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review

Select Broker-Dealer, Investment Adviser, and Investment Company Enforcement Cases and Developments: 2012 Year in Review

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TABLE OF CONTENTS

Page

Executive Summary 1
The SEC 1
FINRA 3
U.S. Securities and Exchange Commission 6
Personnel Changes 6
Enforcement Statistics 10
A High Volume of Enforcement Actions 10
"National Priority" or "High Impact" Cases 11
Categories of Cases 11
Penalties, Disgorgement, and Distributions to Injured Investors 12
Financial Crisis-Related Cases 12
Reasons Behind the Numbers 13
Supreme Court Set to Decide Important Statute of Limitations Issue 13
Office of the Whistleblower 15
Continued Controversy Over the SEC's "No Admit or Deny" Policy 17
Additional Scrutiny of SEC Settlements 20
Focus on Individuals 21
Update on Collateral Bars 21
SEC Suffers Two Significant Trial Losses 22
Commissioner Aguilar Calls for More Robust Enforcement by the SEC 23
The Stronger Enforcement of Civil Penalties Act of 2012 24
Supervisory Liability for Legal and Compliance Officers 26
Criticism of Defense Counsel Tactics 28
Broker-Dealer Enforcement Actions 28
Auction Rate Securities 28
Fraudulent Trading Schemes 30
Initial Public Offerings and Private Offerings 32
Insider Trading 36
Marketing and Sales of Collateralized Debt Obligations 42
Markups 47

TABLE OF CONTENTS
(continued)

Page

- Mortgage-Backed Securities 50
- Municipal Bond Actions 54
- Mutual Fund Cases 56
- Research Analysts 58
- Registration 60
- Securities Exchanges and Alternative Trading Systems 61
- Short Selling 64
- Supervision 66

Enforcement Priorities for Broker-Dealers 69

Enforcement Actions against Investment Advisers and Investment Companies 70

- Anti-Bribery and Pay-to-Play 70
- Best Execution 71
- Compliance Policies and Procedures 72
- Failure To Disclose Conflicts Of Interest 76
- Insider Trading 79
- Market Manipulation 82
- Misappropriation of Client Assets and Fraudulent Trading Schemes 85
- Misrepresentations and False Statements 88
- Performance Advertising 91
- Select Investment Company Cases 95
- Valuation of Assets 99

Enforcement Priorities Regarding Investment Advisers and Investment Companies 103

Financial Regulatory Authority 105

Personnel Changes 105

Enforcement Statistics 105

Referrals of Potential Fraudulent Conduct 106

Credit for Extraordinary Cooperation 106

Targeted Examination Letters and Sweeps 107

FINRA Takes Action Against Ongoing Frauds 108

TABLE OF CONTENTS
(continued)

Page

Cooperation with Foreign Regulators 110
Current FINRA Broker-Dealer Enforcement Priorities 110
Broker-Dealer Enforcement Actions 111
- Advertised Trade Volume 111
- Anticompetitive Activities 113
- Anti-Money Laundering 114
- Arbitration 115
- High-Frequency Trading 118
- Leveraged and Inverse Exchange-Traded Funds 118
- Markups and Markdowns 119
- Mortgage-Backed Securities 120
- Municipal Securities 122
- Mutual Funds 123
- Options Origin Codes 124
- Record Retention 126
- Regulation SHO 126
- Regulatory Reporting 127
- Research Reports 129
- Structured Products 131
- Suitability 132
- Supervision 136
- TRACE Reporting 143

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 2012.[*]

The SEC

The SEC again brought a high number of enforcement actions in FY 2012.[1] Down just one case from FY 2011's record, the Commission filed 734 enforcement actions last year. Senior SEC officials credit the reorganization and reforms put in place in the Division of Enforcement over the last few years for the near record, while at the same time noting that the actions represent increasingly complex and diverse cases.[2] In FY 2012, the SEC also obtained orders requiring the payment of $3 billion in penalties and disgorgement, an 11% increase from the amounts ordered in FY 2011. In sum, the metrics used to measure the SEC's enforcement activity clearly demonstrate that the Commission continues to aggressively enforce the securities laws. At the same time, the Commission and some of its critics both called for even more aggressive measures and legislative changes to enhance the SEC's penalty authority.

Some of the key statistics from FY 2012 are set forth below:

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1 The SEC's fiscal year begins on October 1. References to FY 2012 are to the year that commenced on October 1, 2011 and ended on September 30, 2012.

2 Commission press release, "SEC Enforcement Program Continues to Show Strong Results in Safeguarding Investors and Markets," *available at*: http://www.sec.gov/news/press/2012/2012-227.htm.

- Last year, the Commission brought 734 enforcement actions, just one case less than the 735 initiated in FY 2011.

- 150 actions were designated as National Priority cases, an approximately 30% increase from FY 2011.

- In FY 2012, the SEC brought 58 insider trading cases, one more than in the prior year.

- The SEC filed 29 actions related to the financial crisis, up 6 from the 23 filed in FY 2011, representing a 26% increase versus the prior year.

- Continuing the trend in one of the Commission's principal areas – regulation of broker-dealers and investment advisers/investment companies – the SEC brought more actions against such regulated entities last year than in FY 2011. The Commission initiated 134 actions against broker-dealers, compared to 113 in FY 2011. This represents an approximately 19% increase year-over-year. The SEC also topped the number of actions filed against investment advisers and investment companies, bringing 147 such cases in FY 2012, one more than the record number filed in the previous year. Combined, the statistics reinforce the notion that the Commission continues to focus on regulated entities; last year cases against broker-dealers, investment advisers and investment companies accounted for 38% of the SEC's docket.

- The Commission's Office of the Whistleblower was fully up and running in FY 2012 and received 3,001 tips, complaints and referrals from whistleblowers in all 50 states and 49 foreign countries. The SEC also made its first award to a whistleblower who helped the Commission stop a multimillion dollar fraud.

In addition to the high number of cases brought last year, perhaps the other big headline at the SEC was the significant personnel departures after the reelection of President Barack Obama. Chairman Mary Schapiro announced that she was leaving the agency in November; then-Commissioner Elisse Walter was appointed the new Chair. Ms. Schapiro's leaving was promptly followed by announcements that the Directors of the Division of Corporation Finance and the Division of Trading and Markets, the SEC's General Counsel and Chief of Staff were all departing the Commission. In early January 2013, the Director of the Division of Enforcement also announced his exit from the agency. As this Outline went to press, President Obama announced that he was nominating Mary Jo White to become the next Chair of the Commission; some view this as a signal that the SEC will continue to aggressively enforce the securities laws. This year will be a year of change at the Commission with a new Chair and senior staff appointed to fill these vacancies.

Turning to other key developments, late last year the U.S. Supreme Court granted certiorari in *Gabelli v. Securities and Exchange Commission* that will

determine when, in civil SEC enforcement cases, an action "accrues" for statute of limitations purposes. Oral argument was heard in January 2013; a decision is expected by June.

The SEC's "no admit or deny" settlement policy continued to be a source of controversy. The Second Circuit Court of Appeals began its review of the opinion by Judge Jed Rakoff of the Southern District of New York in the *Citigroup* matter; a ruling should be forthcoming this year. Other judges have also raised concerns about certain SEC settlements.

Senior Commission officials and some members of Congress sought to increase the SEC's penalty authority last year. The Stronger Enforcement of Civil Penalties Act of 2012, which would substantially increase the amount of penalties the SEC could levy on wrongdoers, was proposed in Congress but has not yet been acted upon.

A long-running but important supervisory case involving a broker-dealer's General Counsel came to a conclusion in early 2012, without offering any guidance concerning the definition of a supervisor. Later in the year, Commissioner Daniel Gallagher expressed a desire for the Commission to more realistically define the contours of what it means to be a supervisor.

Last year, the SEC brought broker-dealer cases in matters arising out of the financial crisis, including actions involving mortgage-backed securities and the marketing and sales of collateralized debt obligations. As it has traditionally done, the Commission was also active in the fraud, insider trading and short-selling areas. In the asset management space, it continued to focus on misrepresentations in the marketing and sales of advisory services, failure to disclose conflicts of interest, mutual fund fee arrangements and valuation of assets. Finally, the SEC continued to show interest in cases against securities exchanges and alternative trading systems.

These developments and cases are described in more detail on pages 6 through 104 of this Outline.

FINRA

Last year, FINRA reported two records in its enforcement program: it brought more disciplinary actions (1,541) and ordered more restitution to investors ($34 million) than ever before. In fact, many of the traditional metrics used to measure FINRA's enforcement activity showed increases from 2011.[3]

Turning to the specifics, in 2012, FINRA filed 1,541 new disciplinary actions against firms and individuals, up from 1,488 cases from the prior year – an

[3] In contrast to the SEC, FINRA's fiscal year follows the calendar year; statistics for FINRA reflect the period January 1, 2012 through December 31, 2012. Unless otherwise noted, FINRA's 2012 statistics are taken from its press release "2012: Year in Review."

increase of 3.6% and, as noted, a record since FINRA was established in 2007. FINRA also resolved 1,370 formal actions last year; in 2011, it had concluded 1,287 such cases. Last year, FINRA expelled 30 firms from its membership (compared to 21 in the prior year), barred 294 people (versus 329 in 2011) and suspended 549 individuals (an increase over the 475 such actions in the prior year).

FINRA reported that, in 2012, it had imposed fines of more than $68 million versus almost $63 million in the prior year. FINRA also ordered firms and individuals to provide more than $34 million in restitution to customers; in 2011, such orders totaled $19 million. Again, the 2012 restitution figure was a record and represents an almost 79% increase year-over-year.

In line with the increased number of cases and overall fine levels, cases with significant penalties against firms increased in 2012 when compared to 2011. Our analysis reflects that last year FINRA increased the number of cases in which it imposed fines greater than $100,000 to 79 from 70 in the prior year. That represents an almost 13% increase. This increase is particularly noteworthy at the highest level where FINRA imposed fines of more than $1.5 million in 13 cases compared to 10 such cases in 2011 (an increase of 30%).[4]

In sum, FINRA brought more cases, subjected a significant number of registered representatives to harsh discipline, levied higher fines, and ordered a record amount of money to be returned to injured investors.

In other developments in 2012, FINRA continued its focus on referring potential instances of fraud that fell outside of its jurisdiction to the appropriate regulatory agency. As part of this effort, the Office of Fraud Detection and Market Intelligence referred 692 matters concerning potential fraudulent conduct to the SEC and other law enforcement agencies.

Although we have not undertaken an empirical analysis of all of FINRA's settlements, anecdotally it appears that the staff is willing to include references to firm-initiated actions in its settlements and to note the fact that such steps had been taken into account by FINRA in resolving the matter. For example, at least eight cases described in the summaries below contain such information.

In 2012, FINRA posted five Targeted Examination Letters on its website. These sweeps involve conflicts of interest, Alternative Trading Systems, communications relating to nontraded REITs, the prohibition against trading ahead of customer orders and business continuity plans put into use as a result of Hurricane Sandy. Such inquiries show the breadth of concerns at FINRA last year.

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[4] These statistics were derived from our review of FINRA's monthly "Disciplinary and Other FINRA Actions Publications" and news releases issued between January and December 2012.

As in the past, last year, FINRA actively investigated matters involving anti-money laundering, structured products, mutual fund sales practices, record retention, regulatory reporting, research report disclosures and supervision and concluded cases against firms in each of these areas. It also returned to previous areas of interest, including advertised trade volume and mortgage-backed securities. FINRA opened new fronts in the customer arbitration and options order-marking areas.

These developments and cases are described in more detail on pages 105 through 145 of this Outline.

Personnel Changes[5]

As typically happens in an election year, the SEC had a number of personnel changes in 2012, the most notable coming in November, when Chairman Mary Schapiro announced that she would step down effective December 14, 2012. Ms. Schapiro served as the Commission's chairman for almost four years during the most difficult years of the global financial crisis. In the enforcement area, Ms. Schapiro oversaw a revamping of the SEC's enforcement and examination programs in the wake of scandals like the Madoff and Stanford schemes and led the Commission to a record number of enforcement actions. President Obama appointed then-current Commissioner Elisse B. Walter to succeed Ms. Schapiro as SEC Chair. Additionally, and as detailed below, the SEC's Directors of the Division of Enforcement, Division of Corporation Finance, and the Division of Trading & Markets, its Chief of Staff, and its General Counsel all announced their departures following President Barack Obama's reelection.

- On January 9, 2013, Enforcement Director Robert Khuzami announced that he was leaving the SEC. Mr. Khuzami became the Enforcement Director in 2009 and initiated a significant restructuring of that Division and led his staff in bringing a record number of enforcement actions. Before joining the SEC, Mr. Khuzami was General Counsel for Deutsche Bank Americas and had also served as a federal prosecutor for 11 years in the Southern District of New York.

- December 2012 saw the following departures and appointments in senior executive positions:

    - **Division of Corporation Finance**: On December 4, 2012, the Commission announced that Meredith B. Cross, Director of the Division of Corporate Finance, would leave the SEC at the end of the year. Ms. Cross served in her position since June 2009 and played a key role in implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), the Consumer Protection Act, and the JOBS Act.

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

On December 17, 2012, Lona Nallengara was named the Division's Acting Director. Mr. Nallengara served as the Deputy Director for Legal and Regulatory Policy of the Division since March 2011. Prior to joining the SEC, Mr. Nallengara was in private legal practice.

- **Division of Trading & Markets**: Also in December, Robert W. Cook, Director of the Division of Trading and Markets, announced that he would leave the SEC. Mr. Cook joined the Commission in 2010 and worked to oversee the implementation of substantial rulemaking required by the financial crisis-related legislation.

  On December 17, 2012, the SEC announced that John Ramsay would be the Division's Acting Director. Mr. Ramsay was the Deputy Director for the Division since September 2010. Prior to joining the SEC, Mr. Ramsay was in the private sector and also worked at the SEC from 1989 to 1994, the Commodity Futures Trading Commission ("CFTC"), and the NASD.

- **General Counsel**: On December 5, 2012, the SEC announced that Mark D. Cahn, General Counsel, would leave the Commission at the end of the year. Mr. Cahn had been in his role since February 2011. Prior to that time, he served as Deputy General Counsel for two years. Before joining the SEC, Mr. Cahn was in private legal practice.

  On January 7, 2013, Chairman Walter announced that Geoffrey Aronow would succeed Mr. Cahn and would join the SEC at the end of January. Mr. Aronow comes to the SEC from private practice, and previously served as the Director of the Division of Enforcement at the CFTC from 1995 to 1999.

- **Chief of Staff**: The Commission announced on December 12, 2012 that SEC Chief of Staff Didem A. Nisanci was leaving the SEC. Ms. Nisanci has served in that post since March 2009. Prior to joining the SEC, she was the Staff Director for the U.S. Senate banking Subcommittee on Securities, Insurance, and Investment.

