kim held four securities licenses and managed her own trading account. He further pointed out that there were 32 instances in a three-month period where Kim entered and cancelled swap orders to evade Morgan Stanley's internal risk limits. Commissioner Aguilar wrote that "I believe Kim's offer to settle the Order based on a violation of Section 13(b)(5) of the Exchange Act is inadequate, and fails to address what is in my view the intentional nature of her conduct. The settlement should have included charging Kim with violations of the antifraud provisions."

Unregistered Offerings

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

A. *In the Matter of Divine Capital Markets, LLC, Danielle Hughes and Michael Buonomo,* Admin. Proc. File No. 3-14274 (Feb. 25, 2011)

1. The SEC settled this administrative proceeding against Divine Capital Markets, LLC ("Divine"), Divine's Chief Executive Officer, and a Divine registered representative for facilitating the unregistered sales of penny stocks to investors and failing to implement proper supervisory procedures.

2. The SEC alleged that between February 2006 and June 2007, Divine sold over 9.8 billion shares of unregistered stock without conducting any due diligence on the issuers of those securities. In addition, the SEC alleged that Danielle Hughes – Divine's CEO as well as one of its General Securities Principals – failed to carry out her supervisory responsibilities and ignored red flags that the stock was unregistered.

3. In addition to her roles as CEO and General Securities Principal, Hughes served as Divine's Chief Compliance Officer from June 2006 to September 2006. In that capacity, Hughes was responsible for developing and maintaining the firm's supervisory policies and procedures. The SEC alleged Divine's supervisory policies were inadequate to provide guidance to supervisor's regarding due diligence procedures.

4. The SEC entered a civil cease-and-desist order censuring Divine and suspending it from participating in any offering of a penny stock for one year. It was also ordered to pay disgorgement of $33,762, prejudgment interest of $6,921, and a civil money penalty of $60,000. Hughes agreed to a supervisory bar for four months and a civil money penalty of $25,000. The SEC entered a separate cease-and-desist order against Buonomo, suspending him from the industry for one year. He was also ordered to pay disgorgement of $29,017 and prejudgment interest of $5,948. Based on Buonomo’s financial condition representations, the payment of that amount was waived, except for $3,000. No civil monetary penalty was imposed.

Personnel Changes

J. Bradley Bennett became the new Head of Enforcement, effective January 1, 2011. Mr. Bennett joined FINRA from Baker Botts in Washington, D.C. In one of his earliest press interviews, Mr. Bennett provided three insights to his enforcement approach. Mr. Bennett indicated that he expected his team to be "tough but fair," that he was going to attempt to "streamline the processes that may be bogging down important matters," and warned that although he had recently switched sides from defending the industry to being its chief prosecutor, "he will not go easy" on financial services firms.[34] In a subsequent interview, Richard G. Ketchum, FINRA's Chairman and CEO, commented that Mr. Bennett had "brought a renewed passion" to the Department of Enforcement and predicted that the industry will see both more cases and cases brought more quickly.[35] As evidenced by the statistics cited below, FINRA's enforcement team did in fact initiate more cases in 2011 than it had in the prior year.

In May 2011, two senior Enforcement officials left FINRA. Chief Counsels Linda Riefberg and Suzanne Elovic, who each led an enforcement unit in New York, departed from FINRA after serving with the organization and its predecessor (NYSE Regulation) for many years. According to a media report, Richard Best, a Director of Enforcement, was elevated to Acting Chief Counsel.[36] In August, the media reported that Daniel Nathan, Director of FINRA's Regional Enforcement program, planned to leave the organization.[37] Jessica Hopper was later promoted to lead that group of enforcement attorneys.

Alma Amgotti, FINRA's Senior Special Counsel for its anti-money laundering enforcement efforts, left FINRA in mid-2011.[38]

In the fall of 2011, Susan Schroeder became the Deputy Director of Enforcement, resident in FINRA's New York office. Ms. Schroeder had

34 "After Years of Defending Wall Street Firms, A Transition to Policing Them," Ben Protess, New York Times (Jan. 18, 2011).

35 "Postcrisis, A Regulator Moves to Expand Power Over Wall Street," Ben Protess, New York Times (Apr. 26, 2011).

36 Compliance Reporter, May 2011. Mr. Best later became a Chief Counsel.

37 "Senior FINRA Enforcer Eyes Door," Compliance Reporter (Aug. 1, 2011).

38 "FINRA's Top AML Enforcer Departs," Compliance Reporter (Jul. 25, 2011).

previously been a partner at Wilmer Hale. A long-time FINRA Enforcement official, Emily Gordy, is the Department of Enforcement's Chief of Staff and Deputy Director, located in FINRA's Washington office.

Finally, in late 2011, Michael Solomon became the new Senior Vice President and Regional Director for FINRA's New York Region. Mr. Solomon joined FINRA from Jefferies & Company.

Enforcement Statistics

Last year, all of the traditional statistics used to measure FINRA's enforcement program showed marked increases from 2010. FINRA brought more cases, harshly disciplined more brokers and principals, obtained significantly more money from the industry through the fines it imposed and returned substantially more money to investors than in the prior year.

In 2011, FINRA filed 1,488 new disciplinary actions against firms and individuals, up from 1,310 cases from the prior year – an increase of 13.5%. FINRA also resolved 1,287 formal actions last year; in 2010, it had concluded 1,178 such cases. Last year, FINRA expelled 21 firms from its membership (compared to 14 in the prior year), barred 329 people (versus 288 in 2010) and suspended 475 individuals (an increase over the 428 such actions in the prior year).[39]

As of December 16, 2011, FINRA reported that it had levied fines of more than $63 million versus almost $42.2 million in all of the prior year. The 2011 figure would represent a 50% increase year-over-year. Again, as of December 16, 2011, FINRA ordered firms and individuals to provide more than $19 million in restitution to customers; in 2010 all such orders totaled $6.2 million.[40]

In line with the increased number of cases and overall fine levels, cases with significant penalties increased sharply in 2011 when compared to 2010, as shown in the following table.[41]

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[39] *See* "FINRA's 2011 Activities Highlight Commitment to Investor Protection," Dec. 16, 2011 press release, and FINRA's statistics page available at: http://www.finra.org/Newsroom/Statistics/.

[40] *See* "FINRA's 2011 Activities Highlight Commitment to Investor Protection," Dec. 16, 2011 press release; 2010 Year in Review and Annual Financial Report, available at: http://www.finra.org/.

[41] The information in this table was collected based upon our review of FINRA's monthly "Disciplinary and Other FINRA Actions" publications and FINRA news releases issued between January 2008 and December 2011.

Fine Range	2008	2009	2010	2011
$100,001 to $250,000	45	34	27	24
$250,001 to $500,000	10	20	13	23
$500,001 to $750,000	4	6	7	7
$750,001 to $1,000,000	2	3	3	5
$1,000,001 to $1,500,000	2	4	1	1
$1,500,001 or more	0	6	2	10
Total	63	73	53	70

As can be seen, last year FINRA increased the number of cases in which it imposed fines of greater than $100,000 to 70 from 53 in the prior year. That represents a 32% increase. This increase is even more pronounced at the higher levels. For example, last year FINRA imposed fines of more than $1.5 million in five times as many cases as it did in 2010 (10 such cases in 2011 compared to only 2 in 2010).

Enforcement Policy Developments

There have been several interesting policy developments during Mr. Bennett's first year at the helm of the Department of Enforcement.

Sanctions

At a spring ABA SRO Sub-Committee of the Securities Litigation Committee panel session, Mr. Bennett described his views regarding sanctions. He emphasized that fines should be proportional to the case under review and the violations being alleged. Mr. Bennett further indicated that fines will have a logic and framework that should provide guidance to firms reviewing such actions. This approach is intended to provide clarity and guidance to the industry.[42] Again, as noted above, in 2011 FINRA imposed substantially far higher fines in a number of cases than it had in the prior year.

Enforcement Process

In further comments at the ABA SRO Sub-Committee meeting, Mr. Bennett offered some thoughts concerning the enforcement process. He noted that although he would be generally accessible to defense counsel, he cautioned firms about requesting meetings to discuss "administrative" issues like document production. Rather, Mr. Bennett suggested saving such requests for meetings to

[42] *See* "ABA SRO Sub-Committee of Securities Litigation Committee Sponsors Presentation Featuring New FINRA Enforcement Management," Memorandum prepared by Mark Knoll and Cristina R. Ryfa of Bressler, Amery & Ross, P. C. ("Knoll and Ryfa Memorandum").

discuss important policy and legal issues, after the record in the investigation has been sufficiently developed.[43]

Collaboration Within FINRA

Like the SEC, FINRA's Department of Enforcement is working more closely with other groups within the organization. In particular, at a fall 2011 SIFMA panel, Mr. Bennett noted that his group is in frequent contact with other areas of FINRA, including Member Regulation, Market Regulation and the Office of Fraud Detection and Market Intelligence.[44] In addition, Mr. Bennett pointed out that the Examination Staff are making referrals to Enforcement much earlier in the process and that referrals from that group were up 300% year-to-date.

On-Site Investigations

Mr. Bennett and other senior Enforcement officials have also indicated that the Staff continues to conduct "on site" investigations in appropriate situations. This technique was originally used by FINRA in connection with the 2008 auction rate securities investigations. Senior Staff have indicated that in situations where a member firm is refusing to make data available to FINRA, Enforcement will immediately visit the firm and, using the skills of its technology team, copy all of the necessary data. It appears that some of these visits are being done without notice to the firm in situations where there is a concern that documents could be destroyed prior to retrieval by FINRA. FINRA has indicated that, where appropriate, it is willing to bring summary proceedings to shut down a firm for failing to cooperate with its investigations.[45]

New Self-Reporting Requirements and Cooperation

After several years of operating under two regimes (i.e., NYSE Rule 351 and NASD Rule 3070), effective July 1, 2011, FINRA significantly changed its reporting requirements with the implementation of new Rule 4530.

Perhaps the most important modification concerns firms' requirement to report certain internal conclusions of rule violations. New Rule 4530(b) obligates a firm to promptly report to FINRA (but in no event later than 30 calendar days) after it has concluded or reasonably should have concluded that the firm or an associated person has violated certain laws, rules, regulations or standards of conduct.

In a major change for both legacy NYSE and NASD firms, with respect to violations by a member firm, broker-dealers are expected to report "only conduct

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43 *Id*.

44 Notes of the October 2011 SIFMA Compliance & Legal Society Fall Compliance program.

45 Notes of the October 2011 FINRA Enforcement Case Trends webinar and October 2011 SIFMA Compliance & Legal Society Fall Compliance program.

that has widespread or potential widespread impact to the [firm], its customers or the markets, or conduct that arises from a material failure of the [firm's] systems, policies or practices involving numerous customers, multiple errors or significant dollar amounts."

The new Rule also provides for the reporting of violations by associated persons. Here, FINRA expects a firm to "report only conduct that has widespread or potential widespread impact to the member, its customers or the markets, conduct that has a significant monetary result with respect to a member(s), customer(s) or market(s), or multiple instances of any violative conduct."

Senior officials at FINRA have tried to allay industry concerns regarding the new provision by indicating that the Department of Enforcement will not be looking to initiate stand-alone cases under the new Rule and that, when such actions are brought, it will be clear that a pattern of serious misconduct had occurred but was not reported to FINRA.[46]

Commenting on the new Rule in the spring, Mr. Bennett indicated that credit for extraordinary cooperation will continue to be available to firms in instances where such efforts save FINRA significant time and effort and/or those where firms provide the Staff with information that it would otherwise not be able to obtain on its own.[47]

Later in the year, Mr. Bennett confirmed that, despite the mandatory self reporting required under the new rule, FINRA remained prepared to reward extraordinary cooperation provided during an investigation. Among examples provided by Mr. Bennett include those where FINRA's resources had been conserved due to a firm's analyzing data for the Staff, conducting an internal review and providing the results to FINRA and assessing and remedying customer harm without action by FINRA.[48] Several cases summarized below reflect credit provided by FINRA for a firm's cooperation.

Guidance concerning these new reporting requirements is set forth in FINRA's Regulatory Notices 11-06 and 11-32.

Revisions to FINRA's Sanction Guidelines

In March 2011, FINRA announced four revisions to its Sanction Guidelines. First, the Sanction Guidelines now make clear that "proximate causation" is the required standard for restitution orders in FINRA disciplinary actions. Second, the Sanction Guidelines have been revised to recognize that, where appropriate, adjudicators may order the use of disgorged funds to remedy customer harms,

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46 Knoll and Ryfa Memorandum and "Prospect Unclear This Year Of Congress Moving on Adviser Oversight, Ketchum Says," Broker-Dealer Compliance Report (May 25, 2011).

47 Knoll and Ryfa Memorandum.

48 Notes of October 2011 SIFMA Compliance & Legal Society Fall Compliance program.

rather than adding those moneys as a fine payable to FINRA. Third, the Sanction Guidelines now reflect that not every factor in the Principal Considerations in Determining Sanctions section have the potential to be aggravating and mitigating considerations. Rather, the use of a factor is dependent upon the facts and circumstances of the particular case and the type of violation under consideration. Finally, the Sanction Guidelines have been amended to instruct adjudicators to also consider sanctions imposed by other regulators for the same misconduct and to determine whether that sanction was sufficiently remedial in nature.[49]

Revolving Door Restrictions Proposal

In July 2011, FINRA submitted a proposed rule change to the SEC that would impose certain restrictions on former officers. The proposed rule change would amend Rule 9141 to prohibit a former senior FINRA officer from appearing on behalf of clients before certain adjudicators (i.e., Hearing Officers, Hearing Panels, the National Adjudicatory Council, and the Board of Governors) for a period of one year after leaving the organization. The proposal would also modify Rule 9242 to bar a former officer, for a period of one year after termination, from providing expert testimony for a respondent in a litigated matter. For purposes of both amendments, FINRA officers include Vice Presidents, Senior Vice Presidents, and higher ranking executives.[50]

Targeted Examination Letters and Sweeps

In 2010, FINRA only posted four Targeted Examination Letters on its website versus eight in the prior year.

Continuing this trend, in 2011, only two such letters were published by FINRA. In March 2011, FINRA posted a letter indicating that it was engaging in a review of reverse convertible advertising and sales literature. This is not surprising in light of the enforcement activity surrounding this product. In November 2011, FINRA's Advertising Regulation Department and the Department of Enforcement Case Development Team announced that they were conducting an inquiry regarding spread-based structured products. The Staff requested extensive documents and information from firms including materials relating to advertisements, suitability procedures, written supervisory protocols, risk disclosure documents and customer complaints.