- Lorraine B. Echavarria was promoted in November to lead the Los Angeles Regional Office's enforcement program as an Assistant Regional Director. Ms. Echavarria has been with the SEC since 2000 and has served as an Assistant Regional Director for five years and in the Enforcement Division's national Municipal Securities and Public Pension Specialized Unit for more than two years. Before joining the SEC, Ms. Echavarria was in private legal practice. She succeeded Michele Wein Layne who was named Director of the Los Angeles office.

- In October 2012, Andrew M. Calamari was named Director of the New York Regional Office. Mr. Calamari has been with the SEC since 2000, when he started as a staff attorney. Prior to his time at the Commission, he was in private law practice. Mr. Calamari succeeded George Canellos, who became Deputy Director of the Division of Enforcement earlier in 2012.

- On September 12, 2012, Andrew J. Bowden was named Deputy Director of the Office of Compliance Inspections and Examinations. Mr. Bowden started at the SEC in November 2011 as the National Associate Director for OCIE's Investment Adviser/Investment Company Examination Program. Prior to joining the SEC, he worked in the private sector. Mr. Bowden succeeds Norm Champ, who was appointed to lead the Division of Investment Management.

- In August, the SEC announced that Robert E. Plaze, Deputy Director of the Division of Investment Management, was retiring after an almost-30-year career with the SEC. Mr. Plaze joined the Commission in 1983 as a Division of Investment Management attorney and was later a Special Counsel, Assistant Director, Associate Director for Regulatory Policy, and Deputy Director.

- On July 19, 2012, it was announced that Michele Wein Layne had been named Regional Director of the Los Angeles Regional Office. Ms. Layne has been with the SEC for 17 years and had been an Associate Regional Director for Enforcement since 2005.

- On July 16, 2012, the Commission announced that Paul A. Beswick had been appointed as the Acting Chief Accountant in the Office of the Chief Accountant. Mr. Beswick has been with the SEC since 2007 and, prior to that time, was a partner at Ernst & Young LLP. Mr. Beswick replaced James L. Kroeker, who left the SEC in July of 2012.

- Also in July, Paula Drake was appointed as an Associate Director to serve as Chief Counsel and Chief Compliance and Ethics Officer in the Office of Compliance Inspections and Examinations. Prior to joining the SEC, Ms. Drake was in private practice, most recently as General Counsel and Chief Operating Officer at Oechsle International Advisors, LLC.

- On July 5, 2012, the SEC announced that Norm Champ was named Director of the Division of Investment Management. Since 2010, Mr. Champ served as the Deputy Director of the Office of Compliance Inspections and Examinations. Mr. Champ succeeded Eileen Rominger who in June announced her retirement from the SEC.

- In July, Ken C. Joseph was promoted to lead the Investment Adviser/Investment Company Examination Program in the New York Regional office. Mr. Joseph has been with the SEC for 16 years, most

recently serving as an Assistant Director in the Enforcement Division's Asset Management Unit.

- On May 30, 2012, the SEC appointed Jon T. Rymer to serve as Interim Inspector General until a permanent appointment could be made. Mr. Rymer's most recent position was as Inspector General of the Federal Deposit Insurance Corporation, which he will continue during his time at the SEC. Mr. Rymer replaced Noelle Maloney, who returned to her previous position as Deputy Inspector General.

- On May 17, 2012, the SEC announced that James R. Burns had been appointed as Deputy Director in the Division of Trading and Markets. Mr. Burns was on Chairman Schapiro's staff since March 2010 and most recently served as Deputy Chief of Staff. He replaced James Brigagliano, who left the SEC for the private sector.

- In April, the Commission named George S. Canellos Deputy Director of the Division of Enforcement. He had most recently been the Director of the New York Regional Office since 2009. Mr. Canellos has also served as an Assistant U.S. Attorney in the Southern District of New York and practiced law in the private sector.

- Also in April, Matthew C. Solomon was appointed Deputy Chief Litigation Counsel of the Division of Enforcement. Prior to his appointment, Mr. Solomon was a federal prosecutor, serving as the Chief of the Fraud Unit in the U.S. Attorney's Office for the District of Columbia since 2010. Before the U.S. Attorney's Office, Mr. Solomon was a prosecutor in the Public Integrity Section of the Criminal Division at the U.S. Department of Justice.

- On March 2, 2012, the Commission announced the appointment of Marshall Gandy as the Associate Regional Director for Examinations in the Fort Worth Office. Since 2008, Mr. Gandy was a Senior Regional Counsel at FINRA. Before that time, he was a trial counsel and enforcement attorney at the SEC, the Presiding Judge in a Dallas criminal court and an Assistant District Attorney in Dallas County.

- On January 17, 2012, Jane A. Norberg was appointed Deputy Chief of the Office of the Whistleblower. Before joining the SEC, Ms. Norberg practiced law in the private sector for 14 years. Prior to that time, she was a special agent for the U.S. Secret Service where she worked with confidential informants concerning federal crimes including bank fraud, counterfeiting, and forgery.

- On January 5, 2012, it was announced that Administrative Law Judge Robert. G. Mahony was retiring after 46 years in government service, 14 of them spent at the SEC. Before coming to the Commission, Judge

Mahony was an ALJ for 20 years at the Department of Labor and started his career as a trial lawyer in the U.S. Justice Department.

This year will likely be a year of change at the Commission in light of these departures and the appointment of new senior staff.

Enforcement Statistics

Down just one case from FY 2011's record number, the Commission filed 734 enforcement actions last year. Senior SEC officials credit the reorganization and reforms put in place in the Division of Enforcement over the last few years for the near record, while at the same time noting that the actions represent increasingly complex and diverse cases.[6] In FY 2012, the SEC also obtained orders requiring the payment of $3 billion in penalties and disgorgement, an 11% increase from the amounts ordered in FY 2011. Additional statistical information is outlined below.[7]

A High Volume of Enforcement Actions

Last year, the Commission brought 734 enforcement actions, just one less case from the 735 initiated in FY 2011, which was the highest number ever filed by the SEC. Here are the number of cases brought by the SEC since FY 2004:

Fiscal Year	Number of Enforcement Actions
2004	639
2005	630
2006	574
2007	656
2008	671
2009	664
2010	681
2011	735
2012	734

[6] "SEC Enforcement Program Continues to Show Strong Results in Safeguarding Investors and Markets," *available at*: http://www.sec.gov/news/press/2012/2012-227.html.

[7] To date, the SEC has published statistical information about its Enforcement program in a press release and its 2012 annual report. At the time of the publication of this Outline in late January 2013, the Commission had not yet published its annual Select SEC and Market Data report, which contains more detailed statistical information.

“National Priority” or “High Impact” Cases

The SEC once again emphasized “National Priority” or “High Impact” actions, which the Commission hopes will garner significant attention, serve as a deterrent, and provide guidance to regulated entities. 150 actions were designated as National Priority cases, an approximately 30% increase from FY 2011, when 85 of the SEC’s 735 enforcement actions were National Priority cases.

Categories of Cases

The major categories of cases and the number of actions within each are as follows:

Type of Case	Number of Actions	% of Total Actions
Investment Advisers/Investment Companies	147	20%
Broker-Dealer	134	18.3%
Delinquent Filings	127	17.3%
Securities Offering Cases	89	12.1%
Financial Fraud/Issuer Disclosure	79	10.8%
Insider Trading	58	7.9%
Market Manipulation	46	6.3%
FCPA	15	2%
Other	39	5.3%

Of particular note, continuing the trend in one of the Commission’s principal areas – regulation of broker-dealers – last year the SEC brought 134 actions concerning broker-dealers compared to 113 in FY 2011. This represents an approximately 19% increase year-over-year. This is in keeping with the big jump (a 60% increase) in broker-dealer enforcement cases between FY 2010 and FY 2011. The SEC also increased the number of actions filed against investment advisers and investment companies, bringing 147 such cases in FY 2012, one more than the record number filed in the previous year. Taken together, it is clear that the SEC devoted significant resources toward investigating regulated entities last year; cases in that area represent almost 40% of the Commission’s FY 2012 docket.

As can be seen above, in FY 2012, the SEC brought 58 insider trading cases, one more than in the prior year. This is consistent with the SEC’s aggressive stance on insider trading.

Penalties, Disgorgement, and Distributions to Injured Investors

In FY 2012, the SEC obtained orders requiring the payment of $3 billion in penalties and disgorgement, an 11% increase from the amounts ordered in FY 2011 and the highest since FY 2006.

Below is a chart reflecting the amount of fines and disgorgement orders obtained by the Commission between FY 2004 and FY 2012.

Fiscal Year	Penalties and Disgorgement
2004	$3.1 billion
2005	$3.1 billion
2006	$3.275 billion
2007	$1.6 billion
2008	$1.03 billion
2009	$2.435 billion
2010	$2.85 billion
2011	$2.806 billion
2012	$3 billion

Financial Crisis-Related Cases

In FY 2012, the SEC continued to pursue actions related to the financial crisis. Last year, the Commission filed 29 such actions, which was a 26% increase over FY 2011.[8] As of January 9, 2013, according to the SEC's statistics, overall the Commission has brought charges against 153 individuals and entities, including 65 CEOs, CFOs, and other senior officers in financial crisis-related cases. These actions have resulted in more than $2.6 billion in penalties and disgorgement, and 36 individuals have been barred from the securities industry, from serving as officers and directors of public companies, and/or from practicing or appearing before the Commission.[9] Media reports suggest that the SEC's actions in this area may begin to decline in the coming year as the agency faces statute-of-limitations issues in these matters.[10]

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[8] Fiscal Year 2012 Agency Financial Report, at 125.

[9] "SEC Enforcement Actions Addressing Misconduct That Led to or Arose From the Financial Crisis." *available at*: http://www.sec.gov/spotlight/enf-actions-fc.shtml.

[10] *See* "Clock Is Ticking on Crisis Charges," Jean Eaglesham and Jeannette Neumann, and Reed Albergotti, Wall Street Journal (July 11, 2012); "Clock Ticking for SEC to Pursue Charges Over Financial Crisis," Dina ElBoghdady, Washington Post (July 20, 2012). Notably, the U.S. Supreme Court recently heard oral arguments in the case *Gabelli v. SEC* on the issue of when the statute of

Reasons Behind the Numbers

As discussed above, FY 2011 and 2012 were record years for the SEC in terms of the number of enforcement cases brought. The penalties and disgorgement imposed by the Commission were also at near-record highs. In a recent speech, Chairman Schapiro attributed those numbers to several factors, including:[11]

- A more aggressive enforcement program. Chairman Schapiro noted that a change in internal policy which allowed staff to initiate investigations and settlement negotiations without full Commission approval allowed for a more nimble staff and additional cases to be brought.[12]

- A restructured Division of Enforcement. The creation of five specialized units with expertise in key areas, as well as an upgrade in technology, allowed the Enforcement staff to dig deeper and more quickly into a variety of matters.

- Increased collaboration. Chairman Schapiro noted that the SEC continued to work closely with the FBI, Justice Department, and other regulators.[13] After Dodd-Frank, the staff is also seeing increased collaboration with state regulators, particularly in the area of private fund oversight.

In sum, the metrics used to measure the SEC's enforcement activity clearly demonstrate that the Commission continues to enforce the securities laws aggressively.

Supreme Court Set to Decide Important Statute of Limitations Issue

In September 2012, the U.S. Supreme Court granted certiorari in an important case that will determine when, in civil SEC enforcement cases, an action "accrues" for statute-of-limitations purposes. *Gabelli v. Securities and Exchange Commission*, 11-1274 (cert. granted, Sept. 25, 2012). The *Gabelli* case arises from market timing charges that the SEC levied in April 2008 against two employees of a hedge fund adviser who allegedly permitted a customer to engage in frequent trading in a mutual fund without disclosing the trading or investment to the fund's board of directors. In its April 2008 lawsuit, the SEC alleged that the employees aided and abetted the fund's violation of Section 206 of the Investment Advisers Act of 1940, and sought, among other relief, civil penalties against the employees.

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limitations starts to run in civil fraud cases. "Supreme Court to Hear Gabelli Appeal of SEC Civil Fraud Penalties," Dina ElBoghdady, Washington Post (Jan. 1, 2013). This case is described below.

[11] "Remarks at the 2012 New England Securities Conference," Chairman Mary L. Schapiro (Oct. 11, 2012).

[12] *Id.*

[13] *Id.*

Although the trading at issue ended almost six years before the SEC brought suit, the Commission sought to avoid the five-year statute of limitations set forth in 28 U.S.C. § 2462 by arguing that it had not discovered the basis for its claim until late 2003, when the New York Attorney General's office disclosed that it was investigating several mutual funds for market timing. Section 2462 is a "catch-all" provision that applies to any action for a civil penalty or fine brought by the United States, and thus applies to SEC civil actions.

The United States District Court for the Southern District of New York disagreed with the SEC, and dismissed the agency's claim for aiding and abetting insofar as it sought civil penalties on the grounds that the claim was time-barred. *SEC v. Gabelli*, No. 08-CV-3868, 2010 WL 1253603 (S.D.N.Y. Mar. 17, 2010). In dismissing the claim, the District Court declined to read a "discovery rule" into Section 2462.

In 2011, however, the United States Court of Appeals for the Second Circuit reversed the dismissal and sided with the SEC, holding that the aiding and abetting claim did not accrue until after the Commission discovered facts regarding the alleged fraud. *SEC v. Gabelli*, 653 F.3d 49 (2d Cir. 2011). The Second Circuit agreed with the SEC's position that a special discovery rule should be read into Section 2462 for claims "sounding in fraud" because all fraud is self concealing. In so holding, the Second Circuit stated that "it would be unnecessary for Congress to expressly mention the discovery rule in the context of fraud claims, given the presumption that the discovery rule applies to these claims unless Congress directs otherwise." *Id.* at 60.

The Supreme Court's consideration of this issue is timely given the decision reached by the United States Court of Appeals for the Fifth Circuit over the summer in *SEC v. Bartek*, No. 11-10594, 2012 WL 3205446 (5th Cir., Aug. 7, 2012). In an unpublished opinion, the Fifth Circuit found that, contrary to the SEC's argument (and the Second Circuit's opinion in *Gabelli*), "Congress did not include language to toll [Section 2462] based on an accrual discovery rule." *Id.* at *3. It reiterated that under Section 2462, "first accrued" means the date of the violation. The Fifth Circuit also followed the approach taken by the DC Circuit in *SEC v. Johnson*, 87 F.3d 484, 489-90 (D.C. Cir. 1990) by looking at the "stigmatizing effects" beyond the sanction itself in determining what constituted a "penalty" under Section 2462. It found that the imposition of injunctive relief and officer and director bars "would have a stigmatizing effect and long-lasting repercussions" on the defendants, and thus are punitive and subject to the five year limitations period. *Id.* at *6.

Arguments before the Supreme Court in the *Gabelli* case occurred on January 8, 2013. At the oral argument, the Justices appeared inclined to rule against the SEC, and observed that the Commission could not cite to a single case supporting its position that the limitations period does not begin until it is

reasonably able to detect the fraud.[14] Justices from across the ideological spectrum, including Justices Kagan and Scalia, appeared skeptical of the SEC's case.[15] A decision on the case is expected by June 2013.

This case will be important to watch because a ruling in favor of the SEC would permit it to bring fraud claims well after the conduct occurred without making any showing that the conduct was fraudulently concealed from the agency and that it diligently pursued the claim. For individuals or entities facing an SEC investigation, such a ruling would permit the agency to seek penalties in perpetuity. Important documents may no longer exist and key witnesses will have lost recollection of certain events that are the subject of the investigation. This could prolong the SEC's inquiry or make the agency more willing to pursue an otherwise stale investigation. For example, as we come up on the fifth anniversary of the most significant events in the 2008 financial crisis, how the Supreme Court rules in the *Gabelli* case should determine whether the SEC closes the book on that chapter in its enforcement program or continues pursuing financial crisis cases in its pipeline. A ruling against the SEC, moreover, will equip individuals and entities under investigation for years-old conduct with a powerful tool to defend those matters.

Office of the Whistleblower[16]

In 2011, the Commission approved final rules to implement the whistleblower provisions of the Dodd-Frank Act. The program officially became effective on August 12, 2011.

As part of the Dodd-Frank whistleblower provisions, the SEC was required to set up an Office of the Whistleblower ("OWB"), which it did in early 2011. The OWB is part of the Division of Enforcement and on February 18, 2011, Sean X. McKessy was appointed its head. On January 17, 2012, Jane A. Norberg was appointed Deputy Chief of the OWB.

In FY 2012, its first full fiscal year, the OWB received 3,001 tips, complaints, and referrals from whistleblowers in all 50 states, the District of Columbia, Puerto Rico and 49 foreign countries. Most of the complaints fell into three categories: corporate disclosure and financials (18.2%), offering fraud (15.5%), and manipulation (15.2%). The number of allegations received by the SEC in these and other categories is presented below.

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14 "Supreme Court Skeptical of SEC Power in Gabelli Case," Sarah N. Lynch and Jonathan Stempel, Reuters (Jan. 8, 2013).

15 *Id.*

16 Unless otherwise noted, the information in this section was taken from the following sources: "SEC Receives More Than 3,000 Whistleblower Tips in FY2012" (Nov. 15, 2012), *available at*: http://www.sec.gov/news/press/2012/2012-162.htm#; "Annual Report on the Dodd-Frank Whistleblower Program: Fiscal Year 2012" (Nov. 2012), *available at*: http://www.sec.gov/news/studies/2010/whistleblower_report_to_congress.pdf

Allegation Type	Number of Allegations	Percentage of Total Allegations
Corporate Disclosure and Financials	547	18.2%
Offering Fraud	465	15.5%
Manipulation	457	15.2%
Insider Trading	190	6.3%
Trading and Pricing	144	4.9%
FCPA	115	3.8%
Unregistered Offerings	100	3.3%
Market Event	85	2.8%
Municipal Securities and Public Pension	64	2.1%
Other	703	23.4%
Blank	131	4.4%

Last year, the SEC made its first award to a whistleblower who helped the Commission stop a multimillion dollar fraud. The whistleblower, who has declined to be identified, received $50,000, which represents 30% of the amount collected in the related SEC enforcement action. This is the maximum percentage that can be paid out under the whistleblower program. According to the SEC, the whistleblower provided documents and other information to the SEC, which helped the investigation move more quickly and prevented more people from becoming victim to the fraud. The court in which the SEC filed the matter imposed $1 million in sanctions, approximately $150,000 of which had been collected as of August 2012. Final judgment with respect to other defendants in the case is still pending. If additional sanctions are ordered, the whistleblower will receive an increased award.[17] Lastly, it is interesting to note that another whistleblower involved in the matter was denied an award because the information he provided did not lead to or significantly contribute to the SEC's enforcement action.

The OWB's annual report to Congress outlined the process by which whistleblower tips are evaluated. First, tips received by mail and fax are input into the Tips, Complaints, and Referrals System (the "TCR System"). (Whistleblowers can enter their tips on-line via the TCR questionnaire.) Next, the Office of Market Intelligence ("OMI") evaluates the TCRs and determines which

[17] "SEC Issues First Whistleblower Program Award," (Aug. 21, 2012), *available at:* http://www.sec.gov/news/press/2012/2012-162.htm.

should be sent to the Enforcement staff for investigation. Such tips must be specific, timely, and credible.

TCRs that are connected to ongoing matters are usually sent to the relevant staff. Tips that involve specific expertise are forwarded to the appropriate SEC Division or Office. If a tip falls into the jurisdiction of another federal or state agency, it is sent to the SEC contact at the agency, as long as doing so is consistent with Dodd-Frank's confidentiality requirements. TCRs that relate to the financial concerns of a specific investor or discrete group and that do not warrant SEC investigation are referred to the Office of Investor Education and Advocacy ("OIEA"). Comments and questions about SEC policies or federal securities laws are also sent to the OIEA.

The OWB is also involved in the process of evaluating TCRs. OWB enters TCRs received by mail and fax into the System and may contact the whistleblower for additional information. OWB staff may also help in determining which tips should be investigated and may also act as a liaison between the whistleblower and the investigating staff. The OWB also works with the Enforcement staff regarding documentation of the interaction with whistleblowers and the assistance provided by the whistleblowers.

Finally, the OWB report indicated that there were 143 judgments and orders issued last year that could qualify for a whistleblower award.

Continued Controversy Over the SEC's "No Admit or Deny" Policy

In 2011, the SEC's settlement practices were subject to serious criticism from the judiciary. Judge Jed Rakoff of the Southern District of New York led the attack, taking issue with the SEC's practice of allowing defendants to settle without admitting or denying the allegations, but also requiring that defendants not publicly deny the charges. As Judge Rakoff wrote:

> 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 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.[18]

Judge Rakoff again had occasion to deal with this issue in the SEC's $285 million settlement with Citigroup concerning charges that it had negligently misled investors in connection with its 2007 structuring and sale of a CDO tied to the housing market.[19] In rejecting the settlement in a November 28, 2011 opinion, Judge Rakoff found the settlement 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. Judge Rakoff wrote that the settlement offers little to the public, and nothing to the SEC besides "a quick headline." Judge Rakoff ordered the parties to be ready for trial in the summer of 2012.

The SEC and Citigroup appealed Judge Rakoff's decision, with Enforcement Director Robert Khuzami calling the ruling "unprecedented" and harmful to investors. On March 15, 2012, the United State Court of Appeals for the Second Circuit granted a stay of the district court proceedings pending the resolution of the appeal. Although the opinion granting the stay was not a final determination on the merits, the Second Circuit found that the SEC and Citigroup had a likelihood of success in overturning Judge Rakoff's ruling. Among other points, the Second Circuit stated that the district court did not "appear to have given deference to the SEC's judgment on wholly discretionary matters of policy." The Second Circuit further doubted "that a court's discretion extends to refusing to allow [a private, sophisticated litigant] to reach a voluntary settlement in which it gives up things of value without admitting liability," and did not think that it "lies within a court's proper discretion to reject a settlement on the basis that liability has not been conclusively determined."[20] The appeal is ongoing.

While the battle over the Citigroup settlement continues, one year ago Mr. Khuzami announced a significant change in the SEC's "no admit or deny" policy in cases involving parallel criminal actions. In a January 2012 statement, Mr. Khuzami advised that, in those cases, the Commission will not allow a settling defendant to neither admit nor deny the allegations in an SEC action while simultaneously admitting to a criminal violation or entering into a deferred prosecution agreement with the Justice Department. In such cases, the SEC settlement will note the admissions made in the parallel criminal case. Since the announcement of this new policy, the SEC has omitted the "no admit or deny" language from at least 27 cases in which there were parallel criminal proceedings.[21]

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18 *SEC v. Vitesse Semiconductor Corp., et al.*, 10-Civ-9239 (S.D.N.Y. Mar. 21, 2011).

19 *SEC v. Citigroup Global Markets Inc.,* 1:11-cv-07387-JSR.

20 *SEC v. Citigroup Global Markets Inc.*, 11-5227-cv (2d. Cir. Mar. 15, 2012).

21 *See* "Assessing the SEC's New 'Neither Admit Nor Deny Policy,'" Mei Lin Kwan-Gett, New York Law Journal (Oct. 9, 2012). This article provides an excellent analysis of this issue.

Against this backdrop of SEC and judicial tension, Congress announced that it would hold hearings to study this issue.[22] In May 2012, Mr. Khuzami testified before the U.S. House of Representatives Committee on Financial Services.[23] In his testimony, Mr. Khuzami stated that settlement "serves the important goals of accountability, deterrence, investor protection, and compensation to harmed investors."[24] Moreover, when settlement was utilized appropriately, it allows the SEC to protect investors effectively and efficiently by (i) eliminating the delay and uncertainty that litigation can entail; (ii) providing public accountability close in time to the violations; (iii) enabling prompt payment of restitution to injured investors; and (iv) allowing the SEC to preserve it resources that can be devoted to preventing fraud.

Given the benefits of settlement, Mr. Khuzami expressed his belief that the SEC's "neither admit nor deny" policy was necessary to accomplish those goals. Specifically, he stated that

> There is little dispute that if "neither-admit-nor-deny" settlements were eliminated, and cases could be resolved only if the defendant admitted the facts constituting the violation, or was found liable by a court or jury, there would be far fewer settlements, and much greater delay in resolving matters and bringing relief to harmed investors. The reality is that many companies likely would refuse to settle cases if they were required to affirmatively admit unlawful conduct or facts related to that conduct. … At a minimum, the risks of increased civil and criminal liability that flow from an admission in an SEC action are sufficiently real that defendants are highly unlikely to settle, if at all, until those risks have passed or are quantified and deemed acceptable.[25]

Mr. Khuzami went on to say that while the Commission was not sympathizing with alleged securities violators, there were "very real costs of refusing to settle cases where we otherwise have obtained most or all of the sanctions and other remedies available to compensate and protect harmed members of the public."[26]

Mr. Khuzami was also quick to point out, however, that the SEC recognized that to obtain appropriate settlements, it is necessary for defendants to know that the SEC is prepared to litigate cases. He noted that the Enforcement Division had

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

23 Robert Khuzami, "Testimony on 'Examining the Settlement Practices of U.S. Financial Regulators'" (May 17, 2012), *available at:* http://www.sec.gov/news/testimony/2012/ts051712rk.htm.

24 *Id.*

25 *Id.*

26 *Id.*

improved its ability to bring cases to trial and that 75% of the SEC's financial crisis-related cases filed against individuals were filed as litigated actions. Further,

> Our record of litigation victories – we have prevailed against defendants in 84 percent of our trials since the beginning of fiscal year 2010 – sends a strong message to defendants and those who may contemplate securities law violations in the future. This approach seems to be working. A recent independent study by NERA Economic Consulting concluded that the median monetary value of the Commission's settlements in fiscal [year] 2011 was at or near its highest levels since the enactment of the Sarbanes-Oxley Act in 2002. All of the above metrics – more litigated cases, more trial victories and higher monetary settlements – support the conclusion that we settle a case when it makes sense to do so, and litigate when it does not.[27]

Additional Scrutiny of SEC Settlements

In addition to the debate over the SEC's "no admit or deny" policy, 2012 saw continued concern expressed by federal court judges regarding SEC settlements. For example, Judge Richard J. Leon of the Washington, D.C. District Court has delayed a settlement between the SEC and IBM for nearly two years because of his demands for additional disclosure from the company. The settlement concerns IBM's alleged violations of the Foreign Corrupt Practices Act ("FCPA") and requires IBM to pay $10 million, $2 million of which is a civil monetary penalty. Judge Leon has demanded that IBM issue annual reports concerning its FCPA compliance and any potential accounting violations. The SEC and IBM have objected to such requirements, stating that they would be too difficult for the company. The settlement has not yet been approved.

Additionally, in June 2012, Judge Frederic Bloc of the United States District Court for the Eastern District of New York begrudgingly approved the SEC's settlement with two former Bear Stearns hedge fund managers. Although the fund managers, Ralph Cioffi and Matthew Tannin, were acquitted in 2009 of parallel criminal charges, they agreed, without admitting or denying the SEC's allegations, to pay $800,000 and $250,000, respectively, to settle the SEC's civil case. Cioffi also agreed to be barred from the securities industry for three years, while Tannin was barred for two years.

Judge Bloc initially questioned the settlement and expressed strong reservations about it, calling it "chump change" in light of the conduct alleged in the SEC's complaint and the losses suffered by investors.[28] However, he eventually

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[27] *Id.*

[28] "Cioffi, Tannin Settlement with SEC Approved by U.S. Judge," Patricia Hurtado, Bloomberg (June 18, 2012).

concluded that he was "constrained to accept the settlement" because of the "limited powers that Congress has afforded the SEC to recoup investor losses."[29]

Focus on Individuals

Continuing a trend, the SEC remains focused on the potential liability of individuals in its investigations. In enforcement actions coming out of the financial crisis, as noted above, the Commission has charged 65 senior corporate officers over the last several years. A recent study noted that the total number of settlements with individuals reached 537 in FY 2012, representing a 14% increase from the prior year and the highest level since FY 2005.[30] That same analysis also revealed that median settlement values for individuals have more than doubled since FY 2009, moving from $103,000 to $221,000.[31] Consistent with this data, based upon the summary of the cases in our Outline, in FY 2012, when charging broker-dealers, the SEC often also brought cases against individual employees. Nevertheless, critics of the agency remain dissatisfied, and have complained that the Commission has not acted aggressively enough against individuals.[32]

Update on Collateral Bars

In last year's Outline, we wrote about an April 2011 case in which 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.[33] 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. Dodd-Frank amended Section 203(f) of the Advisers Act 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"), not just an investment advisor, as was previously permitted by the Advisers Act.

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

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[29] *Id.*

[30] NERA Economic Consulting "SEC Settlement Trends: 2H12 Update," (Jan. 14, 2013).

[31] *Id.*

[32] *See* "Weighing SEC's Crackdown on Fraud," Jean Eaglesham, The Wall Street Journal (Apr. 11, 2012).

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

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.

The Division of Enforcement appealed Judge Murray's decision, and in December 2012, the Commission held that the two bars were not impermissibly retroactive, distinguishing between those penalties that are prospective and those that are designed to punish for past misconduct or remedy past harms.[34] In finding that the collateral bars in question in this matter were prospective (and therefore permitted) and overturning Judge Murray's ruling, the Commission stated that its "bars are authorized to protect the investing public from the respondent's possible future actions by restricting access to other areas of the securities industry where a demonstrated propensity to engage in violative conduct may cause further investor harm." Accordingly, the Commission barred Lawton from association with an investment adviser, broker, dealer, municipal securities dealer, municipal advisor, transfer agent or NRSRO.

SEC Suffers Two Significant Trial Losses

Despite the Commission's success in many litigated matters, the agency suffered two high-profile defeats in 2012, both arising out of the financial crisis. First, and as described later in this Outline, in July 2012, a jury found that a former Citigroup employee, Brian Stoker, was not liable for allegedly misleading marketing materials he prepared relating to a CDO that Citigroup issued in 2007. The SEC alleged that Citigroup failed to disclose that it helped pick the underlying mortgage bonds in the CDO and then bet that the CDO's value would decline. When the housing market collapsed, the CDO defaulted but Citigroup made a profit on its short position.