In a panel discussion in early 2011, Mr. Bennett commented that FINRA would consider increasing the number of Targeted Examination Letters to provide firms with more information about such reviews, which in turn could help firms in

49 Sanction Guidelines – FINRA Revises Sanction Guidelines, Regulatory Notice 11-13 (Mar. 2011).

50 Proposed Rule Change to Implement Revolving Door Restrictions on Former Officers of FINRA (July 1, 2011).

examining their own protocols relating to the product or issue that is the subject of the sweep letter.[51]

During an October 2011 FINRA-sponsored webinar on Enforcement Case Trends, senior FINRA staff commented that, in fact, the Department of Enforcement is carrying out various sweep investigations.[52]

Cooperation with Foreign Regulators

Like the SEC, over the last several years FINRA has signed agreements with various foreign regulators to enhance its cooperation with such authorities. In November 2011, FINRA and the Ontario Securities Commission announced that they had executed a Memorandum of Understanding ("MOU") to facilitate the exchange of information regarding entities that operate across the United States and Canadian border. According to FINRA, the MOU will allow the regulators to more easily exchange information on firms and individuals under common supervision, allow collaboration on investigations and cases and provide a more complete review of activities in the markets.[53]

Disciplinary Actions Database

Prior to April 2010, persons interested in obtaining copies of Letters of Acceptance, Waiver and Consent ("AWCs") and complaints described in press releases were obligated to request those documents from FINRA. Beginning April 7, 2010, FINRA routinely started to attach copies of AWCs and complaints to its press releases. For all other disciplinary actions, individuals had to contact FINRA to obtain copies of such cases.

In May 2011, FINRA announced the launch of the Disciplinary Actions on-line database, which makes disciplinary actions available through a web-based searchable system. The new database provides access to AWCs, settlements, National Adjudicatory Council decisions, Office of Hearing Officer decisions and complaints. FINRA has also linked its Monthly Disciplinary Actions case description summary to the corresponding action in its database.

Taken together, these steps significantly promote transparency and make it easier for firms and counsel to both search for and obtain copies of relevant precedent when engaged in discussions with the staff about the potential sanctions to be imposed in a matter under investigation.

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[51] Knoll and Ryfa Memorandum.

[52] Notes from October 2011 Enforcement Case Trends webinar.

[53] FINRA and Ontario Securities Commission Sign Regulatory Cooperation Arrangement, (Nov. 18, 2011), available at: http://www.finra.org/newsroom/newsreleases/2011/p125146.

Additional 2011 FINRA Efforts Complementing Its Enforcement Program

In its 2011 year-end press release, FINRA also highlighted the strides that it had made in several programs complementary to its direct enforcement efforts resulting overall in greater protection of investors from fraudulent schemes, products and practices, as well as a greater level of transparency to financial markets. Among other items, FINRA noted:

- The Office of Fraud Detection and Market Intelligence ("OFDMI") referred more than 600 cases concerning potential fraudulent misconduct to various other regulators and law enforcement agencies.

- FINRA significantly modified its examination program to be more risk-based and to focus examiners on those areas critical to investor safety. FINRA also provided additional resources to its exam program, hired new staff with more expertise, and strengthened its ability to identify those firms, branch offices, registered representatives and products and activities posing the highest risks to investors.

- The Market Regulation Department made significant progress in developing cross-market surveillance patterns to cover all of the markets that FINRA oversees; it plans to launch these protocols this year. FINRA also increased the scope of securities covered by the Order Audit Trail System to include all NMS securities. This will assist FINRA in its cross-market surveillance program.

- FINRA further increased market transparency by expanding the Trade Reporting and Compliance Engine ("TRACE") to include various securitized products and introduced various new reports available to investors.

- Finally, FINRA continued to revise its rules, particularly with respect to its proposals regarding registration of back office personnel, suitability and debt research conflicts of interest.[54]

Risk Alert on Broker-Dealer Branch Inspections

In November 2011, the SEC's OCIE and FINRA jointly issued a Risk Alert and a Regulatory Notice providing guidance on broker-dealer branch inspections. In these notices the regulators highlighted effective practices observed by examiners and typical deficiencies noticed by the SEC and FINRA. Of particular note, the regulators indicated that effective branch exam programs include "a significant percentage of unannounced exams [that are] selected through a combination of risk based analysis and random selection." The notices also set

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54 *See* "FINRA's 2011 Activities Highlight Commitment to Investor Protection," Dec. 16, 2011 press release.

forth a list of documents and information that SEC and FINRA examiners may request when conducting a review of a firm's branch examination program.[55]

Current FINRA Enforcement Priorities

Based upon our review of currently available public information, we believe that the following list reflects some of FINRA's top enforcement priorities.

- **Anti-Money Laundering**: FINRA continues to review anti-money laundering issues, including examining master/sub accounts.

- **Regulation D offerings**: FINRA is concerned about suitability, supervision, advertising and potential fraud in these kinds of offerings. FINRA is also looking closely at the potential liability of individual principals and registered representatives who may have engaged in inadequate due diligence and the suitability of recommendations made by brokers.

- **Structured products**: Continuing its emphasis on the sales practices and supervision regarding structured product offerings to retail investors, FINRA remains focused on reverse convertibles, principal protected notes and other structured products.

- **Regulation S-P**: These matters involve protecting the confidentiality of customer information.

- **Non-traditional ETFs**: FINRA is reportedly probing advertisements relating to these products and sales practices regarding leveraged, inverse or leveraged inverse ETFs.

- **Routine fees**: In 2011, FINRA brought a group of cases relating to alleged excessive charges for routine fees (e.g., postage and handling fees in connection with transactions).

- **Municipal securities**: FINRA's activities appear to be focusing on sales practices, disclosures, suitability and pricing. Moreover, FINRA has indicated interest in the delivery of official statements and firms' procedures for disclosing material information to investors.

- **Municipal securities underwriting**: FINRA has publicly commented that it is reviewing the pricing and fees connected with municipal bond underwritings. Enforcement is also reportedly investigating member expenses related to the entertainment of issuers and rating agency officials.

[55] *See* "SEC Staff and FINRA Issue Risk Alert on Broker-Dealer Branch Office Inspections," (Nov. 30, 2011) available at: www.sec.gov. *See also* FINRA Regulatory Notice 11-54, available at: www.finra.org.

- **Credit crisis**: FINRA officials have remarked that its credit crisis investigations should be wrapped up this year.

- **Prospectus delivery**: This issue has been raised in a 2011 case.

- **Non-Traded REITs**: FINRA is currently litigating a case with one firm in this area and settled a second case involving a type of REIT in late 2011.

- **Insider Trading**: Consistent with its surveillance efforts in OFDMI, FINRA appears to be aggressively pursuing insider trading activities within the securities industry when its jurisdiction permits it to do so. A case barring a former broker for insider trading and failing to provide accurate information in an investigation demonstrates FINRA's approach in this area.

- **Yield Chasing**: In this low interest rate environment, FINRA seems to continue to be concerned about brokers "chasing yield" for investors with unsuitable products.

Key topics for FINRA's Enforcement, Member Regulation and Market Regulation Departments are also set forth in detail in the lengthy 2011 Annual Regulatory and Examination Priorities Letter.[56]

Enforcement Actions[57]

529 Plans

In 2006, the NASD brought two cases involving 529 plans. In early 2011, FINRA brought another case in this area.

A. *Merrill Lynch, Pierce, Fenner & Smith Incorporated* ("Merrill Lynch") (Mar. 2011)[58]

1. FINRA settled a matter with Merrill Lynch in which it alleged that the firm failed to establish and maintain procedures that were reasonably designed to achieve compliance with its suitability obligations for over $3 billion in sales of Section 529 college savings plans ("529 plans") from June 2002 through February 2007.

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56 *See* 2011 Annual Regulatory and Examination Priorities Letter (Feb. 8, 2011).

57 Unless otherwise apparent from the context of the descriptions of the actions, the cases described herein are settlements in which respondents neither admitted nor denied the allegations against them.

58 Where the date is cited as a month only (e.g., "Mar. 2011"), the date reflects the month that the case was included in FINRA's Monthly Disciplinary Actions publication. Exact dates indicate the day on which FINRA issued a press release about the action.

2. FINRA alleged that Merrill Lynch's written supervisory procedures did not adequately ensure that the firm's registered representatives were considering customer state income tax benefits during their 529 plan suitability analyses.

3. FINRA also alleged that Merrill Lynch failed to establish and maintain written supervisory procedures requiring supervisors to perform and document reviews to determine if registered representatives were complying with the suitability requirements before recommending a 529 plan purchase, and did not have effective procedures for documenting suitability determinations.

4. Merrill Lynch consented to a censure and a fine of $500,000.

5. Merrill Lynch also consented to an undertaking that required it to distribute a stand-alone letter to each current customer who resided in a state that offered 529-related state tax benefits when the customer opened an affected account at Merrill Lynch at any time during the period from June 2002 through February 2007. If requested by the customer within 180 days of mailing the letter, Merrill Lynch must assist in transferring or rolling over the customer's account into a 529 plan of the customer's choice within the customer's home state, waiving any fees in connection with the sale, transfer, rollover, and initial purchase. Merrill Lynch must also provide semi-annual reports to the Enforcement staff describing customer inquiries, concerns or complaints relating to the letter.

Anti-Money Laundering

Anti-money laundering cases continue to be fertile ground for FINRA. In addition to mentioning this repeatedly as an enforcement priority, FINRA regularly brings cases in this area. Below are two examples of this trend.

A. *In the Matter of First Clearing, LLC* ("First Clearing") (Mar. 2011)

1. FINRA settled a matter with First Clearing in which it alleged that between January 2007 and September 2008, First Clearing failed to establish and implement an adequate Anti-Money Laundering ("AML") compliance program for detecting, reviewing and reporting suspicious activity as required by Department of the Treasury, FINRA, and Municipal Securities Rulemaking Board ("MSRB") rules.

2. According to FINRA, First Clearing's compliance program was inadequate because the firm reviewed only a limited

number of transactions covering potentially suspicious activity.

3. FINRA alleged that while First Clearing did generate many exception reports and alerts concerning potentially suspicious securities transactions and money movements in customer accounts that were introduced by unaffiliated third-party broker-dealers and provided such reports to the introducing firms, First Clearing itself did not consistently review such reports for suspicious activity reporting.

4. FINRA further alleged that First Clearing reviewed only a limited number and types of transactions for its own suspicious activity reporting obligation, in particular noting that First Clearing did not review patterns of wire activity or create a systemic method to review potentially suspicious penny stock activity.

5. First Clearing consented to a censure and fine in the amount of $400,000, of which $200,000 pertained to the MSRB violation.

B. *Merrill Lynch, Pierce, Fenner & Smith, Inc.* (“Merrill Lynch”) (July 26, 2011)

1. FINRA settled a case with Merrill Lynch in which it alleged that the firm failed to enforce its anti-money laundering compliance program and written procedures when it accepted and deposited into a customer’s account checks that did not identify the customer’s name. As a result, a Merrill Lynch customer, Maxwell Baldwin Smith, was able to move over $9 million of misappropriated funds through his Merrill Lynch account.

2. According to FINRA, from 1992 through at least June 2008, Smith, who was a registered representative at several other FINRA member firms, persuaded seven of his customers to invest over $9 million in a private placement investment called a Health Care Financial Partnership (“HCF”). Four of those customers were elderly. Smith told the investors that Merrill Lynch was an underwriter of the HCF and instructed them to write checks payable to Merrill Lynch and to note a Merrill Lynch account number on the checks. He did not tell investors that the account number was his personal account at Merrill Lynch and, FINRA alleged, that the customers therefore had no indication that the money was going to Smith’s personal account.

3. Smith deposited the checks into his Merrill Lynch account. He never invested the funds, but instead transferred the funds to another personal account and withdrew the funds payable to himself and to cash.

4. From at least April 2002 to June 2008, Merrill Lynch had anti-money laundering procedures in place which stated that non-personal checks, such as the ones Smith deposited, were only acceptable if the payee line read "Pay to the order of Merrill Lynch, Pierce, Fenner & Smith, Inc., for the account of (client's name and account number)."

5. The procedures also noted that certain behavior was potential evidence of money laundering, such as (1) a pattern of depositing checks and later requesting withdrawals without market investment, (2) depositing funds from third parties with whom there is no family or fiduciary relationship, and (3) receiving or disbursing funds not corresponding to the client's known business activities.

6. FINRA alleged that Merrill Lynch failed to follow its written procedures by accepting the checks, as written, for deposit into Smith's account. Merrill Lynch also disregarded the indications of Smith's misconduct. Had Merrill Lynch enforced its procedures, Smith would not have been able to use his Merrill Lynch account to misappropriate the funds. FINRA also alleged that the firm did not have internal controls to monitor compliance with its procedures regarding non-personal checks.

7. Merrill Lynch consented to a censure and a fine of $400,000.

Auction Rate Securities

Since the summer of 2008, regulators have brought numerous cases against broker-dealers arising out of the auction rate securities freeze that occurred earlier that year. FINRA has initiated more than a dozen such actions. Below are descriptions of five settlements and one litigated case. The last is a rare example of a broker-dealer fighting charges laid against it by FINRA.

A. *Jefferies & Company, Inc.* ("Jefferies") (Apr. 14, 2011)

1. FINRA settled a matter with Jefferies in which it alleged that the firm failed to disclose additional compensation it received and conflicts in connection with the sale of ARS and committed certain other violations.

2. Jefferies provided investment advice and services, including purchasing and selling ARS, to 40 institutional clients. According to FINRA, from August 1, 2007 to March 31, 2008, the firm negligently failed to disclose material facts to eight corporate clients for which it exercised discretion to purchase and sell ARS. Specifically, FINRA alleged that the firm:

   (a) failed to disclose that it received additional compensation in 32 transactions by purchasing new-issue ARS for clients when the firm could have purchased other or similar ARS with higher yields at the same time that did not pay such compensation; and

   (b) failed to disclose conflicts when it acted as agent in 32 transactions in which the firm bought ARS from one firm client and sold it to another when Jefferies could have purchased other or similar ARS with higher yields at the same time that the firm effected the trades.

3. FINRA also alleged that Jefferies committed certain other violations, including: exercising discretion for eight clients by relying on oral rather than written authority; failing to deliver 20 official statements in connection with municipal new issue ARS; using misleading marketing materials that represented ARS as cash equivalents or making incomplete comparisons to money-market instruments; selling restricted ARS to one customer no longer qualified to buy them; failing to implement a contractually agreed-upon information barrier with one customer; having deficient or missing order tickets for approximately 400 ARS trades; and failing to establish and maintain an adequate supervisory system, including written supervisory materials, for its ARS activities.

4. Jefferies consented to a censure, a fine of $1.5 million, payment of approximately $425,000 in remediation to certain customers, and an undertaking to repurchase ARS from certain retail accounts.

5. In setting the sanction, FINRA took into account that in July 2008, Jefferies began remitting all trailing commissions it received for frozen ARS held in customer accounts directly to its customers on a going-forward basis (as of October 2010, it had remitted $868,000), and in December 2008, Jefferies bought back approximately $68 million of ARS from retail customers in a partial voluntary buyback.

6. FINRA also took action against three individuals involved in Jefferies' ARS sales and trading, fining one individual $20,000 and suspending him in all capacities for five days, fining a second individual $25,000 and suspending him in all capacities for 10 days, and filing a complaint against a third individual who was not a party to the settlement.

B. *Nuveen Investments, LLC* ("Nuveen") (May 23, 2011)

1. FINRA settled a matter with Nuveen in which it alleged that, from 2006 to March 4, 2008, the firm created misleading brochures that were used for marketing auction rate preferred shares ("ARPS") and failed to have an adequate supervisory system with respect to such materials.