Stoker argued that the purchasers of the CDO were sophisticated investors who were not misled about Citigroup's interest in the security. In finding Stoker not liable, the jury issued an unusual note accompanying its verdict in which it stated that "this verdict should not deter the SEC from continuing to investigate the financial industry, to review current regulations, and modify existing regulations as necessary." Citigroup's settlement with the SEC based on the same CDO is the subject of the ongoing appeal, described above, of Judge Rakoff's rejection of the settlement because Citigroup neither admitted nor denied the allegations in the SEC's complaint.

The SEC's second high-profile loss came in November 2012, when a jury found the principals of the Reserve Primary Fund not liable for fraud charges relating to the near-collapse of that money-market mutual fund. In May of 2009, the SEC filed a civil complaint against the individuals and operating entities connected

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[34] *In the Matter of John W. Lawton*, Opinion of the Commission, Administrative Proceeding File No. 3-14162 (Dec. 13, 2012).

with the Reserve Primary Fund, including Bruce Bent Sr. and Bruce Bent II, who were co-managers of the Fund.[35] The SEC alleged that the defendants had committed fraud by not providing material facts to investors concerning the potential impact on the Fund of Lehman Brothers Holdings, Inc. bankruptcy on September 15, 2008. The net asset value of the Reserve Primary Fund, a money-market fund, fell below $1.00 per share on September 16, 2008.

According to the SEC, the Fund held $785 million in Lehman-issued securities that became illiquid on September 15, thus preventing the Fund from meeting redemption requests. The defendants allegedly told investors that the Reserve Management Company, Inc. would provide credit support to protect the $1.00 net asset value of the Fund, when it did not intend to do so. Additionally, the SEC charged that Reserve Management Company, Inc. understated the number of redemption requests that the Fund was receiving and did not provide the trustees with accurate information about the value of the Lehman securities.

On November 12, 2012, a jury found the Bents not liable for fraud.[36] Mr. Bent II was found liable for negligence concerning statements to investors. Reserve Management Company, Inc., the Fund's investment adviser, was found liable for two claims of fraud and one claim of negligence. The Fund's broker-dealer distribution company was found liable for one claim of fraud.[37]

The SEC has asked for a new trial of the Bents.[38]

Commissioner Aguilar Calls for More Robust Enforcement by the SEC

In an October 2012 speech, Commissioner Aguilar outlined three efforts he believed the SEC could undertake to enhance its ability to prosecute those who violate the securities laws and improve the public's confidence in the capital markets.[39]

- First, there should be greater individual accountability in the cases the SEC brings. Commissioner Aguilar pointed to the actions brought against 115 individuals in connection with the financial crisis as a positive development, but questioned whether individuals were adequately held accountable when charges were pursued against an entity. He asked: "Are we creatively and aggressively looking for ways to hold every

[35] *SEC v. Reserve Management Company, Inc., Resrv Partners, Inc., Bruce Bent Sr. and Bruce Bent II,* Civ. Action No. 09-cv-4346 (S.D.N.Y. May 5, 2009).

[36] *See* "Reserve Primary Managers Cleared in SEC Fraud Case," Kirsten Grind and Julie Steinberg, The Wall Street Journal (Nov. 12, 2012); "Money-Market Pioneer and Son Cleared of Fraud," Nathaniel Popper and Jessica Silver-Greenberg, The New York Times (Nov. 12, 2012).

[37] *Id.*

[38] "SEC to Seek New Trial for Bents," Kirsten Grind, The Wall Street Journal (Dec. 13, 2012).

[39] "Taking a No-Nonsense Approach to Enforcing the Federal Securities Law," Commissioner Luis A. Aguilar, Securities Enforcement Forum 2012 (Oct. 18, 2012).

responsible individual, regardless of title, accountable for violations of the federal securities laws in an entity? And more importantly, is the SEC sending the wrong message in those cases when it charges an entity with wrongdoing without charging an individual for misconduct?"

- Second, the SEC should impose penalties that have a "maximum" deterrent effect. Commissioner Aguilar highlighted three that the SEC may use:
  - Permanent officer and director bars;
  - Collateral industry bars; and
  - Sufficient monetary penalties.
- Finally, Commissioner Aguilar stated that the SEC should monitor recidivists. One way to do this would be for the Commission to impose more robust sanctions on recidivists, including post-sanction monitoring, which may involve unscheduled office visits, access to phone records, and scheduled self-reporting.

The Stronger Enforcement of Civil Penalties Act of 2012

Last year, then-Chairman Schapiro expressed frustration with the limitations on the SEC's penalty authority.[40] Ms. Schapiro recognized that despite imposing harsh penalties and obtaining substantial disgorgement, the Commission's fines were not high enough to create a deterrent effect. In a Fall 2012 speech, she observed:

> [T]he SEC can only force wrongdoers to disgorge their ill-gotten gains and impose a per-violation penalty of up to $150,000 per violation by an individual, or up to $725,000 by an entity. But, in most cases – particularly those involving large financial institutions – the maximum penalty is equal only to the amount of the wrongdoer's ill-gotten gains.
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> We are not permitted to base our penalties on how much investors have lost.[41]

The above calculation applies in both administrative and civil actions. In civil actions, another fine calculation is also available: "the gross amount of pecuniary gain to [the] defendant as a result of the violation."[42]

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40 "Speech by SEC Chairman: Remarks at the 2012 New England Securities Conference," (Oct. 11, 2012).

41 *Id.;* Securities Exchange Act of 1934 ("Exchange Act") §§ 21(d)(3) and 21B(b).

42 Exchange Act § 21(d)(3)(B).

To address this issue, in the summer of 2012, Senators Jack Reed and Chuck Grassley introduced the Stronger Enforcement of Civil Penalties Act of 2012 (the "SEC Penalties Act").[43] Under the SEC Penalties Act, the SEC could impose a fine of $1 million per violation for individuals and $10 million per violation for firms. Additionally, in a substantial change to existing law, the SEC Penalties Act would allow the SEC to impose penalties for each violation up to the greater of $1 million for individuals or $10 million for firms, three times the gross pecuniary gain, or the losses incurred by investors in connection with the violation.[44]

Moreover, regarding defendants who are recidivists, the SEC Penalties Act would permit the SEC to triple the penalty limits for those defendants who have violated the federal securities laws or were subject to SEC administrative relief within the past five years.[45]

The proposed legislation has met with enthusiastic support from some on the Commission. In encouraging the passage of the SEC Penalties Act, Commissioner Aguilar emphasized its deterrent effects:

> The bill will provide the SEC with more tools to demand meaningful accountability from individuals and entities involved in misconduct.
>
> The power to impose higher penalties will enhance the effectiveness of the Commission's Enforcement program by more effectively deterring individual and corporate violators. Enhanced penalties will also allow the Commission to better structure its settlements to compensate investors for actual harm suffered, match the penalty amount to the severity of the alleged violation, and enhance its bargaining power in settlement negotiations.

Speaking in support of the bill, Chairman Schapiro focused on victim compensation with a nod to Judge Bloc's criticism of the SEC's settlement of the Cioffi/Tannin action:

> Last summer, a federal judge questioned our ability to deter violators and compensate victims when he approved an SEC settlement, saying that it represented "chump change" for the offending firm. After reviewing the SEC's legal authority, however, the judge altered his tone, noting in his decision the "limited powers that Congress has afforded the SEC to

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43 S-3416 "Stronger Enforcement of Civil Penalties Act of 2012," *available at:* http://www.govtrack.us/congress/bills/112/s3416/text.

44 "Taking a No-Nonsense Approach to Enforcing the Federal Securities Law," Commissioner Luis A. Aguilar, Securities Enforcement Forum 2012 (Oct. 18, 2012); S-3416 "Stronger Enforcement of Civil Penalties Act of 2012," *available at:* http://www.govtrack.us/congress/bills/112/s3416/text.

45 *Id.*

> recoup investor losses." Wisely, he added, "Congress may wish to consider broadening the SEC's power to recover amounts more reflective of investor losses."
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> I agree.[46]

Congress has not yet acted on the SEC Penalties Act.

Supervisory Liability for Legal and Compliance Officers

In the wake of the 2012 decision *In the Matter of Theodore W. Urban*,[47] supervision may once again be on the SEC's agenda. By way of background, in our 2009 Outline, we reported on settled proceedings brought against Ferris, Baker Watts, Inc. ("Ferris"), its former CEO, its former director of retail sales and a registered representative, Stephen Glantz ("Glantz"), who was engaged in market manipulation.

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

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

The Division of Enforcement petitioned the Commission for a review of the dismissal; Urban cross-petitioned for a review of Chief Judge Murray's ruling that he was Glantz's supervisor. Urban also petitioned for the Commission to summarily affirm Chief Judge Murray's decision. On December 7, 2010, the Commission denied Urban's motion because "a normal appellate process" rather than a summary affirmance was appropriate as "the proceeding raises important legal and policy issues, including whether Urban acted reasonably in supervising Glantz and responded reasonably to indications of his misconduct, whether

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46 "Speech by SEC Chairman: Remarks at the 2012 New England Securities Conference," (Oct. 11, 2012).

47 Admin Proc. No. 3-13655 (Jan. 26, 2012).

securities professionals like Urban are, or should be, legally required to "report up," and whether Urban's professional status as an attorney and the role he played as FBW's general counsel affect his liability for supervisory failure."

On January 26, 2012, the Commission announced that it was evenly divided as to whether the allegations against Urban had been adequately established, and so under its rules dismissed the case against him. Thus, the Commission passed on an opportunity to clarify when someone becomes a supervisor for purposes of failure to supervise liability.

More recently, SEC Commissioner Gallagher has expressed a desire to define more realistically who may be considered a supervisor and what his or her responsibilities are.[48] In a Fall 2012 speech, Commissioner Gallagher argued for more clarity in determining which individuals were supervisors and the standards to which they should be held.

> Optimal supervision requires a framework that encourages in-house legal and compliance officers to depart, when necessary, from the safety of black and white categorizations of who is and who is not a supervisor as well as what a supervisor is expected to do. Our failure to supervise regulatory regime should be a series of guideposts and safe harbors, not a minefield.

At the same time, he noted that the current enforcement regime encourages legal and compliance professionals to do nothing, rather than risk doing the "wrong" thing.

> [T]he individual who fails to act at all in a potentially supervisory role should be more worried about being held liable for the actions he or she *should* take but doesn't than should the individual who steps in and takes action in good faith, even if the results of those actions ultimately prove to be less than optimal.
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> It means we need failure to supervise liability to mean what it says – we should be more concerned with addressing the *failure* to supervise at all than with second-guessing those who act. It should be riskier to do nothing in bad faith than to take action in good faith. … We don't want a world in which legal and compliance personnel are in such fear of being held liable for mistakes that they keep an impeccable record

[48] "Keynote Address at the National Society of Compliance Professionals National Meeting," Commissioner Daniel M. Gallagher (Oct. 23, 2012).

by standing back and doing nothing when the occasion calls for a supervisor to step in and make a tough call.

It will be interesting to see how this important issue for legal and compliance professionals plays out in 2013 with a new Commission and new senior staff.

Criticism of Defense Counsel Tactics

In our 2011 Outline, we reported on Robert Khuzami's speech to the Criminal Law Group of the UJA-Federation of New York, in which he addressed a number of defense counsel tactics that he deemed to be of concern, including multiple representations, instances of witnesses answering "I don't recall" dozens or hundreds of times in testimony, including in response to basic questions, 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.

These concerns carried over into 2012. Some SEC officials have claimed that lawyers (both in-house and outside counsel) have obstructed several investigations, and more frequently, have coached clients to "forget" information.[49] Mr. Khuzami has said that "the problem of less-than-candid testimony … is a serious one."[50] The head of the structured products enforcement unit, Kenneth Lench, said that the SEC "needed to 'seriously consider' charges against lawyers in 'appropriate cases'" and that he had seen "some factual situations where I seriously question whether the advice that was given was done in good faith."[51]

Although the SEC must consider whether such charges would have a chilling effect on a lawyer's representation of his client, it is clear that attorney conduct is an area that the SEC will continue to scrutinize.

Broker-Dealer Enforcement Actions[52]

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 litigated action that was dismissed in 2011, only to be revived by an appellate court in 2012.

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[49] "Legal Eagles in Cross Hairs," Jean Eaglesham, The Wall Street Journal (Apr. 30, 2012).

[50] *Id.*

[51] *Id.*

[52] 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.

A. *SEC v. Morgan Keegan & Company, Inc.* ("Morgan Keegan"), No. 11-13992 (May 2, 2012, 11 Cir.)

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. Last year, U.S. District Judge William Duffey granted Morgan Keegan's motion for summary judgment in this case. In 2012, however, the United States Court of Appeals for the Eleventh Circuit revived the SEC's case and sent the case back to the trial court.

2. In an opinion issued on May 2, 2012, the Appeals Court found that Judge Duffey erred in concluding that alleged misrepresentations made by Morgan Keegan brokers about the ARS market were not material. In the lower court ruling, the Court 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 found 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."

3. In overturning this ruling, the Appeals Court found that the SEC can seek relief for "any violation of the securities laws, no matter how small or inconsequential." Therefore, Morgan Keegan could be found liable for even a single misstatement or omission, if material and made with scienter and in connection with the purchase or sale of securities. The Appeals Court found that the SEC is not required to prove an institution-wide effort by brokers to mislead customers in order to bring or prevail in an SEC enforcement action. Although the extent of the misrepresentations may ultimately affect the size of the remedy, it is not relevant to whether a violation occurred.

4. The Appeals Court further concluded that the lower court erred in finding that the oral misrepresentations made by Morgan Keegan's brokers were immaterial as a matter of law in light of the firm's written disclosures to customers. The Appeals Court concluded that because the disclosures were not given directly to customers but were distributed only in "weak or non-effective" means, the brokers' misleading statements could be considered material.

5. The case now will return to the District Court for further proceedings.

Fraudulent Trading Schemes

Although the Commission has historically pursued a wide array of fraudulent trading schemes, in 2012 the SEC's Market Abuse Unit focused its attention on manipulative trading known as "layering." These cases show that the SEC is more aggressively rooting out misconduct that affects the pricing of securities in today's high-frequency trading environment.

A. *In the Matter of Hold Brothers On-Line Investment Services, LLC, et al.*, Admin. Proc. File No. 3-15046 (Sept. 25, 2012)

1. The SEC filed a settled administrative proceeding against a broker-dealer, its principals, and two affiliates involving manipulative conduct known as "layering."

2. Layering concerns the use of non-bona fide orders, or orders that a trader does not intend to have executed, meant to induce others to buy or sell a security at a price not representative of actual supply and demand. A trader engages in layering when he or she places a bona fide order on one side of the market and simultaneously places numerous non-bona fide orders on the opposite side of the market for the purpose of attracting interest to the bona fide order. The non-bona fide orders are meant to induce other market participants – typically those that operate using algorithmic trading models – to execute against the bona fide order at a price not representative of the actual market. After the bona fide order is executed, the trader cancels the open, non-bona fide orders.

3. The SEC charged broker-dealer Hold Brothers On-Line Investment Services, LLC ("Hold Brothers") and two affiliates with permitting day traders to engage in layering. According to the SEC's Order, these traders entered into more than 325,000 layered transactions, which corresponded to the entry of more than 8 million layered orders. This conduct occurred from January 2009 through September 2010.

4. The SEC accused Hold Brothers, its two affiliates, and its three principals of knowing that the day traders who traded through accounts at Hold Brothers were engaged in layering, but failing to adequately monitor for and investigate the activity.

5. The SEC further observed that broker-dealers like Hold Brothers that provide access to the markets must ensure that they have policies and procedures and systems of controls in place that are reasonably designed to ensure compliance with all regulatory requirements, including the requirement to identify and prevent abusive trading practices. The broker-dealer must also address such activity in an appropriate and timely manner.

6. By violating these requirements, the SEC alleged that Hold Brothers and its two affiliates violated, and Hold Brothers' principals aided and abetted violations of, Section 9(a)(2) of the Exchange Act, which prohibits manipulative conduct. The SEC also accused Hold Brothers and its principals of failing to supervise the traders who engaged in layering.

7. In addition, the SEC charged Hold Brothers with violating rules requiring broker-dealers to provide information to the SEC promptly, based on findings that Hold Brothers failed to produce subpoenaed order information to SEC investigators for several months. Finally, the SEC charged Hold Brothers with failing to file Suspicious Activity Reports based on the layering activity.

8. The settlement ordered Hold Brothers to pay disgorgement of $629,167, prejudgment interest of $9,285.22, and a penalty of $1,887,500. The Hold Brothers' affiliate that operated its trading business was ordered to pay disgorgement of $1,258,333. Hold Brothers' principals, Steven Hold, Robert Vallone, and William Tobias, were each ordered to pay a penalty of $75,000, barred from the securities industry for periods ranging from two to three years, and Steven Hold was barred from acting as a supervisor for three years.

9. In a related FINRA case, *Hold Brothers On-Line Investment Services, LLC* (Sept. 25, 2012), Hold Brothers consented to a censure, a fine of $5,916,667 ($2,516,667 of which was to be paid to the SEC as a fine and disgorgement), and an undertaking requiring the retention of an Independent Consultant to review the Firm's policies, systems and procedures, and training concerning anti-money laundering, trading, sponsored access, direct market access, compliance with a related SEC Rule, day trading, and the use of foreign traders.

B. *In the Matter of Biremis Corporation, Peter Beck and Charles Kim*, Admin. Proc. File No. 3-15136 (Dec. 18, 2012)

1. Later in 2012, the Commission brought a similar case involving layering against broker-dealer Biremis Corp. ("Biremis") and its two principals. Biremis also settled its case with the SEC.

2. Biremis operated a worldwide day trading business that contained as many as 5,000 traders around the globe. The SEC's action alleged that Biremis and its principals failed reasonably to supervise day traders who repeatedly used Biremis' order management system to engage in layering on the U.S. securities markets. Contrary to their supervisory obligations and despite repeated indications of this practice, Biremis and its President and

Chief Executive Officer Peter Beck failed to establish procedures or a system for applying procedures that would reasonably be expected to prevent and detect the traders' manipulative trading.

3. In addition, Beck and Biremis Vice President Charles Kim, who had supervisory authority over the traders, both failed to respond to repeated red flags indicative of layering. Finally, Biremis failed to file Suspicious Activity Reports regarding the manipulative trading and failed to retain instant messages related to its broker-dealer business.

4. In settling the case, Biremis agreed to the revocation of its registration with the Commission as a broker-dealer, and Beck and Kim agreed to be barred from the securities industry. Beck and Kim also agreed to each pay a civil penalty of $250,000.

5. In July, FINRA brought a related case against Biremis and Beck, *Biremis, Corp., Peter Beck* (July 31, 2012). Biremis consented to an expulsion from FINRA membership and Beck agreed to a bar from association with any FINRA member firm in any capacity.

Initial Public Offerings and Private Offerings

Below are two interesting cases involving alleged misconduct in connection with IPOs and private offerings.

A. *In the Matter of SharesPost, Inc. and Greg B. Brogger*, Admin. Proc. File No. 3-14800 (Mar. 14, 2012)

1. The SEC commenced a settled administrative proceeding against SharesPost, Inc. ("SharesPost"), a Utah-based online platform facilitating pre-IPO stock transactions, and its founder and president Greg B. Brogger, alleging that SharesPost and Brogger violated the broker-dealer registration provision of the federal securities laws.

2. The SEC contended that SharesPost acted as a broker-dealer by holding itself out to the public as an online service that matched buyers and sellers of pre-IPO stock and charged members a fee to access the platform. Further, SharesPost entered into agreements with registered representatives of other broker-dealers for those representatives to hold themselves out as SharesPost employees. These "Company Specialists" were assigned certain issuers' online bulletin boards – such as social media companies or green tech companies – and assisted potential buyers and sellers with transactions for those issuers in exchange for a commission. The SEC Order further alleged that the "Company Specialists" entered into agreements with SharesPost whereby they would pay 35% of

the gross commissions they received to a broker-dealer designated by SharesPost.

3. According to the SEC Order, SharesPost's online platform was used to create an auction process for interests in funds managed by a SharesPost affiliate and designed to buy stock in pre-IPO companies.

4. SharesPost and Brogger consented to cease-and-desist orders, an $80,000 civil penalty for SharesPost, and a $20,000 civil penalty for Brogger.

B. *In the Matter of Daniel Bogar, Bernerd E. Young and Jason T. Green*, Admin. Proc. File No. 3-15003 (Aug. 31, 2012); *In the Matter of Jason A. D'Amato*, Admin. Proc. File No. 3-15004 (Aug. 31, 2012); *In the Matter of Jay T. Comeaux*, Admin. Proc. File No. 3-15002 (Aug. 31, 2012)

1. On August 31, 2012, the SEC issued settled and unsettled administrative and cease-and-desist proceedings against various executives associated with Stanford Group Company ("SGC"), the Houston, Texas-based broker-dealer arm of Allen Stanford's Ponzi scheme, in connection with SGC's fraudulent sale of CDs. First, the SEC instituted unsettled administrative proceedings against SGC's former President, Daniel Bogar, former Chief Compliance Officer, Bernerd Young, and former President of its Private Client Group, Jason Green. Second, the SEC brought a settled administrative proceeding against Bogar's predecessor, Jay T. Comeaux. Finally, the SEC brought an unsettled administrative proceeding against Jason A. D'Amato, who oversaw SGC's proprietary mutual fund wrap program.

2. SGC – through its offering documents – made three material representations to investors that enabled Stanford to engage in his Ponzi scheme. First, SGC represented that liquidity was a key feature of the underlying CD investment portfolio. Second, SGC represented that the issuing bank maintained comprehensive depositor insurance. Third, SGC represented that the issuing bank paid SGC a 3% fee for marketing the CDs.

3. According to the SEC's unsettled Order against Bogar, Young and Green, the SGC executives knew or were reckless in not knowing that these three representations were false. The SEC alleged that they knew that the issuing bank for the CDs refused to allow SGC to review its investment portfolio – including analyzing whether the portfolio was truly liquid. The SGC executives also knew that the issuing bank did not maintain private insurance to protect depositors. Finally, the SGC executives knew, or were reckless in not knowing, that the issuing bank paid SGC at least six times the

referral fee to which it was entitled for marketing the CDs to investors. Despite this knowledge, the executives reviewed and approved the offering documents that SGC registered representatives used to market the CDs to U.S. investors.

4. The SEC further alleged that Bogar, Young and Green knew about and endorsed incentives provided to SGC's registered representatives to push Stanford CDs on investors. According to the SEC Order, SGC did not offer any incentives to registered representatives for the sale of any other products. Green was further alleged to have made misleading statements in sales pitches for the CDs to U.S. investors.

5. The settled proceeding against Comeaux alleged that he similarly failed to confirm Stanford's representations about the safety of its CDs and the liquidity of its investment portfolio, and therefore lacked a reasonable basis to recommend the CDs to SGC's customers. Comeaux was also alleged to have failed to disclose material conflicts of interest to SGC's customers arising from his financial interest in selling CDs to customers.

6. Finally, the SEC instituted unsettled administrative and cease-and-desist proceedings against D'Amato based on his allegedly fraudulent conduct. First, he lied about his credentials. Second, as a portfolio manager of a mutual fund, he misstated historical data in personalized proposal pitchbooks.

7. D'Amato lied about his credentials by falsely representing himself as a Chartered Financial Analyst ("CFA") on his business cards and e-mail signature block. According to the SEC, D'Amato fabricated an e-mail purportedly from the CFA Institute that congratulated him on passing the CFA exam and achieving charterholder status. In fact D'Amato failed the CFA exam.

8. D'Amato also misstated historical data in personalized proposal pitchbooks regarding the mutual fund wrap program he oversaw. These pitchbooks – which were used during one-on-one presentations to clients – had historical charts that tracked the mutual fund's performance against the S&P 500. The SEC alleged that D'Amato knew that the information on the historical charts was false, but he continued to use the pitchbooks. Specifically the SEC alleged that D'Amato could not verify the fund's performance data for years 2000 through 2004. Yet D'Amato chose to continue using those figures in pitchbooks under the label "Historical" as opposed to "Hypothetical."

9. The SGC executives, with the exception of Comeaux, are alleged to have violated Section 17(a) of the Securities Act, Sections 10(b)

and 15(c)(1) of the Exchange Act and Sections 206(1) and (2) of the Advisers Act. As for Comeaux, the SEC settled the proceeding whereby Comeaux consented to a cease-and-desist order, a bar from associating with any broker or dealer (with the right to reapply for association), certain undertakings and possible disgorgement and civil penalties to be determined at a future proceeding.

C. *In the Matter of Advanced Equities, Inc., Dwight O. Badger, and Keith G. Daubenspeck*, Admin. Proc. File. No. 3-15031 (Sept. 18, 2012)

1. The SEC filed a settled action against Dwight O. Badger, Keith G. Daubenspeck, and their registered broker-dealer and investment adviser Advanced Equities Inc. ("Advanced Equities"), in connection with misrepresentations, omissions and supervisory failures related to a $150 million late-stage private equity offering in 2009 and a follow-up offering in 2010 by an unnamed nonpublic alternative energy company located in the Silicon Valley, California ("the Energy Company").

2. The SEC alleged that Badger and Daubenspeck proposed to lead the Energy Company's $150 million offering. Daubenspeck and Badger suggested to the Energy Company that they would like to complete the offering during the month of January 2009, by raising the funds from a small number of high net-worth investors, who would each invest at least $20 million. However, Advanced Equities, Badger, and Daubenspeck subsequently realized that they would not be able to raise the entire $150 million from large investors, and needed to raise funds in smaller amounts.

3. Because the Energy Company would not accept direct investments in amounts less than $2 million, Advanced Equities established two limited liability companies through which investors could make investments as low as $25,000 ("the limited liability investors").

4. Advanced Equities, Badger, and Daubenspeck led the efforts to obtain these investments. Badger led at least 49 investor presentations and five internal sales calls (with Advanced Equities' brokers) regarding the Energy Company's offering. The SEC alleged that Badger made several significant misstatements about the Energy Company during these sales calls, including misstating the Energy Company's order backlog, misstating the size of a U.S. Government loan that the Energy Company had recently applied for (and falsely suggesting that Advanced Equities had already received the loan), and misstating the size of an order recently received by the Energy Company.

5. The SEC alleged that Daubenspeck was Badger's supervisor and was the Advanced Equities employee primarily responsible for

obtaining information from the Energy Company, for supervising investment bankers in conducting due diligence, and for sharing information with Badger for use in with Advanced Equities' brokers and investors. The SEC alleged that Daubenspeck failed to respond to red flags that indicated that Badger and other brokers were making misstatements to investors. The SEC alleged specifically that Daubenspeck participated in calls during which Badger made misstatements, but remained silent in the face of the misstatements and failed to take reasonable steps to follow up with investment bankers and the broker-in-charge to ensure that the misstatements were not repeated to investors.

6. The SEC's settled action alleged that Badger and Advanced Equities willfully violated Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933 ("Securities Act"), and that Daubenspeck failed reasonably to supervise Badger and certain other brokers with a view to detecting and preventing their violations.

7. Without admitting or denying the allegations, Advanced Equities agreed, among other things, to pay a $1 million penalty, retain an Independent Consultant, and implement a new internal training program and to use best efforts to locate purchasers for any of its customers who were in the group of limited liability investors and wish to sell their securities at a price equivalent to their original purchase price. Badger paid a penalty of $100,000 and was barred from the securities industry with the right to reapply for reentry after one year. Daubenspeck paid a $50,000 penalty and was suspended from association with a broker-dealer in a supervisory capacity for 12 months.

Insider Trading

In FY 2012, the SEC saw the fruits of the new technology and methods it has implemented in detecting insider trading. One of those tactics involves a database which was created by the SEC to house and process all of the tips and referrals the Commission receives. The Office of Market Intelligence, also a recent addition to the SEC, oversees and coordinates this database by reviewing tips, conducting preliminary investigations when appropriate, and providing the information to Enforcement.[53]

Additionally, the Market Abuse Unit within Enforcement uses statistical methods and computer programs to analyze trading patterns and relationships between

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[53] "With New Firepower, S.E.C. Tracks Bigger Game," Ben Protess and Azam Ahmed, The New York Times (May 21, 2012).

traders with similar patterns.[54] This allows the SEC to detect potentially suspicious trading that was not previously visible.[55]

As a result of these and other efforts, in FY 2012, the SEC brought 58 insider trading cases, one more than in the prior year. Several of these cases involved Wall Street professionals. These cases are described below.

A. *In the Matter of Spencer D. Mindlin and Alfred C. Mindlin, CPA*, Admin. Proc. File No. 3-14557 (Jan. 26, 2012)

1. In January 2012, the SEC settled an administrative proceeding it filed in September 2011 against Spencer D. Mindlin ("Spencer Mindlin"), a former Godlman Sachs employee, and his father, Arthur C. Mindlin ("Arthur Mindlin") involving insider trading in securities underlying an exchange-traded fund ("ETF").

2. The SEC's action related to the SPDR S&P Retail ETF ("XRT"), an equal-weighted ETF composed of a mix of U.S.-based apparel, automotive, and bargain retailers that was designed to replicate the S&P Retail Select Industry Index ("S&P Retail Index"). The SEC alleged that the Mindlins traded in securities that were to be added and deleted from the S&P Retail Index based on nonpublic information that Spencer Mindlin obtained in connection with his employment at Goldman Sachs.

3. According to the SEC's Order, Mindlin, who was employed on Goldman's Exchange-Traded Funds Desk ("ETF Desk"), obtained material nonpublic information concerning the plans of certain Goldman employees to purchase and sell large amounts of securities on behalf of Goldman in the securities underlying the XRT. The SEC further alleged that before Goldman placed buy orders in securities underlying the XRT, Spencer and Alfred Mindlin took long positions in those same securities. Conversely, immediately before Goldman placed large sell orders in securities underlying the XRT, Spencer and Alfred Mindlin took short positions in those same securities.