2. Nuveen is a distributor of ARPS issued by certain closed-end mutual funds sold by an affiliate, Nuveen Investments, Inc. (collectively, the "Nuveen Funds"). According to FINRA, by early 2008, over $15 billion of Nuveen Funds' ARPS had been sold to customers by third-party broker-dealers.

3. As distributor, Nuveen created brochures for the ARPS and provided them to broker-dealers and investors. FINRA found that the brochures served as the primary sales material for Nuveen ARPS and described the ARPS as cash alternatives with weekly liquidity, but failed to adequately disclose liquidity risks for the ARPS.

4. FINRA also found that Nuveen failed to revise the disclosures in its brochures after a lead auction manager responsible for approximately $2.5 billion of ARPS notified the firm in early January 2008 that it intended to stop managing Nuveen auctions and thereafter did not submit supporting bids in a January 22, 2008 auction that failed. According to FINRA, the auction failure and the firm's inability to find a replacement manager raised serious questions about whether investors could obtain liquidity in future auctions, and the firm's negligence in failing to revise the marketing brochures to reflect this risk made the brochures materially misleading.

5. FINRA also alleged that Nuveen failed to establish and maintain a supervisory system reasonably designed to achieve compliance with applicable requirements for marketing materials.

6. Nuveen consented to a censure, a fine of $3 million, and an undertaking to continue to use its best efforts to refinance approximately $1.2 billion of Nuveen Funds' ARPS.

7. In setting the sanction, FINRA took into account that the Nuveen Funds have redeemed approximately $14.2 billion of the $15.4 billion of ARPS that were outstanding as of February 12, 2008, when the ARS markets experienced widespread failures, and took steps to provide information to address investor concerns about illiquidity.

C. *Fidelity Brokerage Services LLC* ("Fidelity") (July 8, 2011)

1. FINRA settled a matter with Fidelity in which it alleged that, from May 31, 2006 through March 4, 2008, Fidelity's advertising and marketing materials related to ARS, including content posted on the firm's website, were not fair and balanced and did not provide a sound basis for evaluating the facts regarding purchases of ARS.

2. Fidelity was not an issuer, distributor or sponsor of the ARS. Instead, Fidelity was a "downstream" firm that sold ARS to its customers through its registered representatives and through its website. Approximately $1.4 billion of ARS were held in retail accounts at Fidelity as of February 29, 2008. Fidelity's customers who had purchased ARS through Fidelity on or before February 28, 2008 still owned approximately $358 million in ARS as of August 15, 2008.

3. According to FINRA, the materials did not contain adequate disclosure of the risks of ARS, including that ARS could fail, the consequences of a failed auction, that investments in ARS could become illiquid, and that customers might not be able to obtain funds invested in ARS for substantial periods of time. The materials also failed to disclose that, while broker-dealers placed supporting bids to prevent ARS auctions from failing, they were under no obligation to do so. Fidelity did not revise its website disclosure to reflect the risk of ARS auctions failing until February 27, 2008, which was two weeks after numerous ARS auctions had already failed, and did not add language to the website disclosure related to the risk of illiquidity until March 4, 2008.

4. FINRA also alleged that Fidelity inadequately reviewed and supervised the drafting of materials discussing ARS that were posted to its website, which was a failure to establish and maintain a supervisory system that was reasonably

designed to achieve compliance with applicable rules related to the marketing and sale of ARS.

5. Additionally, FINRA alleged that Fidelity failed to establish and maintain procedures that were reasonably designed to ensure that the written ARS educational materials that Fidelity distributed to its registered representatives were not misleading and did not omit material information. This included incorrectly describing ARS as putable and callable on schedule reset dates.

6. Fidelity consented to a censure, a fine of $375,000, and agreed to buyback illiquid ARS from certain of the firm's customers who purchased ARS through its website.

7. In setting the sanction, FINRA took into account that Fidelity took significant steps to minimize the impact that illiquidity in the ARS market had on its customers; that Fidelity did not act as an issuer, underwriter or sponsor of ARS; and that, between September 2008 and January 21, 2009, Fidelity bought back approximately $280 million in still-illiquid ARS from 885 of its customers.

D. *SunTrust Robinson Humphrey, Inc.* ("SunTrust RH") (July 26, 2011)

1. FINRA settled a matter with SunTrust RH in which it alleged that the firm made misrepresentations and omissions of material facts by inadequately disclosing to the firm's sales representatives its increasing concern regarding the safety and liquidity of ARS and of ARS auctions failing.

2. SunTrust RH was the lead manager on 36 ARS issues, which accounted for approximately $1.3 billion in par value, was the co-manager on 74 ARS issues, accounting for approximately $4.5 billion in par value, and also served as agent for its customers by placing bids to purchase and sell ARS on their behalf, approximately $1.6 billion of which were held in customer accounts at SunTrust RH as of February 28, 2008.

3. According to FINRA, from late summer 2007 through early 2008, SunTrust RH became aware of increased stresses in the ARS market and the increased risk of ARS auctions failing, which would cause investments in ARS to become illiquid. This concern led the firm to hold four calls with its sales representatives to discuss the conditions in the ARS market. However, the firm did not adequately disclose to the representatives that the firm was increasingly concerned

about its ability to support the SunTrust RH-led ARS issues as it had in the past. Additionally, and despite these concerns, the firm encouraged its sales representatives to continue to sell SunTrust RH-led ARS. The representatives marketed the ARS as safe and liquid investments and represented that SunTrust RH would support the auctions to prevent failure or provide liquidity between auctions.

4. FINRA further alleged that SunTrust RH shared material nonpublic information regarding ARS with its affiliated bank (the "Bank").

5. According to FINRA, on February 13, 2008 the firm provided the Bank, which was exploring investing in ARS for its investment portfolio, with certain information that it typically provided to other potential ARS investors, including available ARS issues, dates of auctions, and par amounts. However, the firm negligently included material information related to possible refinancing or restructuring of SunTrust RH-led ARS issues, which was a breach of the firm's established policies and procedures to prevent material nonpublic information from being shared with the Bank.

6. FINRA also alleged that, from May 31, 2006 through February 2008, SunTrust RH's advertising and marketing materials were not fair and balanced and failed to provide a sound basis for evaluating all of the facts regarding purchasing ARS.

7. According to FINRA, some of the firm's marketing materials disclosed that auctions could fail, but did not adequately disclose all of the risks associated with ARS, including that ARS investments could become illiquid for substantial periods of time. The ARS marketing materials also made misleading comparisons between ARS and other materially different investments, such as money-market instruments. Additionally, language used in certain ARS marketing pieces mistakenly stated that the firm was "under an obligation to make an orderly market," in ARS while other materials accurately stated that the firm was not obligated to do so.

8. FINRA also alleged that SunTrust RH had inadequate supervisory procedures and failed to train its sales representatives.

9. SunTrust RH consented to a censure, a fine of $4.6 million, and to provide remediation to certain customers within six months of the settlement with FINRA.

10. In setting the sanction, FINRA took into account that, as of the date of the settlement with FINRA, the firm had repurchased approximately $381 million in ARS from its customers.

E. *SunTrust Investment Services, Inc.* ("SunTrust") (July 26, 2011)

1. On the same day that FINRA settled its action against SunTrust RH, it also settled a matter with another SunTrust entity. Here, FINRA alleged that, between May 31, 2006 and February 28, 2008, SunTrust used materials related to ARS that were not fair and balanced and did not provide a sound basis for evaluating the facts related to ARS.

2. SunTrust acted as agent for its customers, placing bids to buy and sell ARS on their behalf. As of February 28, 2008, approximately $616 million of ARS and ARPS were held in primarily retail accounts at SunTrust

3. According to FINRA, SunTrust's ARS materials did not contain adequate disclosure of the risks of ARS, including the risks that ARS auctions could fail, that investments in ARS could become illiquid, and that customers might be unable to obtain access to funds invested in ARS for substantial periods of time. The materials also made inappropriate comparisons between ARS and other investments that were materially different, such as money-market funds, and failed to disclose the differences between ARS and these other investments.

4. FINRA also alleged that SunTrust had inadequate supervisory procedures and failed to provide adequate training to its registered representatives regarding the characteristics of ARS and the differences between ARS and other investments.

5. According to FINRA, the firm failed to establish and maintain adequate procedures that were reasonably designed to ensure that it properly marketed and sold ARS, to ensure that its registered representatives were adequately trained and accurately described ARS to customers and to ensure that the firm's ARS marketing and sales materials complied with the appropriate disclosure standards.

6. SunTrust consented to a censure, a fine of $400,000, and to provide remediation to certain customers within six months of the settlement with FINRA.

7. In setting the sanction, FINRA took into account that, as of the date of the settlement with FINRA, the firm had repurchased approximately $262.2 million in ARS and ARPS from its customers.

F. *Thomas Weisel Partners* ("Weisel") and Stephen Brinck, Jr. (Nov. 8, 2011)

1. FINRA filed a contested action against Weisel and Stephen Brinck, Jr., the firm's former head of fixed income and corporate cash management, on May 18, 2010 in connection with the firm's sales of ARS.

2. FINRA alleged that: (1) Brinck, facing pressure from senior Weisel managers to raise $25 million that would be used to pay employee bonuses, fraudulently sold $15.7 million of ARS from a firm proprietary account into three customer accounts the firm managed without the customers' approval, even though, at the time of the sales, the firm was concerned about the ARS market, which crashed weeks later, and Brinck had recommended that all corporate cash clients sell their ARS; (2) the firm made false and misleading statements to two of the customers to induce them to provide retroactive consent; (3) the firm made false statements in a letter to FINRA concerning the transactions; and (4) the firm failed to maintain and implement adequate supervisory procedures and an adequate supervisory system.

3. The Hearing Panel dismissed the first three charges after determining that FINRA failed to prove that Brinck's decision to sell the ARS was inconsistent with his earlier decision to gradually divest from ARS or motivated by concerns about the safety or liquidity of the ARS or the firm's intention to use the cash proceeds to pay bonuses. Instead, the Hearing Panel found that the firm and Brinck were not worried about the safety or liquidity of the ARS when they sold them from the firm proprietary account into the customers' accounts. Specifically, the firm's and Brinck's confidence in the soundness of the ARS was bolstered by ongoing communications between Brinck and the broker-dealers that underwrote the ARS. The firm also continued to purchase over $5 million in ARS for accounts of firm employees and their family members, including Thomas Weisel's personal investment account. Additionally, Brinck was never informed that the proceeds from the ARS sales would be used to pay bonuses and Brinck himself was not eligible to receive a bonus.

4. However, the Hearing Panel determined that Weisel failed to have adequate supervisory systems and procedures surrounding principal transactions it effected, including transactions between proprietary accounts and customer accounts over which the firm exercised discretion. The proprietary account involved in the ARS transactions was an account of Weisel's parent company, but the desk handling the ARS transactions did not recognize it as a proprietary account; rather, it was mistakenly treated as a regular customer account. Moreover, Brinck performed the supervisory review of his own trades.

5. Nonetheless, the firm acknowledged that the transactions were principal transactions and, in accordance with the Investment Advisers Act, that the firm should have obtained customer consent before making the trades. The firm voluntarily repurchased the ARS from the affected customers in July 2009.

6. Weisel was fined $200,000 for failing to have adequate supervisory systems and procedures and was ordered to pay $11,030 for the costs of the hearing.

7. The decision noted that the fine was set at a level above FINRA's Sanction Guidelines because the supervisory failure was ongoing for several years and because the procedures at issue related to a specific statutory requirement designed to avoid the apparent conflict that occurred at the firm.

Collection of Fines

A. *Fiero et. al. v. FINRA*, Case No. 09-1556-cv (2nd Cir. Oct. 5, 2011)

1. As we previously reported in our 2008 Outline, in 2000, an NASD hearing panel expelled and fined John Fiero ("Fiero"), and his firm, Fiero Brothers, Inc., $1 million, after finding that they violated NASD rules by carrying out "a bear raid" to drive down prices of securities underwritten by another firm. Subsequently, the NASD commenced an action in New York Supreme Court to enforce the fines imposed. After the Supreme Court entered a judgment in NASD's favor, the case was eventually appealed to the New York Court of Appeals, where the court held that New York state courts have no subject-matter jurisdiction to enforce NASD Regulation penalties.

2. Immediately after the New York Court of Appeals' ruling in 2008, Fiero and the firm filed suit in federal district court, seeking declaratory judgment that, *inter alia*, FINRA has no authority to collect fines through judicial proceedings. In its counterclaim, FINRA sought to enforce fines imposed by the NASD panel under a breach of contract theory. The district court ruled in FINRA's favor.

3. On October 5, 2011, the Court of Appeals for the Second Circuit reversed the district court decision. The court based its holding on its review of Congressional intent, the language of the Exchange Act, NASD's 1990 Notice of Filing and Immediate Effectiveness of Proposed Rule Change Relating to the Collection of Fines and Costs in Disciplinary Proceedings (the "1990 Rule Change"), and the NASD's long-standing practice of exclusively relying on its power to revoke registration or deny reentry as sanctions in its cases. Specifically, the court found that Congress did not intend to empower FINRA to judicially enforce the collection of its disciplinary fines.

4. Notably, the Second Circuit also pointed out that FINRA's reliance on the 1990 Rule Change for authority to judicially enforce collection of fines was misplaced, as the rule was not properly promulgated as required under procedures enumerated in the Exchange Act. According to the Second Circuit, NASD improperly designated the 1990 Rule Change as a "House-Keeping" rule, as it effectively created "a new substantive rule that affected the rights of barred and suspended member to stay out of the industry and not pay the fines imposed on them in prior disciplinary proceedings." Proper reliance on the "House-Keeping" exception would require existence of an SEC or other statute that authorized the NASD to initiate judicial proceedings to collect fines; no such rule existed prior to the 1990 Rule Change.

Commissions, Fees and MarkUps/Downs

Last year, FINRA brought several cases relating to the commissions, fees and markups/markdowns charged by member firms.

A. *Pointe Capital, Inc., John Thomas Financial, A&F Financial Securities, Inc., First Midwest Securities, Inc., and Salomon Whitney LLC* ("PCI," "JFA," "AFFS," "FMS," and "SW," collectively, the "firms") (Sept. 7, 2011)

1. FINRA alleged that the firms charged their customers a per trade "handling" fee ranging from $65 to $99 in addition to a

commission. The particular dollar amount charged was neither attributable to any specific cost or expense incurred by the firms in executing the trade nor determined by any formula applicable to all customers.

2. According to FINRA, although reflected on customer trade confirmations as a charge for handling, the fee actually served as a source of additional transaction-based remuneration or revenue to the firms, in the same manner as a commission. FINRA alleged that by designating the charge as a handling fee on customer trade confirmations, the firms understated the amount of the total commissions charged by the firms and misstated the purpose of the handling fee.

3. FINRA further alleged that:

   (a) PCI had inadequate supervisory procedures;

   (b) JTF had effected material changes in its business operations without prior approval from FINRA, and had deficiencies in complaint reporting, supervisory controls and certifications, branch office supervision and recordkeeping;

   (c) FMS had unfair and unreasonable markups/markdowns and inadequate written supervisory procedures; and

   (d) AFFS had an inadequate supervisory system and procedures and failed to comply with continuing education requirements.