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[54] *Id.;* "Insider Trading Schemes Pursued With New Tools by Stock Cops," David Voreacos, Washington Post (Dec. 21, 2012).

[55] This technique is similar to one the SEC currently is using to investigate hedge fund performance. The Aberrational Performance Inquiry ("API") team is made up of staff members from various parts of the SEC and uses investment performance data, risk models, and other technology to identify hedge funds that may be engaging in fraudulent practices and that require additional review. The API program has been successful for the SEC and the Commission is poised to expand its use. In November, Merri Jo Gillette, director of the Chicago Regional Office said that the SEC was building its API team and resources and would apply its capabilities to other entities under the 1940 Investment Company Act and "beyond." "SEC to Export API Program To Other Enforcement Areas, Official Says," Yin Wilczek, BNA Broker/Dealer Compliance Report (Nov. 7, 2012). The SEC is also collaborating more with other regulators to gather documents and records to be used in this effort. *Id.*

4. The SEC alleged that Spencer Mindlin anticipated Goldman's trades by calculating the shares that Goldman would need to trade in order to hedge its XRT position. The SEC alleged that Spencer Mindlin's calculation of the shares Goldman needed to purchase to rebalance its hedge was "critical" nonpublic information.

5. Without admitting or denying the allegations, Spencer and and Alfred Mindlin agreed to disgorge $57,481 in profits from their insider trading scheme and pay $10,081 in prejudgment interest. Spencer Mindlin further agreed to pay a fine of $25,000 based on his inability to pay a greater penalty, and was barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or NSRO, with a right to reapply after three years.

6. Like the SEC's controversial case against Rajat K. Gupta, (Admin. Proc. File No. 3-14279 (March 1, 2011)), which it later dismissed in favor of a civil action, the case against the Mindlins was a rare administrative proceeding involving insider trading.

B. *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 2011, the SEC charged 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. In a parallel criminal proceeding, the United States Attorney's Office for the Southern District of New York charged Gupta with similar violations. *United States v. Gupta*, 11 Cr. 907 (JSR).

2. Both the SEC and the DOJ 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 Sachs' financial results from the second and fourth quarters of 2008. Because of the disclosure of this material, nonpublic information, the Galleon hedge funds were alleged to have made trades resulting in profits or loss avoidance in excess of $17 million.

3. The SEC and DOJ 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 were alleged to have made trades generating profits in excess of $570,000.

4. In June 2012, a jury found Gupta guilty of three counts of securities fraud and one count of conspiracy relating to the Goldman Sachs trades. The jury acquitted him of the charges relating to the P&G trades. Judge Jed Rakoff sentenced Gupta to two years in prison and ordered him to pay a $5 million fine. Gupta is appealing his conviction.

5. Although Gupta continues to contest the SEC charges against him, on December 27, 2012, the SEC announced that Rajaratnam had agreed to pay approximately $1.3 million in disgorgement and $147,738 in prejudgment interest to resolve the claims arising from the profits gained and losses avoided by the Galleon funds as a result of Gupta's tips.

C. *SEC v. Waldyr Da Silva Prado Neto*, 12-CV-7094 (S.D.N.Y. Sept. 20, 2012); *SEC v. Igor Cornelsen and Bainbridge Group, Inc.*, 12-CV-08712 (S.D.N.Y. Nov. 30, 2012).

1. On September 20, 2012, the SEC filed a civil injunctive action against Waldyr Da Silva Prado Neto ("Prado"), a former employee of Wells Fargo Advisors, LLC ("Wells Fargo") for alleged insider trading in connection with the September 2010 acquisition of Burger King Holdings, Inc. ("Burger King") by a Brazilian private equity firm. The SEC also brought a related action on November 30, 2012 against one of Prado's tippees, who also traded in Burger King stock.

2. Prado allegedly obtained information about the Burger King acquisition from one of his brokerage clients, who became privy to the nonpublic information directly from the private equity firm that was targeting Burger King. The private equity firm, in an attempt to have Prado's client invest in its fund, informed Prado's client that Burger King was an acquisition target. After Prado's client signed a confidentiality agreement with the private equity firm, its partners periodically informed Prado's client about the progress of the Burger King acquisition.

3. Prado communicated with his client regularly and traveled to Brazil on numerous occasions to meet with the client. The SEC claimed that it was during these contacts that Prado obtained the nonpublic information concerning the Burger King acquisition. The SEC further alleged that Prado – after his client informed him of the looming Burger King acquisition – began purchasing Burger King securities on his own behalf. On the date the acquisition was

announced, Prado sold his Burger King stock for a profit of over $175,000.

4. In addition to filing a civil injunction action against Prado, the SEC sought an asset freeze on Prado's assets because of the risk that he would transfer his assets outside of U.S. jurisdiction. To support this assertion, the SEC claimed that Prado abandoned his most current job, put his Miami home up for sale and began transferring his assets out of the country. The court decided to freeze Prado's assets. In addition to the asset freeze, the SEC seeks injunctions, disgorgement and civil penalties.

5. In its action against Prado's tippee, Igor Cornelsen ("Cornelsen"), the SEC alleged that Prado tipped Cornelsen about the Burger King acquisition in May 2010, using the information Prado obtained from his other client. Cornelson reaped profits of over $1.68 million by trading Burger King options in advance of the acquisition. Cornelsen and his trading firm, Bainbridge Group, Inc., agreed to disgorge those profits and to pay a two-times penalty of more than $3.62 million to settle the SEC's charges.

D. *SEC v. Jauyo ("Jason") Lee, Victor Chen and Jennifer Chen*, 12-civ-5031 (N.D. Cal. Sept. 27, 2012)

1. On September 27, 2012, the SEC filed an enforcement action alleging that Jauyo "Jason" Lee, a former analyst at a Boston-based investment bank, tipped his close friend Victor Chen about impending mergers and acquisitions.

2. Between 2009 and 2010, while working at investment bank Leerink Swann LLC, Lee obtained nonpublic information about potential transactions from coworkers who worked on the deals or by reviewing internal documents about the deals. After becoming privy to the information, Lee tipped his longtime friend Victor Chen. Chen traded heavily on these details.

3. In the days leading to the public announcements of the deals, Chen spent a large portion of his cash trading on the companies. Chen had never traded in these companies before. Chen waited until the companies publically announced the deals and then sold most of the securities. According to the SEC, Chen profited over $600,000.

4. The SEC alleged that Lee and Chen violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and Section 14(e) of the Exchange Act and Rule 14e-3 thereunder.

E. *SEC v. Thomas C. Conradt, David J. Weishaus and Trent Martin*, 12-cv-8676 (S.D.N.Y. Nov. 29, 2012)

1. In November 2012, the SEC charged two retail brokers who formerly worked at a Connecticut-based broker-dealer with insider trading in advance of IBM Corporation's acquisition of SPSS Inc. The SEC amended its complaint on December 26, 2012 to allege that the defendants in the original complaint learned of the information from a friend who worked at an international, registered broker-dealer.

2. The SEC's amended complaint alleged that Trent Martin, an Australian Equities analyst and registered representative, learned about the SPSS transaction from a friend who worked at a New York law firm. Martin purchased SPSS securities and tipped his friend and roommate, Thomas C. Conradt, who also worked at the same broker-dealer. Conradt purchased SPSS securities and subsequently tipped his friend and fellow broker David J. Weishaus, who also traded.

3. The SEC's amended complaint further alleged that three additional brokers who worked for the same broker-dealer also traded on the information. These three additional brokers were not charged in the SEC's amended complaint. In total, the insider trading by the three defendants and the three other brokers yielded more than $1 million in illicit profits.

4. The SEC's investigation included the uncovering of instant messages in which Condradt and Weishaus discussed the inside information and their intention to trade on it.

5. The case, in which the SEC is seeking disgorgement and penalties, is unsettled.

F. *SEC v. John Femenia*, et al., 3:12-cv-803 (GCM) (W.D.N.C. Dec. 5, 2012)

1. In December 2012, the SEC charged former Wells Fargo investment banker John Femenia and nine others involved in an insider trading ring that garnered more than $11 million in illicit profits trading on confidential information about impending mergers.

2. Femenia began working in Wells Fargo's Industrials Investment Banking Group in May 2010. The SEC alleged that starting in July 2010, Femenia misused his position at Wells Fargo to obtain material, nonpublic information about four separate merger transactions involving Wells Fargo clients. Femenia learned about the deals either through his work or by abusing his relationship with other Wells Fargo colleagues.

3. Upon learning about the impending deals, Femenia tipped his longtime friend Shawn C. Hegedus, who worked as a registered broker. Femenia and Hegedus illegally tipped other friends who in turn tipped more friends or family members in a ring that spread across five states.

4. The SEC alleged that the illegal trading occurred between July 2010 and July 2012, and involved at least four separate mergers and acquisitions. Femenia's tippees made at least $11 million from the illegal trades, some of which the SEC alleges was passed back to Femenia.

5. The SEC obtained asset freezes against the traders, who, along with Femenia, are contesting the SEC's charges.

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 two cases from last year. In addition, the SEC suffered a rare defeat at trial when it lost a high-profile case against a Citigroup banker, Brian Stoker.

A. *SEC v. Mizuho Securities USA Inc.*, 12-cv-5550 (S.D.N.Y. July 18, 2012)

1. The SEC filed settled actions against the U.S. investment banking subsidiary of Japan-based Mizuho Financial Group and three former employees alleging they misled investors in a collateralized debt obligation ("CDO"), called Delphinus 2007-1 ("Delphinus"), by using "dummy assets" to inflate the deal's credit ratings. The SEC also filed a settled action against Delaware Asset Advisers ("DAA"), the firm that served as the deal's collateral manager and Wei ("Alex") Wei, the DAA portfolio manager.

2. The SEC's action focused on Mizuho's involvement with Delphinus, a $1.6 billion mezzanine CDO backed by subprime bonds, which Mizuho structured and marketed in mid-2007, when the housing market was showing signs of severe distress. Mizuho allegedly was paid approximately $10 million in structuring and marketing fees for Delphinus, which suffered an event of default in January 2008, less than six months after the deal closed.

3. The Delphinus offering documents required that, at closing, each class of notes issued was to be rated by S&P, Fitch, and Moody's, and that each class obtain a specific rating from each agency.

4. The SEC alleged that on July 18, 2007, the day after Delphinus was fully ramped and Mizuho was ready to obtain the required ratings, but before it had notified the ratings agencies that the

portfolio was ramped, S&P announced changes to its CDO rating methodology. S&P explained the change as a reflection of accurate calculations of the default probability of certain categories of RMBS. The SEC alleged that the Mizuho employees involved in Delphinus were aware that the deal could not meet S&P's new standards to obtain the ratings required to close the deal. Allegedly in order to obtain the required ratings under the new criteria and still meet the scheduled closing date of July 19, 2007, Mizuho submitted multiple alternative portfolios to S&P containing millions of dollars in "dummy assets" that inaccurately reflected the credit quality of the collateral actually held by Delphinus. The SEC alleged that once Mizuho obtained the necessary ratings, it closed the transaction and sold the securities to investors as originally comprised, but using the misleading ratings.

5. Further, the SEC alleged that when Delphinus later submitted a required request for a rating confirmation from S&P, Mizuho employees provided and arranged for others to provide inaccurate information about the Delphinus assets and the effective date of the deal.

6. According to the SEC's settled actions against the Mizuho employees allegedly involved in the Delphinus deal, Alexander Rekeda headed the group that structured Delphinus, Xavier Capdepon modeled the transaction for the ratings agencies, and Gwen Snorteland was the transaction manager responsible for structuring and closing the deal. All three were alleged to have committed willful violations of the securities laws.

7. In resolving the SEC's action, Mizuho agreed to pay a penalty of $115 million, disgorgement of $10 million, and prejudgment interest of $2.5 million. Rekeda and Capdepon each agreed to pay a $125,000 penalty, while a penalty for Snorteland will be decided at a later date. Rekeda also agreed to be suspended from the securities industry for 12 months, while Capdepon and Snorteland each agreed to be barred from the securities industry with a right to reapply after one year.

8. DAA and Wei were charged based upon their post-closing conduct, including providing inaccurate information about Delphinus to ratings agencies to obtain rating confirmations. DAA agreed to pay a penalty of $2,228,372, disgorgement of $2,228,372, and prejudgment interest of $357,776. Wei agreed to pay a $50,000 penalty and be suspended from associating with any investment adviser for six months.

B. *In the Matter of Wells Fargo Brokerage Services, et al.*, Admin. Proc. File No. 3-14982 (Aug. 14, 2012)

1. The SEC filed settled actions against Wells Fargo and a former vice president, Shawn McMurtry, alleging they sold investments tied to mortgage-backed securities without fully understanding their complexity or disclosing the risks of the investments to investors.

2. The SEC's action centered on asset-backed commercial paper ("ABCP") issued by Structured Investment Vehicles ("SIVs") structured with high-risk mortgage-backed securities and collateralized debt obligations ("CDOs"), which the SEC alleged Wells Fargo and McMurtry recommended and sold to municipalities, nonprofit institutions, and other customers with generally conservative investment objectives, despite not having read the Private Placement Memoranda ("PPMs") or other disclosure documents prior to recommending the investments. Instead, the SEC alleged that Wells Fargo's registered representatives relied largely on credit ratings as the basis for their investment recommendations.

3. The SEC specifically alleged that, from January 2007 to August 2007, despite the significantly increasing complexity involved in ABCP investments backed by subprime mortgages or related derivatives such as CDOs, Wells Fargo continued its existing practice of not reviewing PPMs of ABCP programs and providing no assessment of risks or other information to potential investors. Notably, the SEC alleged that "multiple registered representatives at Wells Fargo had never heard of a SIV at the time they were selling the SIV-issued asset-backed commercial paper to their customers." Wells Fargo allegedly instead relied almost solely upon credit ratings when advising customers about potential investments.

4. Wells Fargo's institutional customers included municipalities that had directed Wells Fargo not to invest in MBS – some motivated by investment preferences, others prohibited by state law from such investments. Allegedly owing to Wells Fargo's registered representative's failure to review disclosure documents which purportedly included extensive risk disclosures, Wells Fargo sold these municipal customers at least three products that, although highly rated, were backed by MBS and other complex securities such as CDOs. Wells Fargo did not disclose to investors the nature of the investments, the risks associated with the investments, or Wells Fargo's failure to investigate the investments.

5. When the three investment programs defaulted in August and October 2007, the SEC alleged that approximately ten Wells Fargo

customers were holding approximately $104.4 million in ABCP issued by the programs, and thus, the defaults resulted in or created a significant risk of substantial losses. Meanwhile, Wells Fargo allegedly received $65,000 in commissions for these transactions in 2007.