4. FINRA fined PIC $300,000, JFA $275,000, FMS $150,000, AFFS $125,000 and SW $60,000. Each of the firms also consented to a censure and certain undertakings to implement corrective action to remedy the handling fee-related violations.

B. *Raymond James & Associates, Inc. and Raymond James Financial Services, Inc.* (“RJA” and “RJFS”) (Sept. 29, 2011)

1. FINRA alleged that RJA and RJFS failed to establish and maintain a supervisory system reasonably designed to achieve compliance with FINRA rules resulting in customers being charged unfair and unreasonable commissions on equity transactions.

2. According to FINRA, from January 1, 2006 through at least October 31, 2010, RJA and RJFS utilized an automated commission schedule pursuant to which the firm charged commissions on certain purchases and sales of primarily low-priced securities that were not fair and reasonable, and, as a result, RJA charged $893,888.69 in excessive commissions in a total of 13,663 transactions effected on behalf of approximately 7,424 customers and RJFS charged $795,568.02 in excessive commissions, in a total of 13,519 transactions effected on behalf of approximately 8,310 customers.

3. In addition, FINRA alleged that RJA and RJFS's supervisory system for commission setting was inadequate.

4. RJA consented to a censure, a fine of $225,000, and restitution of $893,888.69, and RJFS consented to a censure, a fine of $200,000, and restitution of $795,568.02.

C. *Morgan Stanley & Co. and Morgan Stanley Smith Barney LLC* (collectively, "Morgan Stanley") (Nov. 10, 2011)

1. In connection with 13 investigations conducted by FINRA during the period 2003 through approximately mid-2011, and in connection with activity that occurred during 2005 through December 2010, FINRA alleged that Morgan Stanley's markups and markdowns (ranging from below 5% up to 13.8 percent) on 384 pairs of corporate and municipal bond transactions were too high, considering such factors as market conditions, the best judgment of the broker as to the fair market value of the securities at the time of the transaction, the expense involved in effecting the transactions and the fact that the broker is entitled to a profit, the total dollar amount of the transaction, and the value of the services provided to the client.

2. FINRA further alleged that from 2003 through mid-2011, Morgan Stanley's supervisory system for corporate and municipal bond markups and markdowns was not adequate in that the firm's supervisory reports did not include markups and markdowns that may have been excessive even if they were under 5%. Additionally, prior to August 2009, Morgan Stanley's policies and procedures did not consider both the sales credit charged to the customer and the wholesale desk compensation when it determined whether a markup or markdown was reasonable.

3. Morgan Stanley consented to a censure and a fine of $1 million. The MSRB was allocated $500,000 of the $1 million fine.

4. Morgan Stanley consented to pay restitution to investors in the amount of $371,475 plus interest.

5. Morgan Stanley also consented to an undertaking to revise their written supervisory procedures to address certain deficiencies.

Customer Confidential Information

FINRA remains focused on firms' obligations to maintain the confidentiality of customer information. In addition to a significant action last year, FINRA brought the two cases below on the same date in early 2011. Of note, all three cases indicate that FINRA will take into account significant remedial actions undertaken by a firm to promptly address any customer information breaches.

A. *Lincoln Financial Securities Inc.* ("LFS") and *Lincoln Financial Advisors Corporation* ("LFA") (Feb. 16, 2011)

1. FINRA settled separate matters with LFS and its affiliate, LFA, in which FINRA alleged that they violated privacy rules requiring firms to protect customer information and also failed to adequately supervise their personnel.

2. According to FINRA, the firms failed adequately to protect customer records and information in their electronic portfolio management system, OmniSource, and specifically allowed certain employees to share computer sign-on credentials to access OmniSource files for the purpose of conducting business on behalf of the firms. OmniSource contained customer account records consisting of confidential information including names, addresses, Social Security numbers, account numbers, account registrations, transaction details, account balances, birth dates, and e-mail addresses. OmniSource contained approximately 513,559 LFS customer account records and 1,148,874 LFA customer account records as of August 20, 2009.

3. FINRA alleged that the firms did not place adequate controls and procedures on the use or dissemination of sign-on credentials, allowing access to customer information outside of the firms' control and management. According to FINRA, the firms also did not have procedures to disable or change the sign-on credentials after an employee was terminated.

4. During a portion of the period from 2002 to 2009, the common user names and passwords were used to access approximately 513,559 LFS customer account records. From 2007 to 2009, the common user names and passwords were used to access approximately 800,661 LFA customer account records.

5. FINRA also alleged that LFS failed to establish procedures mandating that its representatives in the field install antivirus software and other protection on representative-owned computers that were used to conduct LFS securities-related business away from the home office, and failed to audit the computers to confirm the installation of such security software. As a result, nonpublic personal information was not properly safeguarded and was at risk of hacking or intrusion schemes.

6. LFS consented to a censure and a fine of $450,000 and LFA consented to a censure and a fine of $150,000.

7. In setting the sanction, FINRA noted that once the firms became aware of the potential vulnerability of their sign-on credentials within the OmniSource system, they immediately disabled access to the system through the use of common sign-on credentials and transferred oversight to an information security team, established procedures, hired a technology consultant to investigate whether any security breaches had occurred, notified customers and offered credit monitoring and restoration services for one year, established antivirus and other protections, and implemented auditing and inspection plans.

Directed Brokerage

In 2005 and 2006, the NASD brought at least 30 disciplinary actions regarding directed brokerage commissions. As part of that sweep effort, the NASD commenced litigation against the American Fund Distributors. After decisions by an NASD Hearing Panel and the National Adjudicatory Council, a divided SEC struck down the NASD's claims on the case.

A. *In the Matter of Department of Enforcement v. American Fund Distributors, Inc.* ("AFD") (Jun. 24, 2011)

1. The SEC set aside a FINRA National Adjudicatory Council ("NAC") decision affirming that AFD violated FINRA's Anti-Reciprocal Rule intended to prevent "conflicts of interest that might cause retail firms to recommend investment company shares based upon the receipt of commissions

from that investment company." Commissioners Casey and Paredes issued the opinion, Commissioner Aguilar dissented, and Chairman Schapiro and Commissioner Walter (both of whom were senior executives at the NASD when the case was originally brought) did not participate.

(a) In the proceedings below, the NAC held that AFD violated the rule by arranging for its subsidiary to direct over $98 million brokerage in commissions to 46 retail securities firms between 2001 and 2003 based on those firms' sales of American Funds.

(b) Notably, the NAC disagreed with the Hearing Panel's conclusion that AFD's violations were negligent. Rather, the NAC found that AFD's violations were intentional. The NAC also found additional aggravating factors that the Hearing Panel did not find, including that AFD's reciprocal arrangements undermined fair competition in the industry and could have harmed the brokerage firm's clients.

(c) The NAC rejected certain mitigating factors that the Hearing Panel accepted, such as that directed brokerage was widespread in the industry. The NAC found no evidence in the record to support that conclusion and, in any event, found that it would not excuse the failure to follow FINRA's rules. The NAC also rejected the Hearing Panel's determination that FINRA's subsequent modification of its directed brokerage rules was a mitigating factor. The NAC determined that subsequent rule modifications did not affect AFD's obligations to follow rules that were in effect during the relevant period.

(d) Although FINRA Enforcement had sought a $98 million fine from the Hearing Panel, the Hearing Panel imposed only a $5 million fine and a censure, and the NAC upheld the sanctions.

2. In setting aside the decision and sanctions, the Commission focused on the text of the rule during the relevant period, which prohibited requesting or arranging for the direction of a specific amount or percentage of brokerage commissions **conditioned upon** that member's sales or promises of sales of investment company shares. The SEC agreed with AFD that the commissions were non-binding targets, not obligations, and it was ambiguous whether the rule

prohibited such arrangements until a subsequent rule amendment clearly prohibited such practices.

3. Commissioner Aguilar's dissent noted that while the rule may not have been a model of clarity, he found FINRA's interpretation that the "conditioned upon" phrase prohibited fund sales as a prerequisite to directing brokerage commissions more reasonable and that it was not necessary that there be a binding obligation. He further found that FINRA had provided sufficient guidance with respect to its interpretation in a Notice to Members.

Insider Trading

Like the SEC, FINRA is keenly focused on identifying insider trading. While most of FINRA's investigative work is referred to the SEC for enforcement, below is a rare example of a FINRA disciplinary action in this area.

A. *Michael Wade Hendry* (May 2, 2011)

1. FINRA alleged that Mr. Hendry engaged in insider trading and failed to respond truthfully while being interviewed by FINRA staff in connection with such trading.

2. Mr. Hendry was a Divisional Vice President at a FINRA member firm from January to September 2010. According to FINRA, Mr. Hendry was informed in early February 2010 that Boots and Coots, Inc. ("WEL") was going to be acquired by another company and he knew that the ultimate source of that information was a WEL insider. At the time, there had been no public disclosure of WEL's acquisition.

3. FINRA alleged that thereafter, between February 25 and March 17, 2010, Mr. Hendry purchased 73,000 shares of WEL, and thereafter sold those shares at a profit of approximately $69,955.

4. In addition, FINRA alleged that Mr. Hendry failed to respond truthfully during a September 23, 2010 interview with the staff of FINRA's Office of Fraud Detection and Market Intelligence.

5. Mr. Hendry consented to a bar from the securities industry in all capacities and a fine of $69,955, which includes the disgorgement of the unlawful profits.

Mortgage-Backed Securities

The credit crisis has led to several enforcement actions regarding mortgage-backed securities. The three cases below relate to alleged misrepresentation of data regarding subprime residential mortgaged-back securities.

A. *Credit Suisse Securities (USA) LLC* ("Credit Suisse") (May 26, 2011)

1. FINRA settled a matter with Credit Suisse in which it alleged that the firm misrepresented data regarding certain subprime RMBS for which the firm acted as underwriter and sold to institutional investors, failed to name or define its delinquency calculation method for certain RMBS, and failed to establish and maintain a reasonably designed supervisory system.

2. According to FINRA, on or about November 1, 2006, Credit Suisse was informed that one of its third-party vendors had provided erroneous information in connection with delinquency data for the period from January to September 2006 for certain subprime RMBS, which had been posted on the firm's Regulation AB ("Reg AB") website. Under Reg AB, issuers are required to disclose certain historical performance information, including delinquency rates, for prior securitizations containing similar mortgage loans ("static pool information").

3. FINRA alleged that the third-party vendor informed Credit Suisse that it believed the errors were immaterial and that it did not intend to provide investors with amended monthly reports. FINRA further alleged that Credit Suisse did not sufficiently investigate the extent or the materiality of the delinquency errors reported to it by the third-party vendor or whether static pool information for the period from February 2001 through December 2005 posted on the Reg AB website also contained inaccuracies.

4. According to FINRA, the inaccuracies impacted the delinquency rates for 21 subprime RMBS, including six for which the delinquency errors may have affected an investor's assessment of subsequent securitizations. The inaccurate data for these six securitizations remained on the firm's Reg AB website after the firm learned of the error and was hyperlinked to four subsequent RMBS securitizations involving a combined total of $3.76 billion in notes.

5. FINRA also alleged that the firm failed to name or define the delinquency calculation methodology used for five RMBS, and as a result, potential investors may have improperly evaluated the securities.

6. FINRA further alleged that Credit Suisse failed to establish a reasonable system to supervise the maintenance and updating of its Reg AB website and failed to pursue its own review of the accuracy of posted information for RMBS deals that Credit Suisse should have known were likely to contain erroneous calculations.

7. Credit Suisse consented to a censure and a fine of $4.5 million.

B. *Merrill Lynch, Pierce, Fenner & Smith Incorporated* ("Merrill Lynch") (May 26, 2011)

1. FINRA settled a matter with Merrill Lynch in which it alleged that the firm negligently misrepresented data regarding certain subprime RMBS for which the firm acted as underwriter and sold to institutional investors and failed to establish and maintain a reasonably designed supervisory system.

2. In or about January 2006, Merrill Lynch contracted with a third-party vendor to assist with its Reg AB website. FINRA alleged that shortly thereafter, in or about February 2006, Merrill Lynch became aware of inaccuracies in certain of the delinquency rate information provided to it with respect to subprime RMBS securitizations that Merrill Lynch had underwritten in 2004 and 2005; Merrill Lynch was informed that these delinquency calculations were corrected. In December 2006 or January 2007, Merrill Lynch terminated the relationship with the vendor and thereafter Merrill Lynch personnel exclusively maintained the Reg AB website.

3. In or about June 2007, Merrill Lynch discovered that it posted inaccurate data on its Reg AB website after taking the function in-house. According to FINRA, the inaccuracies impacted static pool information for 61 subprime RMBS posted on the Reg AB website from January 2006 through June 2007, including eight for which the assessment of fair market value, certificate yield, anticipated holding periods and anticipated performance for subsequent securitizations may have been affected.

4. FINRA alleged that the inaccurate postings were maintained on the Reg AB website even after Merrill Lynch became aware of the situation, and were hyperlinked to five subsequent RMBS securitizations totaling more than $1.9 billion that were sold based on the inaccurate data. The firm recalculated the static pool information for the 61 RMBS securitizations and posted the accurate data in August 2007.

5. FINRA further alleged that from January 1, 2006 to June 2007, Merrill Lynch failed to establish a reasonable system to supervise the maintenance and updating of its Reg AB website, and failed to take reasonable steps to review, identify and correct potential inaccuracies in the static pool information once it learned in February 2006 of errors in the delinquency data provided to it.

6. Merrill Lynch consented to a censure and a fine of $3 million.

C. *Barclays Capital Inc.* ("BCI") (Dec. 22, 2011)

1. FINRA settled a matter with BCI in which it alleged that the firm (i) failed to provide accurate data regarding certain subprime RMBS for which the firm acted as underwriter and sold to institutional investors and (ii) failed to establish and maintain a reasonably designed supervisory system.

2. According to FINRA, in or about October 2006, BCI learned that it had been provided with erroneous mortgage delinquency data, which was used to populate the firm's Reg AB website. BCI was subsequently provided with corrected data in November 2006 but, as of March 2007, had not uploaded the corrected data to its Reg AB website. The inaccurate data was immaterial prior to March 2007 when BCI reconfigured its Reg AB website, during which time the same inaccurate delinquency data was posted to the firm's Reg AB website for three subprime RMBS for the period from March 2006 through September 2006. The inaccurate data remained on the firm's Reg AB website until December 2010 when, after receiving an inquiry from FINRA on the matter, the firm posted the correct delinquency data.

3. FINRA alleged that the inaccurate data for the three subprime RMBS may have affected an assessment of fair market value, certificate yield, anticipated holding periods and anticipated performance of subsequent securitizations that referred to these three RMBS. According to FINRA, the inaccurate information for two of these RMBS was

hyperlinked to five subsequent RMBS securitizations totaling over $3.9 billion, which may have been improperly evaluated by potential investors.

4. FINRA further alleged that, by failing to provide for the follow up and review of supervision regarding the accuracy of the firm's Reg AB website, BCI failed to establish a reasonable system to supervise the maintenance, updating and review of its Reg AB website.

5. BCI consented to a censure and a fine of $3 million.

Municipal Securities

Consistent with the priorities listed above, FINRA settled the following municipal securities case last year.

A. *Southwest Securities, Inc.* ("Southwest") (Feb. 8, 2011)

1. FINRA settled a matter with Southwest in which FINRA alleged that the firm violated various MSRB rules by (1) using the services of nonaffiliated individuals to solicit municipal securities business for Southwest, (2) failing timely to file official statements and other documents, (3) failing accurately to report certain municipal securities transactions, and (4) failing reasonably to supervise such activities.

2. According to FINRA, between October 2006 and April 2009, Southwest paid over $200,000 to five unaffiliated individuals to solicit municipal securities business, some through formal consulting agreements and others through one-time payments. Improper payments included those made to three former officials of Texas issuers of municipal securities and a former Southwest registered representative whose registration had been terminated for more than three years. Southwest received over $1.9 million in gross revenues from the municipal securities business obtained by the individuals.

3. FINRA also alleged that, between March 2007 and January 2009, Southwest failed in 10 instances to make timely filings of final official statements or other forms, which ranged from one day to 59 days late.

4. FINRA also alleged that, between October 2007 and February 2009, Southwest failed on 304 occasions accurately to report information concerning municipal securities transactions to MSRB's transaction reporting system.

5. According to FINRA, between October 2006 and February 2009, Southwest failed to adopt, maintain and enforce procedures designed to ensure compliance with various MSRB rules. In particular, Southwest failed to amend its procedures to address changes to MSRB rules and failed to enforce certain procedures. The firm's procedures required that all municipal finance professionals pre-clear their political contributions through the Compliance Department; however, no such preapproval process was ever implemented. FINRA alleged that Southwest's inadequate supervisory systems and procedures failed to detect that one of its municipal professionals had made a political contribution, leading to the firm engaging in prohibited municipal securities business, for which the SEC brought a regulatory action in March 2010.

6. Southwest consented to a censure and a fine of $500,000. Southwest also was required to certify within 60 days of the issuance of the AWC that it had reviewed its procedures regarding compliance with applicable MSRB rules and established systems and procedures reasonably designed to achieve compliance therewith, as well as provide a written detailed description of the review conducted, Southwest's systems and procedures, and any changes to Southwest's systems and procedures.

Private Placements

In 2011, private placements were an area of regulatory concern. FINRA initiated the following actions last year.

A. *Workman Securities Corporation* ("Workman") (Apr. 7, 2011)

1. FINRA settled a matter with Workman in which it alleged the firm sold interests in certain private placements between June 2006 and June 2009 without conducting a reasonable investigation, causing significant investor losses when the companies ultimately failed.

2. FINRA alleged that Workman did not have reasonable grounds to believe that the private placements were suitable for any of their customers, failed to engage in an adequate investigation of such private placements, and failed to establish, maintain and enforce a supervisory system reasonably designed to achieve compliance with the applicable securities laws and regulations.

3. FINRA also alleged that, without performing proper due diligence, Workman could not identify and understand the inherent risk of the offerings and did not have reasonable grounds to allow Workman's registered representatives to continue selling the offerings despite red flags that the companies had financial issues including, among other things, that the companies were not timely making interest payments with respect to the privately placed securities.

4. FINRA further alleged that from December 2007 to February 2010, Workman failed to preserve electronic communications in a format that complies with the books and records requirements.

5. Workman consented to a censure and partial restitution to investors totaling $700,000. Workman's former president was barred from acting in any principal capacity and fined $10,000.

6. Workman also consented to establishing and implementing a system and procedures reasonably designed to achieve compliance with recordkeeping requirements related to electronic communications.

7. In other actions involving the same private placements, FINRA settled a matter with Askar Corporation in which it was censured and fined $45,000, and settled matters with six individuals in which various fines, bars and suspensions were imposed.

B. *Next Financial Group, Inc. and Steven Lynn Nelson; Investors Capital Corporation; Garden State Securities and Kevin John De Rosa; Vincent Michael Bruno; National Securities Corporation and Matthew G. Portes; Capital Financial Services; Brian W. Boppre; Equity Services, Inc.; Anthony Paul Campagna; Stephen Anthony Englese; Securities America, Inc.; Newbridge Securities Corporation; Robin Fran Bush; Leroy H. Paris II; Michael D. Shaw* (Nov. 29. 2011)

1. FINRA settled cases against eight firms and 10 individuals for allegedly selling interests in private placements without having a reasonable basis for recommending the investments.

2. FINRA alleged that the firms had not established adequate supervisory systems to indentify and understand the risks of the securities. As a result, many of the broker-dealers did not perform an adequate diligence of the private placements.

Additionally, according to FINRA, some of the firms did not have reasonable grounds to believe that the investments were suitable for any of their customers.

3. Further, FINRA alleged that some of the principals against whom cases were brought did not have reasonable grounds to allow registered representatives to continue to sell the private placements, particularly in light of “numerous” red flags that were present.

4. Sanctions were imposed against the firms and individuals for failing to conduct reasonable diligence regarding the offerings or for failing to enforce procedures regarding private placements offered by Provident Royalties, LLC, Medical Capital Holdings, Inc. or DBSI, Inc. For the firms, these sanctions included censure, fines (ranging from $25,000 to $250,000) and/or restitution. (FINRA ordered restitution of $3.2 million.) Individuals were also subject to a range of sanctions, including fines, suspensions and/or bars from the industry.

5. In March 2010, FINRA expelled Provident Asset Management for marketing fraudulent private placements offered by its affiliate, Provident Royalties. Civil SEC actions against Medical Capital Holdings and Provident Asset Management are ongoing.

Prospectus Delivery

Since at least 2004, regulators have been focused on firms’ deficiencies regarding delivery of prospectuses. Below are two more cases in this area.

A. *In the Matter of Wells Fargo Advisors, LLC.* (“WFA”) (May 5, 2011)

1. FINRA alleged that WFA failed to deliver prospectuses on a timely basis and failed timely to file certain amendments to Forms U4 and U5.

2. Specifically, FINRA alleged that WFA failed to deliver prospectuses within three days of purchase with respect to 934,074 mutual fund transactions occurring between January 1, 2009 and December 31, 2009. The customers received the prospectuses between one and 153 days late; 94% of the prospectuses were delivered within 14 days of settlement. FINRA noted that the primary cause of the late deliveries was that certain fund companies did not maintain adequate supplies of paper copies of prospectuses.

3. FINRA noted that WFA used a third-party service provider to deliver prospectuses. The service provider had a “print on demand” service whereby it would print an electronic copy of a fund’s prospectus when paper copies were unavailable, but WFA did not use the service extensively. FINRA further alleged that WFA was aware of the deficiencies because the service provider sent daily exception reports to WFA and met quarterly with WFA to review delivery statistics and WFA conducted monthly reviews, all of which showed that prospectuses were not timely sent.

4. FINRA further alleged that from July 1, 2008 through June 30, 2009, WFA filed 147 late Form U4 amendments and 40 late Form U5 amendments, representing 7.6% and 8.1%, respectively, of amendments to such forms required in the period.

5. WFA consented to a censure, a fine of $1 million, and an undertaking to adopt and implement systems and procedures reasonably designed to achieve compliance with the filing requirements for Forms U4 and U5 and provide a written certification of such compliance.

6. In setting the sanction, FINRA noted that WFA had previously paid a fine of $1.4 million for prospectus delivery and related supervisory violations, and that WFA and an affiliate paid a fine of $1.1 million for failing to provide approximately 800,000 required customer notifications.

B. *TD Ameritrade, Inc.* (“TD Ameritrade”) (Aug. 11, 2011)

1. FINRA, on behalf of Nasdaq, alleged that TD Ameritrade failed to deliver a product description to customers who purchased certain ETFs index fund shares prior to September 1, 2010.

2. FINRA alleged that this failure involved a significant number of transactions. For example, between January 1, 2009 and September 1, 2010, the firm failed to deliver the required product descriptions for approximately 4,818,230 separate transactions involving an initial purchase of an ETF.

3. According to FINRA, in October 2009, TD Ameritrade realized that it was failing to comply with Nasdaq’s rules; however, TD Ameritrade did not begin to implement an operations solution to the ETF product description or prospectus delivery issue until July 2010.

4. In addition, FINRA alleged that TD Ameritrade did not begin delivering prospectuses in lieu of product descriptions to customers who made initial purchases of ETF index fund shares until September 1, 2010.

5. TD Ameritrade consented to a censure and a fine of $2,650,000.

6. FINRA took into account the fact that TD Ameritrade self-reported the ETF transactions and violations and provided significant cooperation to FINRA staff.

Real Estate Investment Trusts ("REITs")

Below is a description of a litigated and settled matter involving REITs.

A. *Department of Enforcement v. David Lerner Associates, Inc.* ("DLA") (May 31, 2011)

1. In this complaint filed with the Office of Hearing Officers ("OHO"), FINRA alleged that DLA had marketed and sold $300 million of a REIT without performing adequate due diligence in violation of its suitability obligations.

2. According to FINRA, since 2004 DLA had valued the shares in certain REITs consistently and falsely at $11 per share, despite a fluctuating market. DLA also consistently charged a ten percent fee on all REIT shares sold.

3. Further, DLA acted as best efforts underwriter and sole distributor of a series of REITs and FINRA's complaint alleges that DLA failed to perform sufficient due diligence on the valuation and suitability of the REIT, instead relying on information provided in the REIT's security filings and opinions issued by outside auditors that did not address valuation practices. FINRA noted that DLA's undertaking to be best efforts underwriter and sole distributor carried extra responsibility, making it inappropriate to rely on outside sources for due diligence.

4. FINRA further alleged that in marketing and soliciting customers for the REIT, DLA presented performance information for earlier REITs, implying that the current REIT would be able to perform similarly. DLA also allegedly mischaracterized the source of distributions of the REIT on its website as well. FINRA noted that these advertising practices had been the subject of two warnings by FINRA's Advertising Regulation Department in the past year.

5. In its complaint, FINRA sought monetary sanctions, disgorgement and any other sanctions OHO deemed appropriate.

B. *Wells Investment Securities, Inc*. ("Wells") (Nov. 22, 2011)

1. FINRA settled a matter with Wells in which it alleged that between May 31, 2007 and September 30, 2009 (the "relevant period"), the Firm, acting as dealer manager, engaged in certain violations related to the marketing of a public offering of a non-traded Timberland Real Estate Investment Trust ("TREIT"), and failed to implement adequate procedures to protect sensitive and proprietary customer information.

2. TREIT was unlike other REITs in that it made only one type of property acquisition, could not make distributions, and did not allow redemptions. These differences prevented TREIT from qualifying for REIT favorable tax election in the initial stages.

3. FINRA alleged that during the relevant period Wells reviewed, approved and distributed over one hundred communications which did not provide an adequate basis for evaluating the facts regarding TREIT and/or contained misleading, unwarranted, or exaggerated statements. Specifically, materials allegedly failed to disclose the implications of TREIT's non-REIT status and/or suggested that TREIT was a REIT at a time when in fact it had not qualified to be one. The materials also did not disclose the lack of diversification of the investment and the inability to make distributions and redemptions.

4. FINRA also alleged that Wells had an inadequate supervisory system of educating employees such that they understood the specific features of the investments for which marketing they reviewed.

5. Finally, FINRA alleged that the firm did not have policies and procedures reasonably designed to protect confidential customer and propriety information as required under SEC Regulation S-P. For example, on one occasion, personal and confidential information of 37,864 customers, including social security numbers, investment data and account numbers, were placed at risk when a laptop containing that information was stolen from the car of an employee of a Wells affiliate. Wells had no procedures for laptop

encryption and no requirement for encryption of all data on firm laptops.

6. Wells consented to a censure and a fine of $300,000.

7. In setting the sanctions, FINRA considered the firm's proactive steps taken after theft of a laptop containing sensitive information, including, undertaking an investigation, notification of affected customers, the attorneys general and other appropriate authorities in the relevant states, as well as credit reporting agencies.

Short Sales/Regulation SHO

Short sales actions, including those under Regulation SHO, have been a steady part of FINRA's (and its predecessors') enforcement program. Here are seven cases brought last year. One of those actions was brought against a compliance officer.

A. *In the Matter of Southwest Securities, Inc.* ("Southwest") (Mar. 22, 2011)

1. FINRA alleged that Southwest had supervisory and operational deficiencies involving its Clearing Services Department from January 2008 to August 2009 that permitted one of its correspondent firms, Cutler Securities, Inc. ("Cutler") to create risk for Southwest through improper short sales.

2. Specifically, FINRA alleged that on August 6, 2009, Cutler bought more than 17.8 million shares of a stock while selling more than 20.3 million shares of the same stock. Southwest, as Cutler's clearing broker-dealer, had received Nasdaq automated alerts about the trading during the day through the Nasdaq ACT alert system, but still allowed Cutler to establish a 2.5 million share short position that day. Southwest issued a margin call the following morning which Cutler was unable to meet, resulting in an unsecured debit balance of $6.3 million.

3. Though the short sale occurred on Cutler's second day of clearing through Southwest, FINRA noted that the company was established and had a 13 year record in the business. FINRA alleged that, as a result of Southwest's failure adequately to supervise its clearing business, Southwest entered into a correspondent relationship with Cutler without having completed adequate due diligence on Cutler.

4. In investigating the short sales, FINRA alleged several deficiencies in the overall practices of Southwest in establishing and maintaining correspondent relationships like that with Cutler, including, among other things, that Southwest lacked operational and escalation policies and procedures, lacked due diligence in clearing services, and failed properly to identify and conduct risk assessments of correspondents.

5. Southwest consented to a censure, a fine of $650,000 and an undertaking requiring it to designate a risk management officer to identify and manage the risks associated with its correspondent clearing services business.

6. In determining the appropriate sanctions, FINRA took into account that Southwest performed an internal audit immediately after it had learned of the trading by Cutler on August 6, 2009 and shared the results of that audit with FINRA staff. Southwest also updated its automated risk management limits to lower thresholds for which Nasdaq alerts would be triggered, as well increased the number of employees who would receive such alerts. In addition, Southwest implemented mandatory Nasdaq training regarding the ACT system. FINRA also noted Southwest's substantial assistance to FINRA staff during the investigation.

7. FINRA also expelled Cutler for improper short selling, net capital, and other violations. Cutler's president, Glenn Cutler, consented to a bar from association in any supervisory or principal capacity, a two-year suspension and a fine of $100,000.

B. *In the Matter of Robert W. Baird & Co. Inc.* ("Baird") (Apr. 2011)

1. FINRA settled a matter with Baird in which FINRA alleged that between January 2005 and March 2010, Baird failed to comply with the locate requirements of Regulation SHO ("Reg SHO"), engaged in related supervisory violations, and failed to disclose its market-maker status in certain equity research reports. Interestingly, several months later FINRA initiated an action against Baird's compliance officer. That case is described immediately below.

2. According to FINRA, Baird released significant numbers of proprietary, institutional, retail and employee short sale orders for execution without valid locates. In samples selected over a three-month period, FINRA found that 592 of

713 proprietary short sale orders, nine of 753 institutional short sale orders, and 114 of 1,403 retail and employee short sale orders did not have properly documented locates. FINRA also alleged that the firm's traders entered an indeterminable number of short sale orders for which locates were not obtained or documented.