6. The SEC alleged that internal Wells Fargo records memorialized that one municipal entity that had been a customer of Wells Fargo or a predecessor firm since at least 1988 had directed Wells Fargo not to invest in MBS and that applicable state law prohibited such investments. Notwithstanding a policy that registered representatives were prohibited from selecting investments without written authority to do so and this particular customer's belief that Wells Fargo purchased only traditional commercial paper on its behalf, McMurtry exercised his discretionary authority and selected and purchased for this municipal customer an SIV-issued ABCP program backed by MBS and related high-risk mortgage-backed derivatives. The SEC alleged that, at the time, McMurtry did not know what an SIV was, did not read the PPM, and did not inform the customer of the risks related to the SIV structure or the underlying high-risk mortgage-backed assets. Only after the investment defaulted did the customer learn of the risks and nature of the ABCP in which it had invested.

7. The SEC alleged that Wells Fargo relied almost exclusively on credit ratings of ABCP programs in making recommendations to their customers despite a 2005 NASD written warning not to do so as well as similar cautionary statements in many of the PPMs at issue.

8. Without admitting or denying the SEC's findings, Wells Fargo agreed to pay a penalty of $6.5 million, disgorgement of $65,000, and prejudgment interest of $16,571.96. Wells Fargo also agreed to be censured and to cease and desist from committing or causing any violations or future violations of the securities laws. The SEC noted in its findings that the settlement gave consideration to the remedial actions undertaken by Wells Fargo – including a procedure for the review of offering documents for a limited number of commercial paper products offered for sale to institutional customers, enhanced supervisory procedures to assess product knowledge, quarterly meetings of trading and sales personnel to review product types, associated risks and market developments, and a practice of providing access to offering materials to purchasers of ABCP.

9. Without admitting or denying the SEC's findings, McMurtry agreed to pay a penalty of $25,000 and to a six-month suspension from the securities industry. McMurtry also agreed to cease and desist from

committing or causing any violations or future violations of the securities laws.

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

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

2. The SEC's complaint against Citigroup alleged 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 alleged 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 alleged 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 alleged 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 alleged 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, which only require a showing of negligent conduct.

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, or in the public interest to allow Citigroup to settle without admitting to any of the allegations in the complaint.

9. Both the SEC and Citigroup filed an interlocutory appeal of Judge Rakoff's decision seeking a stay of the district court proceedings pending appeal. In addition, the SEC petitioned the Second Circuit for writ of mandamus to set aside the district court's order and seeking an expedited appeal.

10. On March 15, 2012, the Second Circuit found that the parties satisfied the criteria for a stay of the proceedings and granted the motions to stay. The court, however, denied the SEC's motion to expedite the appeal. The parties filed their initial briefs on May 14, 2012, and filed their reply briefs on September 13, 2012. Oral arguments are currently scheduled for February 2013.

11. In addition to the case against Citigroup, the SEC charged Citigroup employee Brian Stoker ("Stoker") alleging he was primarily responsible for structuring the Class V III transaction. The case against Stoker proceeded to trial, and on July 31, 2012, after a two-week trial, the jury found Stoker was not liable for the alleged violations. The SEC did not appeal the jury's verdict and the time for appeal has since expired.

Markups

Below are two cases related to alleged improper markups.

A. *SEC v. Fabrizio Neves and Jose Luna*, 1:12-cv-23131 (S.D. Fla. Aug. 29, 2012); *In the Matter of Angelica Aguilera*, Admin. Proc. File No. 3-14999 (Aug. 29, 2012)

1. The SEC filed an enforcement action against two former Miami brokers for their fraudulent scheme to overcharge customers approximately $36 million by using hidden markups on transactions in structured notes, and against their former supervisor for failing to supervise the brokers' activity.

2. In the first action filed in federal district court, the SEC charged Fabrizio Neves and Jose Luna, two former registered representatives of LatAm Investments LLC, with defrauding two Brazilian public pension funds and a Colombian institutional investor that purchased structured notes issued by major commercial banks. To perpetrate the fraud, Neves and Luna altered the term sheets of the structured notes by using "white out" or by electronically removing the actual price and trade information, and replacing it with the marked-up amounts. Using the forged term sheets, Neves and Luna then sold the notes to customers for as much as 67% over the price at which the banks had issued them. Neves and Luna further concealed the markups by first purchasing the notes into accounts in the name of nominee entities in the British Virgin Islands that Neves and Luna controlled.

3. According to the SEC's complaint against Neves and Luna, as a result of the fraudulent markup scheme, the Brazilian pension funds overpaid for the structured notes by approximately $24 million and the Colombian institutional investor overpaid for its structured notes by approximately $12 million.

4. The SEC's complaint seeks disgorgement of ill-gotten gains, financial penalties, and injunctive relief against Neves to enjoin him from violations of the federal securities laws. Luna settled the case against him by agreeing to the entry of a judgment ordering him to pay disgorgement of $923,704.85, prejudgment interest of $241,643.51, and a penalty amount to be determined. Luna also agreed to settle a related SEC administrative proceeding by agreeing to be barred from the securities industry.

5. The SEC also instituted an unsettled administrative proceeding against LatAm's former president, Angelice Aguilera, the direct supervisor over Neves and Luna, alleging that she failed to reasonably supervise them or effectively enforce LatAm's policies and procedures related to fairness of markups. The SEC also alleges that Aguilera improperly delegated her supervisory functions to LatAm's chief compliance officer, who, according to the SEC's Order, lacked meaningful authority over Neves and Luna

because he did not have the ability to discipline them, and because he was not in the office on a regular basis.

B. *SEC v. Marek Leszczynski, et al.*, 12-cv-923 (S.D.N.Y. Oct. 5, 2012)

1. The SEC charged four brokers – Marck Leszczynski, Benjamin Chouchane, Gregory Reyftmann, and Henry Condron – who formerly worked on the cash desk at a New York-based interdealer broker with illegally overcharging customers $18.7 million by using hidden markups and markdowns and secretly keeping portions of profitable customer trades. The SEC alleged that the brokers were paid more than $15.6 million in performance bonuses based, in part, on these fraudulent earnings.

2. The SEC's action centered on the allegation that the four brokers told customers, who were primarily large foreign institutions and banks, they were being charged very low commissions, typically flat rates between $0.005 and $0.02 per share, but the brokers reported false prices – markups and markdowns – when executing those customers' orders. The SEC alleged that the brokers charged the markups and markdowns during times of market volatility, which helped conceal their actions from customers.

3. The SEC alleged that after Leszczynski, Chouchane, or Reyftmann received customer orders, Condron, a sales trader, executed them. Allegedly, Condron recorded actual execution prices on the trade blotter and informed the sales brokers of the execution. Shortly after the trades were executed, the sales brokers examined other market executions around the time of the actual executions to determine whether stock prices had fluctuated. If a stock price's fluctuation was favorable to the firm and sufficient to conceal the fraud from customers, the sales brokers allegedly instructed Condron to record a false execution price in the gross price field on their internal trade blotter, and the brokers or trader reported the false execution price and the commission to the customer.

4. The SEC further alleged that when customers placed limit orders to purchase shares at a specified maximum price, the brokers filled the order at the customer's limit price but sold a portion of that order back to the market, making a profit for the firm while reporting back to the customer that they could not fill the order at the limit price.

5. The embedded markups and markdowns allegedly ranged from a few dollars to over $228,000 per transaction and involved more than 36,000 transactions from 2005 through at least February 2009, totaling at least $18.7 million. The SEC also alleged that of the 36,000 transactions marked up or down, more than 3,300 were

marked up or down by 1,000% or more above the disclosed commission.

6. The SEC's complaint charges the brokers with violating the antifraud provisions of the federal securities laws and seeks disgorgement, penalties, and a permanent injunction.

7. Simultaneously with the SEC's action, the U.S. Attorney's Office for the Southern District of New York filed criminal charges against Leszczynski and Chouchane, and Condron pled guilty to criminal charges.

Mortgage-Backed Securities

The Commission continues to bring enforcement actions arising from the mortgage crisis. 2012 saw two cases against large financial institutions involving mortgage-backed securities, another case involving the alleged mispricing of such securities, and the conclusion of one of the first SEC cases in this area.

A. *SEC v. J.P. Morgan Securities LLC, EMC Mortgage, LLC, Bear Stearns Asset Backed Securities I LLC, Structured Asset Mortgage Investments II, Inc., SACO I Inc., and J.P. Morgan Acceptance Corporation I.*, (D.D.C. Nov. 16, 2012)

1. In November 2012, the SEC filed a settled complaint alleging that J.P. Morgan Securities LLC ("JPMS") and certain affiliates that J.P. Morgan & Co. acquired when it bought Bear Stearns ("Bear"), violated the securities laws through their practices in connection with residential mortgage-backed securities ("RMBS") offerings.

2. Beginning in 2005, Bear had a practice of repurchasing securitized loans from RMBS trusts when the loans were discovered to be in breach of certain representations and warranties (so called "early payment default" or "EPD" loans) that had been given to Bear by the originators from whom Bear had purchased the loans. The originators would repurchase the loans from Bear and Bear would pass the payment on to the trusts, thereby making the trusts whole.

3. As originators began to experience financial difficulties, rather than repurchasing the EPD loans from the securitizations, Bear negotiated with the originators for discounted bulk settlements for large numbers of EPD loans, and rather than repurchasing the loans, Bear left the loans in the trusts and retained the cash settlements. Bear did not notify the trusts of the bulk settlements.

4. Bear entered into bulk settlements for approximately 6,535 EPD loans in 156 different securitizations. Of those, Bear only repurchased approximately 13.5% of the EPD loans from the trusts.

The proceeds from the bulk settlement practice were at least $137.8 million.

5. The defendants agreed to pay $137.8 million in disgorgement, $24,265,536 in prejudgment interest, and a $60.350 million penalty for the bulk settlement practice misconduct.

6. The SEC also alleged that JPMS included a material number of delinquent loans in one securitization in December 2006 and failed to disclose that fact in the prospectus supplement. JPMS disclosed in the prospectus supplement that 0.04% (or 4 loans) in the trust had experienced an instance of a delinquent payment of 30 days or more in the prior 12-month period ("historical delinquency"). The SEC alleged that JPMS failed to disclose 620 loans that the SEC asserted were more than 30 days delinquent at the cut-off date for the offering. The SEC also alleged that JPMS received fees of $2.7 million for underwriting the securitization, and investors sustained losses of at least $37 million related to the delinquent loans.

7. The defendants agreed to pay disgorgement of $39.9 million plus $10.6 million in prejudgment interest, and a $24 million penalty for the delinquency misstatements.

B. *In the Matter of Credit Suisse Securities (USA) LLC; DLJ Mortgage Capital Inc.; Credit Suisse First Boston Mortgage Acceptance Corp.; Credit Suisse First Boston Mortgage Securities Corp.; and Asset Backed Securities Corporation* ("Credit Suisse"), Admin. Proc. File No. 3-15098 (Nov. 16, 2012)

1. Similar to the action against JPMS, the SEC filed a settled administrative action against Credit Suisse Securities (USA) LLC ("Credit Suisse") and certain affiliates alleging that the firm violated the federal securities laws through its practices in connection with RMBS offerings.

2. From approximately 2005 to 2012, Credit Suisse had a practice of negotiating with loan originators for bulk settlements for securitized EPD loans and, rather than repurchasing the loans from the RMBS trusts, Credit Suisse left the loans in the trusts and retained the cash settlements. Credit Suisse did not notify the trusts or investors about the bulk settlements.

3. In failing to repurchase the loans from the trusts, Credit Suisse also failed to comply with its obligations under the RMBS offering document provisions requiring Credit Suisse to repurchase EPD loans.

4. Between 2005 and 2010, Credit Suisse entered into approximately 110 bulk settlements with originators, involving loans from 75 different securitizations. Credit Suisse retained approximately $28.1 million that it received from its bulk settlements, and avoided losses of approximately $27.6 million by not repurchasing the bulk settlement loans from the trusts.

5. In late 2006, in connection with two RMBS transactions that Credit Suisse underwrote, Credit Suisse made a “First Payment Default” covenant, which obliged Credit Suisse to repurchase certain delinquent loans, or otherwise cure breaches of the covenant, if originators failed to do so. By failing to remove the delinquent loans, Credit Suisse failed to fulfill its obligations under this covenant. Investors sustained losses of $10,056,561 on the delinquent loans that remained in the trusts.

6. To settle the matter, Credit Suisse agreed to pay disgorgement of $55,747,769, prejudgment interest of $13 million and a $33 million civil penalty.

C. *SEC v. Kareem Serageldin, et al.*, 12-cv-0796 (S.D.N.Y. Feb. 1, 2012)

1. In February 2012, the SEC filed an enforcement action against four senior investment bankers and traders at Credit Suisse Group (“Credit Suisse”) for engaging in a scheme to fraudulently overstate the prices of $3 billion in subprime bonds owned by Credit Suisse during the height of the subprime mortgage crisis.

2. The SEC’s lawsuit alleged that Credit Suisse’s former global head of structured trading, Kareem Serageldin, and its former head of hedge trading, David Higgs, along with two mortgage bond traders, intentionally mispriced subprime bonds in order to allow Credit Suisse to achieve fictional profits. Deliberately ignoring specific market information showing a sharp decline in the price of subprime bonds under the group’s control, Serageldin and Higgs instead directed traders to change the bond prices in order to hit daily and monthly profit targets, cover up losses, and give the appearance of profitability to senior management at Credit Suisse. The fraudulent scheme purportedly reached its peak in late 2007, at the same time that the subprime market was collapsing.

3. To perpetrate the scheme, Serageldin, who oversaw a significant portion of Credit Suisse’s structured products and mortgage-related businesses, communicated to Higgs the specific profit and loss outcome he wanted for the particular day or month. Higgs, in turn, directed traders to mark the firm’s inventory in a manner that would achieve the desired profit and loss, notwithstanding the plummeting market prices of subprime bonds at the time. This practice violated

relevant accounting principles and Credit Suisse policy, which required the group to price the bonds at fair value. Proper pricing would have reflected that Credit Suisse was incurring significant losses as the subprime market collapsed. According to telephone calls that were recorded as part of Credit Suisse's routine recording of the trading desk, Serageldin and Higgs purportedly acknowledged that falsely overstated year-end marks were too high and expressed concern that risk personnel at Credit Suisse would "spot" their mispricing.

4. When the mispricing was eventually detected in February 2008, Credit Suisse disclosed $2.65 billion in subprime-related losses related to the investment bankers' misconduct. It was also revealed that the mispricing scheme was driven, in part, by the employees' desire for lavish year-end bonuses and internal promotions.

5. Although the SEC filed civil fraud charges against the four investment bankers, it decided not to bring any charges against Credit Suisse, citing several factors listed in the Commission's 2001 Seaboard Report. In determining not to bring charges against Credit Suisse, the SEC considered (i) the isolated nature of the wrongdoing; (ii) Credit Suisse's immediate self-reporting to the SEC and other law enforcement agencies; (iii) the prompt public disclosure of corrected financial results; (iv) the voluntary termination of the four investment bankers; (v) the implementation of enhanced internal controls to prevent recurrence of the misconduct; and (vi) the vigorous cooperation of Credit Suisse with the SEC's investigation.