3. The firm used multiple order entry systems, none of which prevented the release of short sale orders for execution without valid locates, and one of which did not require the entry of any locate information. According to FINRA, the noncompliance with locate requirements was not corrected in a timely manner because the firm's post-trade review for locates was not reasonable. FINRA also noted that Baird failed to allocate sufficient resources to the locate process.

4. FINRA further alleged that Baird misapplied the bona fide market-maker exception as a result of the firm's traders' mistaken belief that the firm's status as a market-maker in a security exempted all firm short sales in that security from the locate requirement.

5. According to FINRA, the firm experienced systemic operational and supervisory deficiencies that persisted, in some instances, for five years. FINRA noted, among other things, that the firm's Compliance Department failed to establish a reasonable supervisory system for Reg SHO, the firm failed properly to train and supervise stock loan personnel, the firm lacked reasonable written policies and procedures for Reg SHO compliance, and the firm's limited reviews of Reg SHO compliance were ineffective. FINRA further alleged that even after being alerted to Reg SHO deficiencies by NYSE examiners in June 2007, Baird failed to take reasonable remedial action.

6. FINRA also alleged that Baird failed to disclose its market maker status in 693 equity research reports concerning 360 securities.

7. Baird consented to a censure and fine of $900,000.

C. *LaBranche Structured Products* ("LSP") *and Harsh Padia* ("Padia") (June 24, 2011)

1. On behalf of NYSE Regulation, Inc. a FINRA Hearing Officer found that LSP and Padia, an equity options trader at LSP, (collectively, the "Respondents"): (1) violated Reg SHO by failing to obtain locates prior to effecting a short sale and by

failing to properly close out their fail-to-deliver positions in Reg SHO threshold securities; (2) engaged in conduct inconsistent with just and equitable principles of trade by failing to properly close out their fail-to-deliver positions in Reg SHO threshold securities; (3) effected short sale transactions in violation of the SEC's September 18, 2008 Emergency Order which temporarily prohibited short selling in publicly traded securities of certain financial institutions; and (4) failed to establish, maintain and enforce an adequate system of procedures and supervisory controls reasonably designed to achieve compliance with Reg SHO and the SEC's September 18, 2008 Emergency Order.

2. During March 1, 2005 to approximately July 31, 2007, Padia effected 81 proprietary short sales in 11 threshold securities without first obtaining a locate. The short sales were related to option transactions, on which the Respondents made a profit of $1.5 million.

3. During the same time period, LSP's clearing firm notified Respondents of a potential buy-in due to a "fail-to-deliver position." A buy-in would require the Respondents to make large market purchases of the securities to cover the position, exposing Respondents to market risk. To avoid a buy-in, Padia executed a series of transactions that appeared to close out the fail-to-deliver position.

4. For example, Padia executed stock purchases and simultaneously bought one-day deep in-the-money put options for a corresponding number of shares. The purchases were then reflected on ABC's books and records, having the effect of temporarily resetting the buy-in date. At expiration, Padia exercised the put options, requiring the market participant he purchased them from to purchase the stock from Padia. Padia had not received delivery of the long stock he had purchased the previous day, so shares were never delivered to close out the original short position. The close-out obligation, however, was re-set to Day 1.

5. As a result of these transactions, Respondents maintained fail-to-deliver positions in a number of Reg SHO threshold securities beyond the 13-day close-out period.

6. Additionally, during September 19, 2008 to October 8, 2008, Padia effected approximately 69 proprietary short sale orders in the stock of at least 35 financial firms, in violation of the SEC's September 18, 2008 Emergency Order.

7. Respondents consented to a censure and a $500,000 joint and several fine, and a $1.5 million joint and several disgorgement.

D. *Keystone Trading Partners* (“Keystone”) *and Timothy D. Lobach* (July 7, 2011)

1. The NASDAQ OMX PHLXBusiness Conduct Committee issued a disciplinary decision against Keystone and its general Partner, Timothy D. Lobach (collectively, the “Respondents”), alleging that between August 1, 2006 and July 17, 2009, Respondents: (1) failed to close out fail-to-deliver positions timely; (2) improperly used Reg SHO’s locate and hedge exemptions; (3) effected sham transactions to reset the firm’s delivery obligations; and (4) failed to satisfy Keystone’s quoting obligations in certain options series.

2. In executing numerous short sale transactions, Respondents improperly relied on the market-maker exemption of Reg SHO and, therefore, did not arrange to borrow (or “locate”) shares for trades in at least 10 hard-to-borrow, threshold securities. After they failed to deliver the securities, they were notified by their clearing firm that they must close out the fail-to-deliver positions by the 13th settlement day.

3. Rather than close out the positions (which would normally involve purchasing the stock in the open market), Respondents instead effected short-term paired transactions of stock and options, which made it appear that they had purchased the securities and satisfied the obligation to close out the fail-to-deliver positions. In reality, the paired transactions did not close out the short positions, but the purchase of the stock in the paired transactions caused the clearing firm to reset the close-out obligation dates in their books and records. This extended the Respondents’ short position in the securities beyond the permitted 13 days.

4. Respondents gained approximately $2 million in profits as a result of their conduct.

5. Respondents also consented to findings by the Committee that they had: (1) on 51 occasions, sold a near equivalent number of shares on the same day they had been “bought-in” by the clearing firm (negating the clearing firm’s buy-in and acting in contravention of the SEC’s guidance requiring Respondents be a net purchaser of the open fail position in the security); (2) not acted as a bona fide market-maker in

the ten threshold securities in that they failed to quote in their options series and their option activity consisted predominantly of transactions that enabled Respondents to reset their buy-in dates; (3) failed to locate securities prior to effecting short sales in ten threshold securities in light of the fact that they had not engaged in bona fide market-making activity; and (4) failed to meet their obligation to continuously disseminate two-sided markets electronically in at least 60% of their options series. Keystone also failed to implement reasonable supervisory systems and controls to ensure compliance with Reg SHO.

6. Keystone agreed to a censure, a fine of $500,000, and disgorgement of profits in the amount of $2 million. Lobach consented to a censure and a three-month suspension from acting in a supervisory capacity.

E. *In the Matter of Susan Margaret Labant* (Aug. 19, 2011)

1. This is a companion case to the *Baird* matter. Here, FINRA brought a case against Susan Labant, a former Assistant Compliance Director at Baird. According to FINRA, Labant "was the person responsible for, among other things, the firm's Capital Markets' Regulation SHO compliance." In this role, her responsibilities included establishing policies and procedures designed to achieve compliance with Reg SHO. FINRA charged, however, that Labant failed to implement a "comprehensive and effective framework" for compliance with Reg SHO. FINRA criticized Labant in the following respects:

(a) First, FINRA alleged that the policies and procedures drafted and/or reviewed by Labant and subsequently put in place by the firm were not reasonably designed to comply with certain requirements of Reg SHO.

(b) Second, Labant failed to review and/or coordinate the firm's Reg SHO-related policies and procedures established for various areas of the firm.

(c) Third, the written policies and procedures she created or reviewed were unreasonable and in some instances incorrect.

(d) Fourth, Labant did not coordinate the firm's stock loan desk's role and responsibility regarding Reg SHO.

2. According to FINRA, as a result of these deficiencies, "among other reasons," the firm experienced systemic Reg SHO-related operational and supervisory problems.

3. FINRA also charged that Labant failed to take reasonable steps to remedy the firm's violations even after being informed of various deficiencies by NYSE examiners.

4. Labant's conduct allegedly violated NASD Rules 3010, 2110 and 2010.

5. Labant consented to a nine-month suspension as a principal, a $10,000 fine and the requirement that she requalify as a principal for resuming such activities.

F. *UBS Securities LLC* ("UBS") (Oct. 21, 2011)

1. FINRA settled a case against UBS in which it alleged that during the period covering, in whole or in part, January 3, 2005 through March 2010, with several violations continuing through December 31, 2010, the firm violated Reg SHO and other FINRA, NASD and federal securities laws and regulations as a result of flaws in the firm's supervisory and compliance programs concerning Reg SHO.

2. FINRA alleged that UBS had a systemic supervisory failure with respect to Reg SHO, which resulted in numerous violations throughout the firm's equities trading business. Those supervisory failures included: (1) a lack of a supervisory structure to adequately supervise the firm's compliance with Reg SHO; (2) failing to establish and enforce written supervisory procedures for all of its trading desks regarding compliance with Reg SHO; (3) failing to develop and implement effective Reg SHO monitoring reports; (4) failing to establish appropriate information technology procedures concerning Reg SHO; and (5) failing to establish an adequate Reg SHO compliance monitoring program. According to FINRA, UBS's supervisory system was not reasonably designed to achieve compliance with Reg SHO until at least 2009.

3. Based on extrapolation, FINRA alleged that these failures resulted in UBS entering tens of millions of proprietary and customer short sales without locates, a significant number of which were in hard-to-borrow securities.

4. According to FINRA, the numerous violations were caused by: (1) desks misapplying exceptions to the locate

requirement without adequate discussion or approval beyond the trading desks; (2) improperly including certain threshold and hard-to-borrow securities on the firm's easy-to-borrow lists; (3) allowing certain direct execution clients to bypass order entry system locate checks; and (4) failing to supervise that locates were obtained or documented for orders in the firm's order entry systems. FINRA stated that "the duration, scope and volume of the trading created a potential for harm to the integrity of the market."

5. FINRA also alleged that UBS mismarked millions of sale orders, some of which were improperly marked long, resulting in additional locate violations. UBS also failed to maintain the independence of its aggregation units, lacked accurate written aggregation unit plans, and had inaccuracies in its risk management systems in connection with its aggregation units. These issues may have resulted in additional locate and order-marking violations.

6. In addition, as a result of its order marking violations, FINRA alleged that UBS had significant blue sheet, ACT and OATs reporting violations as well as recordkeeping violations.

7. UBS agreed to a censure and a $12 million fine. In determining the sanction, FINRA noted that as the locate and order marking problems were identified during the investigation, UBS implemented changes to its systems and procedures designed to prevent the recurrence of those issues. FINRA also credited UBS for the substantial assistance it provided to the enforcement investigation, specifically acknowledging that the firm undertook an internal review of its supervisory policies, procedures and systems and reported the findings of its internal investigation to FINRA.

G. *Credit Suisse Securities (USA) LLC* ("CS") (Dec. 27, 2011)

1. FINRA settled a matter with CS in which it alleged that CS violated the locate requirements of Reg SHO and failed to properly supervise short sales and the marking of sale orders. According to FINRA, from June 2006 through December 2010, CS's supervisory system for locates and marking sale orders was flawed and resulted in a systemic supervisory failure across its equities trading business.

2. In particular, FINRA alleged that firm's Reg SHO violations occurred due to: (1) the failure to decrease available locate shares to account for short sale orders entered but

unexecuted; (2) programming errors that resulted in trading systems failing to recognize the rejection of locate requests and/or using prior days' locate approvals; (3) misapplication of the bona fide market-maker exception to the locate requirement; (4) trading systems and traders mismarking sale orders; and (5) the failure to adequately supervise locates and order marking.

3. Relying on extrapolated data, FINRA further alleged that CS released millions of proprietary short sale orders to the market without locates, including threshold and hard-to-borrow securities and mismarked tens of thousands of sale orders in its trading systems.

4. As a result of the mismarked sale orders, CS also had blue sheet, ACT, and OATS reporting violations and recordkeeping violations.

5. The violations were not detected or corrected by the firm until after FINRA's investigation caused CS to conduct a substantive review of its systems and monitoring procedures for Reg SHO compliance.

6. CS consented to a censure and a fine of $1.75 million.

7. The AWC noted that CS had four prior short sale-related violations. The AWC also noted that after FINRA initiated its investigation, CS conducted a substantive review of its systems for Reg SHO compliance in April 2009 and as problems were self-identified by the firm or FINRA, CS implemented changes to its systems and procedures that were designed to prevent a recurrence of these violations.

Structured Products

While the SEC has seemingly targeted alleged misconduct regarding the marketing and sale of structured products to institutional investors, FINRA has focused its efforts on the sale of these investments to retail customers. Five cases brought last year are summarized below. These cases involve reverse convertible notes, CMOs, principal protection notes and unit investment trusts.

A. *In the Matter of UBS Financial Services, Inc.* ("UBSFS") (Apr. 11, 2011)

1. FINRA alleged that between March 2008 and June 2008, UBSFS made statements and omissions that effectively misled some investors regarding the "principal protection" feature of "100% Principal Protection Notes" ("PPNs") that

Lehman Brothers Holdings Inc. issued prior to its September 2008 bankruptcy.

2. According to FINRA, some UBSFS financial advisors described the structured notes as principal-protected investments and failed to emphasize that the investments were unsecured obligations of Lehman Brothers subject to issuer credit risk.

3. FINRA alleged that UBSFS failed to establish an adequate supervisory system for the sale of these notes and failed to provide sufficient training and written supervisory policies and procedures, noting that some of the financial advisors did not understand the product.

4. FINRA also alleged that the firm did not adequately analyze the suitability of the sales of Lehman-issued PPNs to certain customers and created and used advertising about the PPNs that was effectively misleading to customers, particularly in light of the changes in the market after the takeover of Bear Stearns in early 2008.

5. UBSFS consented to a censure, a fine in the amount of $2.5 million, and customer restitution of $8.25 million.

B. *Santander Securities Corporation* (“Santander”) (Apr. 12, 2011)

1. FINRA settled a matter with Santander in which it alleged unsuitable sales of reverse convertible securities to retail customers, inadequate supervision of sales of structured products, inadequate supervision of accounts funded with loans from its affiliated bank, and other violations related to the offering and sale of structured products.

2. According to FINRA, for most of the period from September 2007 to September 2008, the firm had no formal procedures for reviewing or approving structured products before offering them to customers. Instead, individual brokers evaluated the products, but received limited and inadequate training, guidance and supervision related to structured products, including their risks and their suitability for individual clients. During the relevant period, Santander customers invested $130 million in reverse convertibles and the firm earned more than $1.7 million in commissions.

3. According to FINRA, the firm also failed adequately to follow up on compliance reports of accounts over-concentrated with positions in reverse convertibles, including identification

of 108 accounts holding more than 20% of the accounts' value in a single reverse convertible product, accounting for approximately $17.8 million in reverse convertibles.

4. FINRA also found that the firm actively solicited account holders to borrow money from its banking affiliate using securities pledged in their brokerage accounts as collateral, and some brokers then assisted clients in using the borrowed funds to buy reverse convertibles, even though the clients did not understand the products or risks. When the stock market declined precipitously in 2008, some clients were left with large debts to the bank.

5. FINRA alleged other violations by Santander, including: (i) failing to comply with certain public offering and corporate financing requirements; (ii) inserting confidentiality provisions inconsistent with FINRA guidance in five customer settlement agreements; and (iii) filing six Forms U4 or U5 for brokers that inaccurately reported broker contributions to reverse convertibles settlements when no such contributions were made.

6. Santander consented to a censure, a fine of $2 million and an undertaking to: (i) review its written policies and procedures, training and available tools in the areas of product suitability, sales supervision and intrastate offerings; (ii) establish written policies and procedures for the development and vetting of new products; and (iii) train personnel with responsibility for FINRA regulatory filings.

7. In setting the sanction, FINRA noted that Santander had provided over $7 million in restitution to customers.

C. *In the Matter of Northern Trust Securities, Inc.* ("Northern Trust") (June 2, 2011)

1. FINRA alleged that during the period October 2006 through October 2009, Northern Trust failed to establish and implement an adequate supervisory system with respect to sales of certain collateral mortgage obligations ("CMOs") to retail customers and for monitoring certain high volume securities trades.

2. According to FINRA, Northern Trust utilized an exception reporting system provided by Northern Trust's clearing firm that would flag transactions or accounts that triggered pre-determined parameters established by Northern Trust. The transactions that were flagged were to be reviewed by

the compliance department for suitability. However, Northern Trust was unaware that the system was not capturing 43.5% of the Firm's business during the relevant period because certain trades were done on a separate system that was not fed into the exception reporting system. As a result, Northern Trust failed to monitor and review potentially unsuitable CMO concentration levels in customer accounts.

3. FINRA found that between January 2007 and June 2008, 26 customer accounts held by customers over the age of 70 held cumulative CMO positions in excess of 50% of the value of their accounts.

4. FINRA alleged that Northern Trust did not become aware of this issue until a 92 year old widowed customer filed an arbitration proceeding regarding concentration levels of a Countrywide CMO in her account totaling nearly 47.6% of her total liquid net worth. The Countrywide CMO had a maturity date of 2037 and a high risk of default due to the location of many of the underlying mortgages, thus exposing this customer to high risk and causing an unrealized loss of about $183,000.

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

D. *Chase Investment Services Corp.* ("CISC") (Nov. 15, 2011)

1. FINRA settled a matter with CISC in which it alleged that, between January 1, 2007 and December 31, 2008, CISC made 257 unsuitable recommendations of two particular higher-risk unit investment trusts ("UITs"), which contained a high percentage of "junk" bonds, to customers with little or no investment experience and conservative risk tolerances. CISC's customers made 3,582 purchases of these two UITs, which represented a value of $141 million, generated over $2.8 million in commissions and resulted in losses of approximately $1.435 million.

2. According to FINRA, CISC provided no formal UIT training to its registered representatives. Instead, most of the information that the registered representatives obtained and utilized came directly from the UIT wholesalers' and sponsors' websites. CISC's supervisory procedures also failed to provide reasonable guidance regarding determining the suitability of UIT transactions.

3. Additionally, in certain instances CISC did not require verification of the information within customer applications, including suitability information, which caused actual customer profiles to not match the information in the application and led to the approval of unsuitable UIT transactions. Also, in several instances registered representatives changed customer risk tolerance profiles or investment objectives to be consistent with the suitability requirements of a particular UIT, but these changes were not verified to ensure that they were accurate.

4. FINRA also alleged that CISC failed to have a supervisory system reasonably designed to ensure that all UIT transactions received principal approval. Specifically, two types of UIT transactions that did not receive principal review accounted for over 11,000 separate UIT transactions and included 27 unsuitable purchases.

5. FINRA also alleged that CISC failed to comply with its procedures that required review of a UIT product approximately six months after it was approved and launched. Specifically, CISC approved seven new UITs in October 2007 but did not conduct a post-launch review until July 2008.

6. FINRA also alleged that CISC made unsuitable floating rate fund recommendations to customers who had conservative risk tolerances and/or were seeking preservation of principal, resulting in losses of approximately $736,000.

7. According to FINRA, CISC did not provide any formal training to registered representatives regarding floating rate funds. Specifically, CISC failed to adequately train its registered representatives regarding credit and liquidity risk of floating rate funds and regarding the customers for whom floating rate funds would be suitable.

8. FINRA also alleged that CISC failed to implement its internal policy that required all sales of floating rate funds to be reviewed to determine whether they exceeded 10% of the client's investable assets, in which case the registered representative was required to cancel the trade, obtain an internal waiver from the policy, adjust the trade to be within the policy's acceptable standards or obtain an executed disclosure form from the customer.

9. According to FINRA, in addition to failing to follow up on floating rate fund trades that exceeded the percentage

guideline, registered representatives also updated customers' risk tolerances on their suitability profiles without any further verification with the customer that the revised information was accurate.

10. FINRA also alleged that, between January 2, 2007 and July 31, 2008, WaMu Investments, Inc. ("WaMu"), which merged into CISC in July 2009, made unsuitable floating rate fund recommendations to customers and failed to reasonably supervise the sale of floating rate funds to customers.

11. According to FINRA, WaMu made recommendations to certain customers without reasonable grounds for believing that the floating rate funds were suitable for the customers, who suffered approximately $180,000 in losses. Additionally, WaMu did not provide any formal training to registered representatives regarding floating rate funds.

12. CISC consented to a censure, a fine of $1.7 million, and restitution of approximately $1.92 million to certain customers.

E. *Wells Fargo Investments, LLC* ("WFI") (Dec. 15, 2011)

1. FINRA alleged that between January 2006 and July 2008, WFI, through one of its registered representatives, Alfred Chi Chen, effected hundreds of unsuitable reverse convertible transactions for 21 customers, most of whom were elderly, with 15 over 80 years old, including four over 90 years old. As of May 2008, each of the 21 customer accounts held over 50% of investible assets in reverse convertibles.

2. In addition, FINRA alleged that WFI failed to provide certain eligible UIT customers with breakpoint and rollover and exchange discounts to which they were entitled.

3. According to FINRA, WFI failed to reasonably supervise Mr. Chen and had deficiencies in its supervisory system and procedures relating to reverse convertibles from June 2006 through December 2009 and relating to UITs from January 2004 through December 2009.

4. WFI consented to a censure, a fine of $2 million and to provide remediation to certain customers who purchased reverse convertibles and UITs.

5. FINRA also filed a complaint against Mr. Chen for recommending and selling the unsuitable reverse

convertibles and for making unauthorized trades in several customer accounts, including accounts of deceased customers.

Supervision

Year in and year out, FINRA brings a number of supervisory cases. Below are 11 such actions initiated in 2011.

A. *NEXT Financial Group, Inc.* ("NEXT") (Jan. 2011)

1. FINRA settled a matter with NEXT in which it alleged that during the period from February 2008 to March 2009, NEXT failed to detect excessive trading of certain customer accounts and engaged in other supervisory and reporting violations.

2. According to FINRA, the most significant violation concerned the firm's failure to detect excessive trading by one of its registered representatives in five customer accounts, resulting in unnecessary sales charges totaling approximately $102,376. FINRA further alleged that 13 other registered representatives engaged in transactions in 38 customer accounts that, based on turnover to cost-to-equity ratios, raised the possibility that they were improperly excessive, but the firm failed to detect or inquire about the transactions. FINRA noted that the firm relied on OSJ branch managers and home office compliance personnel to review weekly blotters of registered representatives' transactions, but did not utilize exception reports or any other reasonable system for detecting improper and excessive trading. As such, FINRA found NEXT failed to properly supervise its trading.

3. With respect to the other supervisory and reporting violations, FINRA alleged the following:

   (a) NEXT failed reasonably to supervise variable annuity transactions in that the firm was unable to provide evidence of principal approval of 27 of 115 transactions reviewed by FINRA.

   (b) NEXT failed reasonably to supervise municipal bond markups and markdowns with respect to 19 riskless municipal bond transactions in which the markups or markdowns ranged from 3.01% to 4.58%.

(c) NEXT failed to establish a reasonable branch audit program. FINRA reviewed 60 branch audits and found that in certain instances, firm auditors left audit questions unanswered, there was no home office follow up on potentially problematic activity, the branch's response to deficiencies was not obtained or maintained, and the audit did not include a review of the branch's checking account.

(d) The firm failed to put two registered representatives on heightened supervision in accordance with its procedures and failed to follow the heightened supervision plan for two other registered representatives.

(e) The firm also failed to perform adequate Rule 3012 tests or submit an adequate Rule 3012 report, reasonably supervise private securities transactions in 36 registered representatives' accounts, make certain Rule 3070 and Form U4 and U5 filings in a timely and accurate manner, and properly follow up on certain AML exception reports.

4. NEXT consented to a censure, a fine of $400,000 and restitution to customers in the amount of $103,179.84.

B. *KeyBanc Capital Markets Inc.* ("KeyBanc") (Jan. 31, 2011)

1. FINRA, on behalf of NYSE Regulation, settled a matter with KeyBanc in which FINRA alleged that the firm failed to: (i) establish adequate controls and a reasonable supervisory system with respect to its Control Room procedures, Watch and Restricted Lists, and related trading activities from January 2007 to December 2009; (ii) disclose that it had completed an internal investigation into potentially violative insider trading; and (iii) obtain, review and monitor certain employee trade confirmations and account statements.

2. FINRA alleged that KeyBanc had in place written policies and procedures pertaining to its Control Room, Watch and Restricted Lists, and related trading activities which required, among other things, employees to report material nonpublic information to the Control Room for inclusion on the Watch and Restricted Lists; however, KeyBanc failed to establish adequate controls to ensure that its employees were adhering to such policies and procedures. As a result, KeyBanc failed to report a significant number of companies, issuers and event updates to its Watch and Restricted Lists.

3. FINRA also alleged that KeyBanc failed to disclose to the NYSE in its July 2008 Quarterly Insider Trading Attestation that, in the second quarter of 2008, it conducted and completed an internal investigation into potentially violative insider trading activity. The internal investigation concluded that there was insufficient evidence of violative insider trading.

4. According to FINRA, KeyBanc also failed to obtain, review and monitor trade confirmations for certain employee and employee-related accounts from January 2007 to June 2008 in a manner reasonably designed to ensure compliance with prohibitions against insider trading and manipulative activity.

5. KeyBanc consented to a censure and a fine of $350,000.

6. In setting the sanction, FINRA noted that KeyBanc undertook a comprehensive review and overhaul of its Control Room compliance procedures and increased its compliance resources, and that there was a lack of evidence related to the misuse of material nonpublic information in connection with securities on KeyBanc's Watch and Restricted Lists.

C. *In the Matter of BNP Paribas Securities Corp.* (Feb. 2011)

1. FINRA alleged that BNP Paribas Securities Corp. ("BNPP") failed to establish and maintain adequate systems and procedures regarding its Listed Option Desk ("LO Desk") and Stock Loan and Borrow ("SLAB") desks, maintained certain inaccurate books and records, and filed an inaccurate Form U5 during 2007.

2. According to FINRA, the LO Desk was one of only a few desks at BNPP that was allowed to mark positions manually throughout the trading day on a case-by-case basis by individual traders. However, no supervisor on the LO Desk or in the larger department housing the LO Desk reviewed the manual valuations and, although there was a procedure in place to create a report of such valuations, none was ever generated.

3. Because of this deficiency, BNPP was unaware of losses, caused by one trader, of more than $18 million incurred over an 11-week period in 2007 on the LO Desk. When another trader was promoted to supervisor of the desk in late 2007, he undertook a review of the manual positions and discovered the issues with this trader. Following this

discovery, BNPP sought the trader's resignation, in lieu of termination. At that time, BNPP filed a U5 for the trader.

4. FINRA alleged that failures stemming from the LO Desk caused certain of BNPP's books and records to be inaccurate prior to November 2007. In addition, FINRA alleged that, when BNPP filed its U5 form for the trader responsible for the inaccurate marks on the LO Desk, it incorrectly indicated that the trader's termination was "voluntary" when in fact the trader was "permitted to resign." That trader was also under internal review at the time of his termination, but BNPP further incorrectly indicated that he was not. In May 2008, when BNPP's internal investigation was completed, the Firm filed an amended U5 and self-reported the LO Desk incident to FINRA.

5. In addition, in February 2007, BNPP's SLAB desk pursued an arbitrage opportunity in which it borrowed shares of a stock from a custodial bank and loaned them to a BNPP affiliate. However, the arbitrage opportunity was lost when there was an over-subscription of the cash option of the tender offer of the stock, and BNPP lost approximately €3.4 million. FINRA alleged that BNPP failed to have a system or procedure in place to track and assess the risk of loss for such arbitrage trades.

6. BNPP consented to a censure and fine in the amount of $650,000.

7. In determining the appropriate sanctions, FINRA considered the fact that BNPP self-reported the inaccurate U5 filing prior to filing an amended U5, and also provided substantial assistance to the staff's investigation of the circumstances that led to the mismarking and improper filing. BNPP was specifically recognized for its efforts in providing witnesses for on-site interviews and for creating and providing to the Staff a compendium of highly relevant documents.

D. *UBS Securities LLC* ("UBS Securities") (Feb. 2011)

1. FINRA settled a matter with UBS Securities in which FINRA alleged that from January to May 2006 UBS Securities failed to: (i) monitor adequately the trading activity of a junior trader on its Fixed Income Emerging Markets Latin American Desk ("LatAm Desk"); (ii) provide the trader's supervisors with reports and information necessary to supervise the trader's activity; (iii) establish and maintain adequate written procedures; and (iv) maintain accurate books and records.

2. FINRA alleged that the trader made false and inaccurate entries into the firm's trading systems for transactions in Brazil 40 bonds and nondeliverable forward ("NDF") contracts involving Brazilian Reals and U.S. Dollars, causing the trader's risk positions to be incorrectly calculated and his profits to be overstated and losses to be understated. The trader lost more than $28.7 million during the period.

3. While most traders on the LatAm Desk used NDFs for hedging, the trader in question was permitted to trade NDFs as a primary product on a proprietary basis for the firm. UBS Securities authorized the trader to enter his own NDF transactions into two trading systems, although other traders on the desk were permitted to use only one. These trading systems belonged to and were maintained on the servers of UBS AG in Zurich, Switzerland.

4. While UBS Securities did provide the trader's supervisor with daily supervisory reports, these reports did not capture NDF trade data, and UBS Securities did not advise the supervisor of the lack of such detail. UBS AG personnel created daily NDF-related profit and loss reports and exception reports, but the majority of the reports were not provided to the firm or the supervisor. In other instances, UBS Securities provided reports to the trader himself detailing his own activity, but not to his supervisor.

5. According to FINRA, the firm failed to make and keep a memorandum of each NDF transaction; instead, such records were created and maintained by UBS AG. In addition, UBS Securities' books and records contained false, delayed and fictitious entries made by the trader.

6. FINRA also alleged that UBS Securities failed to have adequate written supervisory procedures for supervising the trader and the transactions and for maintaining required books and records for the LatAm Desk.

7. UBS Securities consented to a censure and a fine of $600,000.

8. In setting the sanction, FINRA noted that UBS Securities conducted an internal investigation after the trader's activity came to light and that the Firm subsequently instituted remedial measures to prevent the same activity from recurring.

9. In separate actions, the NYSE barred the trader from the securities industry and the Board of Governors of the Federal Reserve barred him from the banking industry.

E. *Morgan Stanley & Co. Incorporated* (“Morgan Stanley”) (Jun. 2011)

1. FINRA settled a matter with Morgan Stanley in which it alleged that from August 1999 to December 2008, a firm employee responsible for processing corporate actions misappropriated $2.5 million from the firm, its institutional customers, and a firm counterparty, and that the firm failed to have adequate systems and procedures to prevent such conduct.

2. According to FINRA, the employee, who was terminated, made numerous false journal entries into the firm’s electronic system to transfer and credit money associated with corporate actions and caused 50 checks to be issued to a shell company created by the employee. The employee entered check requests himself, which were approved by persons who reported to him. The employee also caused other employees to enter check requests or used another employee’s identification to do so, and then approved the requests.

3. FINRA alleged that Morgan Stanley did not have a system for reviewing journal entries prior to April 2003. Thereafter, the firm established certain processes and systems, but the employee continued to review and approve his own entries. According to FINRA, from June 2007 to December 2008, the employee made at least 450 journal entries, at least 168 of which were flagged high priority; the employee approved 57 of them and 111 were not reviewed.

4. FINRA also found that the firm did not require persons approving check requests to be supervisors and did not confirm that a check request was associated with a corporate action.

5. Morgan Stanley consented to a censure and a fine of $375,000.

6. In determining the appropriate sanctions, FINRA noted that Morgan Stanley discovered and self-reported the employee’s misconduct, investigated and corrected its systems and procedures, made remediation to its customers, and provided substantial assistance to FINRA’s investigation.

F. *Deutsche Bank Securities Inc.* ("DBSI") *and Adrienne Tubridy* (June 27, 2011)

1. FINRA settled a matter with DBSI and Tubridy, a manager of DBSI's Boston, MA branch, in which FINRA alleged that, between January 2005 and May 2008, DBSI failed to establish, maintain, and enforce an adequate supervisory system to detect improper "shadowing" of third-party investment adviser trades by at least five of the firm's registered representatives. FINRA further alleged that Tubridy failed to recognize and follow up on red flags indicating that the shadowing was occurring.

2. DBSI had entered into contractual arrangements with third-party investment advisers through which the advisers provided advisory services to DBSI's "adviser select" clients. These agreements prohibited DBSI employees from shadowing the advisers' portfolio recommendations for other DBSI clients' accounts. However, according to FINRA, DBSI registered representatives in the Boston branch placed shadowed trades, sometimes hundreds per day, for at least 35 accounts. The shadowed trades, which circumventing the fee arrangement in place with the advisers, resulted in DBSI's failure to pay more than $200,000 to the advisers during the relevant period.

3. In October 2006, DBSI had adopted a written firm policy prohibiting the practice of shadowing, which was included in the firm's overall policies and procedures manual, a copy of which was provided to Tubridy. However, according to FINRA, DBSI did not implement any systems or checks to detect and/or prevent shadowing. For example, exception reports were not created to specifically identify shadowing, training related to shadowing was not conducted, and supervisory systems were not implemented to monitor accounts for potential shadowing.

4. Also, certain shadowed trades that were flagged for reasons unrelated to the shadowing activity were nevertheless examined and approved by Tubridy, even after making notations for certain of the trades indicating that, based upon conversations with the registered representatives who were conducting the shadowing, Tubridy was aware that they were shadowed trades. However, Tubridy failed to follow up on these trades and did not escalate the issue to DBSI's compliance department or her own supervisors.

5. DBSI consented to a censure and a fine of $350,000, which took into consideration the financial benefits that DBSI had obtained. Tubridy consented to a 10-day suspension from her supervisory capacity and a fine of $10,000.

6. In setting the sanction, FINRA noted that DBSI, once it learned of the shadowing activity at the Boston branch, conducted an immediate and extensive internal investigation, with Tubridy's assistance, across all branch offices to identify and halt any other shadowing activity.

G. *Morgan Stanley & Co. Incorporated* ("Morgan Stanley") (Jun. 28, 2011)

1. FINRA settled a case against Morgan Stanley alleging that during the period of 2004 to 2007, the firm failed to supervise, establish and enforce adequate written supervisory procedures related to total return swaps and off-shore stock loan transactions designed to create tax advantages, known as yield enhancements, for certain off-shore clients with respect to dividends paid on U.S. securities.

2. In order to capture the tax advantage, Morgan Stanley structured the dividend payment transactions as a swap or loan, and provided yield enhancement as part of a securities derivative or stock loan-related payment. In both types of transactions, the client did not hold the stock on the dividend record date.

3. In total return swaps transactions, a yield enhancement payment was improper if the client held beneficial ownership of the stock throughout the life of the swap. A major factor in determining the propriety of the payment was whether the client was subject to market risk during the transaction.

4. FINRA alleged that Morgan Stanley was unable to substantiate the propriety of some yield enhancement payments because of supervisory deficiencies in the use of "crosses," short-term transactions, and market-on-close pricing. Morgan Stanley's procedures prohibited clients who "crossed in" stock, which occurred when clients sold the stock to Morgan Stanley, from "crossing back," which occurred when clients reacquired the stock from Morgan Stanley. However, Morgan Stanley made no efforts, other than obtaining an oral representation from clients, to determine whether clients were actually covering a short position or were establishing positions after obtaining the

yield enhancement payment. This allowed clients to both "cross in" and "cross out" on securities transactions that were related to the swap transactions. Accordingly, Morgan Stanley could not evidence clients' exposure to market risk.

5. FINRA also alleged that Morgan Stanley failed to establish written supervisory procedures and lacked effective working control of business operations that involved clients, client securities held in accounts at Morgan Stanley, and personnel in relation to off-shore stock loans. According to FINRA, Morgan Stanley allowed affiliates to initiate and conduct off-shore stock loan transactions without sufficient oversight. As a result, Morgan Stanley was unable to substantiate that the off-shore stock loans were made in a way such that the yield-enhancement payments were appropriate.

6. Morgan Stanley consented to a censure and a fine of $575,000.

H. *Citigroup Global Markets, Inc.* ("CGMI") (Aug. 9, 2011)

1. FINRA settled a case against CGMI alleging that from approximately January 2001 to March 2008 CGMI failed to: (i) supervise and investigate red flags regarding a former registered sales assistant who misappropriated $749,978 from 22 customers, falsified account records and engaged in unauthorized trading in customer accounts; (ii) implement reasonable systems and controls concerning the supervision of customer accounts; and (iii) keep accurate books and records.

2. According to FINRA, the sales assistant, who was terminated upon admitting to misappropriating customer funds, provided operational support to registered representatives. This included processing new account applications and addressing irregularities identified by certain exception reports. In performing these tasks, the sales assistant targeted elderly, ill or otherwise vulnerable customers. The sales assistant created accounts using false addresses and, in some instances, Social Security numbers of deceased customers, and later caused checks to be issued to her personal bank account. She also gained access to accounts considered to be abandoned, and engaged in unauthorized trades and misappropriated funds from those accounts.

3. FINRA alleged that CGMI failed to supervise, detect and investigate red flags that upon further inquiry would have alerted CGMI to the sales assistant's improper use of customer funds. For example, CGMI failed to investigate and relied on unverifiable information provided by the sales assistant in addressing irregularities in addresses and Social Security numbers that were apparent in exception reports. Furthermore, CGMI failed to investigate bounced check notices on 20 separate occasions indicating the sales assistant's financial difficulties, and improperly coded the sales assistant's employee and employee-related accounts.

4. FINRA also alleged that CGMI failed to implement a reasonable system and controls regarding the supervision of employee accounts and those deemed abandoned property. CGMI acknowledged that employee accounts were not reasonably reviewed because of miscoding, some of which was due to a systems glitch. According to FINRA, CGMI's failure to supervise enabled the sales assistant to falsify information in new account applications, letters of authorization and other records, thereby causing CGMI's failure to make and keep accurate records for each customer account.

5. CGMI consented to a censure and a fine of $500,000.

I. *Beta Capital Management* ("Beta") (Sept. 26, 2011)

1. FINRA alleged that from 2006 through 2007, Beta's supervisory system was deficient because Beta did not maintain an order entry system that was reasonably designed to prevent an improper post-execution allocation of trades.

2. According to FINRA, Beta's third-party order entry system permitted trades to be entered into the system without assigning an account to the trades, which were then completed later in the day to the advantage or disadvantage to certain accounts.

3. In particular, FINRA alleged that one customer with both a personal and institutional account directed Beta to assign trades after the securities had increased or decreased in value, to the benefit of the customer's personal account and to the detriment of the institutional account. During a two-year period, FINRA alleged that in trading of the same nine equities, the customer's personal account received more favorable pricing than the intuitional account 74% of the

time, in turn realizing a $586,220 profit for the customer's personal account and a $50,789 profit for the institutional account.

4. Beta consented to a censure and a fine of $450,000.

J. *Merrill Lynch, Pierce, Fenner & Smith Inc.* ("Merrill Lynch") (Oct. 4, 2011)

1. FINRA alleged that Merrill Lynch failed to establish, maintain and enforce an adequate supervisory system to ensure monitoring of employee and employee-interested accounts, leading to a failure to monitor approximately 40,000 employee and employee-interested accounts from January 2006 until June 2010 and allowing a Ponzi scheme to be facilitated by a Merrill Lynch employee.

2. According to FINRA, EARS, the employee account monitoring system used by Merrill Lynch, was programmed to automatically monitor accounts of employees based on the use of their social security number, but was inadequate in that it failed to automatically capture employee and employee-interested accounts if a tax identification was used instead or if the social security number of an employee on record was not the primary number for the account. FINRA found that Merrill Lynch should not have relied solely on employees' reporting of such accounts.

3. FINRA alleged that due to the inadequate monitoring system, a registered Merrill Lynch employee opened a Merrill Lynch business account using a business tax identification number and was able to facilitate a Ponzi scheme involving 11 individual investors who invested more than $1 million for over ten months while Merrill Lynch failed to monitor and identify suspicious withdrawal and deposit activity in the employee's business account. In addition to the faulty monitoring system, Merrill Lynch failed to review the employee's proof of business and verify approval to engage in outside business activities prior to authorizing the employee's business account. The employee has been permanently barred from the industry.

4. Merrill Lynch consented to a censure and a fine of $1 million.

5. In setting the sanction, FINRA noted that Merrill Lynch discovered the employee's misconduct and took remedial actions by fully compensating harmed investors, transitioned from EARS to a new monitoring system, and developed an account reconciliation tool to perform regular checks of the new account monitoring system.

K. *Wells Fargo Advisors, LLC* ("WFA") *(Dec.* 2011)

1. FINRA settled a matter with WFA in which FINRA alleged that from at least October 2005 to September 2008, WFA failed to establish, maintain and enforce adequate written supervisory procedures for its Escheatment Group ("Escheatment") addressing the restoration of abandoned accounts.

2. WFA considered an account to be abandoned upon receipt by the firm of three returned account statements by the postal service. The firm's procedures required that employees wishing to restore customer accounts from an abandoned status send a written request to Escheatment to restore the account, but such employees did not need to obtain supervisory approval. Upon receipt of the written request, and based solely upon the representations contained therein, Escheatment restored the account to an active status and notified only the requestor that the account had been restored to an active status.

3. FINRA found that after the restoration of an abandoned account, the requestor was required to submit an address change request with the customer's new address to the firm's New Accounts Group. Upon receipt of these requests, the firm changed the address of record of the restored account and sent letters confirming the change of address to both the customer's new and old address, although the old address was invariably an invalid address.

4. FINRA alleged that the firm's deficient procedures facilitated a firm operations manager's conversion of approximately $850,000 in customers' funds from 11 retail accounts for her personal use and enabled the operations manager's conduct to escape detection by the firm.

5. WFA consented to a censure and a fine of $350,000.

Trading Practices

NYSE Regulation had always brought a steady stream of cases regarding market-on-close and limit-on-close orders. Last year FINRA brought such an action on behalf of NYSE Regulation.

A. *SG Americas Securities, LLC* ("SG Americas") (May 13, 2011)

1. FINRA, on behalf of NYSE Regulation, settled a matter with SG Americas in which FINRA alleged that between October

2008 and June 2009, SG Americas failed to: (i) comply with requirements governing cancellation of market-on-close ("MOC") and limit-on-close ("LOC") orders; (ii) adhere to principles of good business practice; and (iii) reasonably supervise and implement adequate controls to comply with MOC and LOC order requirements.

2. MOC and LOC orders are designed to purchase or sell listed securities at the NYSE closing price. During the relevant period, no MOC or LOC orders could be entered except to offset a published imbalance after 3:40 p.m., MOC and LOC orders were irrevocable except to correct legitimate errors between 3:40 p.m. and 3:50 p.m., and no MOC and LOC orders could be canceled after 3:50 p.m.

3. SG Americas' trading system included a feature that allowed traders to use a single keystroke to cancel large numbers of orders at once, and included a block on routing LOC and MOC orders to the NYSE after 3:40 p.m. FINRA alleged that upon implementation of trading system enhancements, SG Americas neglected to re-enable the MOC and LOC blocks on the single-keystroke cancellation feature. As a result, during the relevant period, approximately 7,800 MOC and LOC orders were canceled after the prescribed deadlines.

4. FINRA alleged that SG Americas failed to adhere to the principles of good business practice when it failed to re-enable its blocks or take other appropriate remedial action to prevent future violation, even after certain traders, supervisors, IT staff and a compliance officer became aware of the disabled blocking system. SG Americas did not re-enable the blocking system until a day after it was contacted by NYSE Regulations' Division of Market Surveillance on June 16, 2009.

5. FINRA also alleged that SG Americas failed to provide reasonable supervision in that it did not have a system or procedure, including a follow up review process, designed to detect possible MOC and LOC violations.

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

7. In determining the sanction, FINRA noted that although SG Americas had been subject to disciplinary action in June 2007 for MOC and LOC violations, it continued to lack systems or procedures and a follow up process to detect such violations until March 2009, and failed to re-enable its

blocks to prevent late cancellations of MOC and LOC orders after upgrading its system. FINRA also took into consideration that after being contacted by Market Surveillance, SG Americas promptly took remedial action.

Variable Life Settlements

In 2010, the SEC published a staff report regarding, among other things, the risks of investments in life settlements. Similarly, FINRA appeared focused on this issue from an enforcement perspective. In early 2011, FINRA resolved a case in this area.

A. *USA Advanced Planners, Inc., et al.* ("USAAP") (Jan. 2011)

1. FINRA settled a matter with USAAP in which it alleged that between September 2005 and April 2007, USAAP, acting through its registered principals Michael Rodman and Dennis Tubbergen, effected five variable life settlement transactions[59] in which it charged customers, who ranged in age from 69 to 81 years old, excessive commissions.

2. FINRA alleged that USAAP failed to disclose the source and amount of remuneration it received in connection with the life settlement transactions. USAAP received commissions for each of the transactions that ranged from 17% to 36% of the highest gross offer for the variable life policy, and in turn paid approximately 90% of that amount to the registered principals.

3. FINRA also alleged that USAAP did not provide the customers with a confirmation of each transaction.

4. FINRA further alleged that USAAP's supervisory systems, including its written supervisory procedures, were not reasonably designed to achieve compliance with FINRA rules related to the firm's variable life settlement business.

5. USAAP and Tubbergen consented to a censure, Rodman consented to a 10-day suspension, and USAAP and Rodman were ordered to pay, jointly and severally, partial restitution to customers of $351,995 plus interest. Of that amount, $52,647 was imposed jointly and severally against all three respondents for the transaction that involved the 36% commission. USAAP is also paying all of its outstanding shareholder equity to the five customers as

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[59] A life settlement involves the sale of an existing life insurance policy to a third party for more than the policy's cash surrender value but less than the net death benefit.

partial restitution, and consequently will have no remaining assets to distribute to its stockholders at its pending dissolution.