6. Simultaneously with the filing of the SEC's case, the DOJ obtained an indictment against Serageldin and a criminal information against Higgs and one of the traders, Salmaan Siddiqui, based on the same conduct. Higgs and Siddiqui have pleaded guilty to the charges, which Serageldin is contesting. In September, Serageldin was arrested in London, where he had been living since the charges were filed, and in January 2013 a British court approved his extradition to the U.S.

D. *SEC v. Brookstreet Securities Corp. and Stanley C. Brooks*, SA 8:09-cv-1431-DOC (C.D. Cal. Mar. 1, 2012)

1. In February 2012, the SEC concluded one of its first financial crisis cases when it obtained summary judgment against Brookstreet Securities Corp. ("Brookstreet") and its former President and CEO, Stanley Brooks ("Brooks"). The SEC had charged Brookstreet and Brooks in December 2009 with fraud for systematically selling risky CMOs to retail customers. Those customers, who at Brookstreet's

recommendation used margin to leverage their CMO investments, lost almost their entire portfolios in 2007, when the prices for these CMOs plummeted.

2. The SEC alleged that Brooks and Brookstreet created a program through which Brookstreet's registered representatives sold risky CMOs to, among others, seniors and retirees. Brookstreet frequently sold the CMOs to IRA accountholders and to customers who listed "preservation of capital" as their investment objective. The SEC further alleged that Brookstreet and Brooks continued to promote and sell the CMOs even after Brooks received numerous warnings that the CMOs were dangerous investments that could become worthless overnight. According to the SEC's December 2009 complaint, approximately 90% of these CMOs were inverse floaters, interest-only and inverse interest-only bonds, which are among the riskiest types of CMOs. Indeed, Brooks had received warnings from Brookstreet's compliance department and other traders that the CMOs were too risky for retail investors.

3. On February 23, 2012, the Court entered an order granting summary judgment in favor of the SEC, finding Brookstreet and Brooks liable for securities fraud, and ordering them to pay a penalty of $10,010,000 and Brooks to pay disgorgement of $110,713.31.

Municipal Bond Actions

In 2012, the Commission released a long-awaited report on the municipal bond market, continuing its scrutiny of this area. In the enforcement area, however, last year saw only one action – in contrast to four in 2011 – involving broker-dealer misconduct in the municipal bond market.

A. *In the Matter of Goldman, Sachs & Co*, Admin. Proc. File. No. 3-15048 (Sept. 27, 2012)

1. The SEC filed a settled action against broker-dealer and registered municipal securities dealer Goldman, Sachs & Co. ("Goldman") for alleged "pay-to-play" violations, based on the conduct of former vice president Neil M.M. Morrison. The settled action alleged that Goldman violated Section 15B(c)(1) of the Exchange Act, based on willful violations of Municipal Securities Rulemaking Board ("MSRB") Rules. The SEC alleged that Goldman violated MSRB Rules G-8, G-9, G-17, G-27, G-37(b), and G-37(e).

2. The SEC's action related to in-kind contributions and one cash contribution made by Morrison in support of Massachusetts Treasurer Timothy P. Cahill's campaigns for reelection as treasurer, and for election as governor. Morrison performed these activities

while soliciting municipal underwriting business from the Commonwealth of Massachusetts's Treasurer's office. The SEC also alleged that Morrison made an undisclosed cash contribution to Cahill's campaign.

3. In particular, the SEC alleged that Morrison engaged in an array of campaign activities, including speech-writing, assisting with personnel decisions, fund-raising (including sending e-mails from his Goldman e-mail account), and interviewing consultants. The SEC alleged that Morrison's conduct, between November 25, 2008 and October 4, 2010, constituted "in kind" campaign contributions to Cahill, attributable to Goldman. These in-kind contributions, along with the one undisclosed cash contribution (alleged to have been $400, which is more than the $250 *de minimis* exception), disqualified Goldman from municipal securities business with the issuers associated with Cahill ("the associated issuers") for two years. However, during this time, Goldman participated as senior manager, co-senior manager, or comanager for 30 negotiated underwritings by the associated issuers, totaling approximately $9 billion. Goldman received fees in the amount of $7,558,942.

4. The SEC noted that Morrison was able to perform these activities from his Goldman office because he worked in a one-person office and was supervised by an out-of-state Goldman employee. Morrison certified to Goldman that he had disclosed all of his political activities and contributions, however, the SEC alleged Goldman failed to adopt, maintain and enforce written supervisory procedures reasonably designed to ensure Morrison's compliance. The SEC made these allegations in light of the fact that Goldman knew of Morrison's political background, personal relationship with Cahill, and close relationship with other issuer employees.

5. The SEC noted that in light of Morrison's conduct, Goldman suspended solicitations of negotiated municipal finance offerings by Massachusetts issuers and terminated Morrison's employment.

6. The SEC alleged that Goldman's conduct violated Section 15(B)(c)(1) of the Exchange Act and the MSRB Rule G-37(b). The SEC alleged that Goldman's failure to disclose these activities and to maintain records of these activities violated MSRB Rules G-37(e), G-8, and G-9. Rule G-17 requires broker-dealers to deal fairly and avoid deceptive, dishonest and unfair practices. Goldman violated that rule by its failure to take steps to ensure that the contributions, campaign work, and conflicts of interest were disclosed in bond offering documents. The SEC also alleged that Goldman violated Rule G-27 for its failure to effectively supervise Morrison.

7. Without admitting or denying the allegations, Goldman agreed to cease and desist from committing or causing any violations and any future violations of Section 15B(c)(1) of the Exchange Act, as well as MSRB Rules G-8, G-9, G-17, G-27, G-37(b), and G-37(e). Goldman agreed to a censure and to pay disgorgement of $7,558,942, with prejudgment interest. Goldman agreed to pay a civil monetary penalty in the amount of $3.75 million.

8. In a related action, the SEC issued contested administrative proceedings against Morrison, alleging that he aided and abetted and caused Goldman's violations of MSRB Rules G-8(a)(xvi), G-9, G-37(b), G-37(e), and 15B(c)(1), and willfully violated Rules G-17, G-37(c), and G-37(d).

Mutual Fund Cases

The Commission brought two cases in 2012 involving alleged misconduct relating to the marketing of mutual funds.

A. *In the Matter of UBS Financial Services Inc. of Puerto Rico*, Admin. Proc. File No. 3-14863 (May 1, 2012); *In the Matter of Miguel A. Ferrer, and Carlos J. Ortiz*, Admin. Proc. File No. 3-14862 (May 1, 2012)

1. The SEC filed a settled administrative proceeding against UBS Financial Services Inc. of Puerto Rico ("UBS-PR"), and an unsettled administrative proceeding against two former UBS-PR executives, involving the allegedly fraudulent sales and marketing of proprietary mutual funds.

2. The SEC's action found that UBS-PR made misrepresentations and omissions to investors regarding the secondary market liquidity and pricing of nonexchange traded closed-end funds ("CEFs") that were affiliated with UBS-PR. UBS-PR was the primary underwriter of 14 CEFs and comanaged nine others. The CEFs constituted UBS-PR's largest single source of revenue; UBS-PR was the only secondary market dealer or liquidity provider for the sole-managed funds, and was the dominant dealer for several comanaged CEFs.

3. The SEC alleged that during 2008 and 2009, UBS-PR made material misrepresentations and omissions in statements to retail customers, including implying that CEF prices were based on market forces and failing to disclose that the share prices were typically set by UBS-PR's trading desk. UBS-PR also failed to disclose that it controlled the secondary market for the CEFs.

4. The SEC alleged that UBS-PR priced the CEFs to reduce volatility and to maintain high premium to Net Asset Value ("NAV"), which was an important selling feature of the CEFs. UBS-PR used an

inventory account to purchase excess supply in order to prop up prices and create the appearance of liquidity. According to the SEC's Order, as early as May 2008, UBS-PR noted a significant supply and demand imbalance in the CEF secondary market. UBS-PR continued purchasing shares and made only small, infrequent changes to CEF prices. The SEC alleged that these unchanging and consistently high prices, in the face of unfavorable market conditions, were inconsistent with UBS-PR's representations that market forces determined CEF prices.

5. The SEC further alleged that UBS-PR's CEO Miguel Ferrer and Head of Capital Markets Carlos Ortiz made misrepresentations about the pricing and liquidity of the CEFs to UBS-PR's financial advisors and, with respect to Ortiz, at an investor conference.

6. In March 2009, UBS-PR's parent company, UBS Financial Services, Inc. ("UBSFS") became concerned about UBS-PR's CEF inventory holdings and mandated that UBS-PR reduce its CEF holdings. The SEC alleged that in June 2009, Ortiz devised a strategy to have UBS-PR purchase the fewest amount of customer shares as possible, and lower the price of sell orders on UBS-PR's inventory to keep ahead of any client open orders. The SEC also alleged that in the summer of 2009, Ferrer and Ortiz authorized a share repurchase program which recommended that customers sell their shares of the newest CEF offerings and to then purchase other CEF shares from UBS-PR's inventory. UBS-PR did not disclose that a material basis for recommending the purchases was to reduce its own inventory holdings. The SEC alleged that by September 30, 2009, UBS-PR had reduced its inventory to the level mandated by UBSFS.

7. Without admitting or denying the allegations, UBS-PR agreed to a cease-and-desist order, to pay $11.5 million in disgorgement, prejudgment interest of $1,109,739.94, and a $14 million civil money penalty. UBS-PR also agreed to engage an independent third-party consultant to review UBS-PR's CEF disclosures and trading and pricing policies, procedures, and practices for accuracy.

8. In a related action, the SEC issued unsettled administrative proceedings against Ferrer and Ortiz.

B. *In the Matter of OppenheimerFunds, Inc. and OppenheimerFunds Distributor, Inc.*, Admin. Proc. File No. 3-14009 (June 6, 2012)

1. The SEC filed a settled action against a mutual fund distributor, OppenheimerFunds Distributor, Inc. ("OFDI") and an affiliated investment adviser, OppenheimerFunds, Inc. ("OFI"), charging

them with making misleading statements about two mutual funds in the midst of the 2008 credit crisis.

2. The SEC's action centered on derivative instruments known as total return swaps, which the SEC alleged OFI used to gain substantial exposure to commercial mortgage-backed securities ("CMBS") in two funds that OFDI distributed (the "Funds"), without purchasing actual bonds. The SEC alleged that, beginning in mid-September 2008, steep CMBS market declines led to falling net asset values ("NAVs") for both Funds and that to raise cash for month-end swap contract payments, OFI was forced to sell depressed securities in an increasingly illiquid market. As the value of the Funds' assets fell, the notional amounts of their swap contracts remained constant, so the Funds' relative exposure to CMBS increased. In mid-November, senior management allegedly instructed the Funds' portfolio managers to reduce the Funds' CMBS exposure, though the CMBS market collapse was accelerating and the Funds faced significant cash liabilities, driving NAVs even lower.

3. The SEC alleged that OFDI provided its sales personnel with misleading information about the Funds' losses and exposure to CMBS, which those sales personnel then passed to independent financial advisers or the Funds' investors. Among the allegedly misleading statements were representations that the Funds had only suffered paper losses, not "permanent impairments," that the Funds' holdings and strategies remained intact, and that absent actual defaults, the Funds would continue collecting payments on the Funds' bonds as they waited for markets to recover. The SEC alleged that OFDI included certain of these misstatements in "talking points" scripts given to call center personnel who fielded inquiries from shareholders and their financial advisers.

4. Both OFI and OFDI were censured and ordered to cease and desist from committing or causing any violations or future violations of certain antifraud provisions of the federal securities laws. OFI also agreed to pay a penalty of $24 million, disgorgement of $9,879,706, and prejudgment interest of $1,487,190. In settling the matter, the SEC noted OFI and OFDI's cooperation in the investigation and several prompt remedial acts they undertook.

Research Analysts

The Commission settled a matter involving research analysts.

A. *In the Matter of Goldman, Sachs & Co.*, Admin. Proc. File No. 3-14845 (Apr. 12, 2012)

1. In a settled administrative proceeding instituted in April 2012, the SEC charged Goldman Sachs with failing to have adequate policies and procedures to address the risk that the firm's analysts could share material, nonpublic information about upcoming research changes. These risks arose in connection with weekly "huddles" during which Goldman Sachs' equity research analysts met to provide their best trading ideas to the firm's traders.

2. The SEC alleged that from 2006 to 2011, Goldman held the weekly huddles at which equity research analysts discussed their top short term trading ideas and traders discussed their views on the markets. The SEC alleged that, at times, sales personnel attended the huddles. Further, starting in 2007, Goldman Sachs began a program in which analysts shared information and trading ideas from the huddles with select clients. The SEC Order also alleged that until 2009, members of the firm's risk management group, who were authorized to establish large, long-term positions on behalf of the firm, attended the huddles.

3. The SEC Order further alleged that Goldman Sachs monitored the analysts' contributions to huddles and the increased commissions generated from clients who received the trading ideas, and incorporated these contributions into analyst evaluations. One method by which Goldman Sachs tracked the analysts' contributions was "broker votes" received from the firm's clients, who rated analysts and allocated their trading according to which analysts they rated most highly.

4. According to the SEC, Goldman Sachs failed to establish policies and procedures to address the risks that the huddle program created. Among other things, the SEC found that although Goldman Sachs had policies that permitted analysts to share "short-term trading issues or market color" internally and with clients without broadly disseminating that information, Goldman Sachs did not define or provide adequate guidance or training to research analysts regarding the limits of what constituted "short-term" trading ideas or "market color." The firm's policies, therefore, failed to adequately define the difference between a material statement that required broad dissemination and a "short-term" trading idea that did not.

5. The SEC Order also cited several examples in which Goldman Sachs analysts shared trading ideas for specific stocks during huddles, even though the analysts had already drafted reports or sought approval regarding ratings changes on those stocks.

Further, the SEC noted that between January 2007 and August 2009, there were hundreds of instances when a ratings change occurred within five business days after the stock was discussed at a huddle or referenced in a huddle script.

6. In addition to alleging that Goldman Sachs lacked adequate procedures, the Order alleged that the firm's controls over the huddles were deficient. For example, representatives from the firm's compliance department did not attend all huddles, and the SEC noted that hundreds of huddles were not monitored by compliance. Goldman Sachs also did not conduct any regular review or comprehensive audit to identify circumstances when ratings changes occurred shortly after a stock was discussed in a huddle.

7. Finally, the SEC alleged that Goldman Sachs failed to conduct sufficient surveillance of trading ahead of research changes, and in particular, surveillance relating to huddles. According to the SEC Order, surveillance group analysts who conducted reviews of trading ahead of ratings changes did not know that a stock was discussed in a huddle before the ratings change.

8. In settling the matter, Goldman Sachs agreed to pay a $22 million penalty, half of which was paid to FINRA in a related proceeding, and to conduct a comprehensive review of its insider trading policies and procedures.

Registration

In addition to the short-selling case described later in this Outline, broker-dealer optionsXpress found itself charged in a separate case involving the broker-dealer registration provisions of the securities laws.

A. *In the Matter of OX Trading, LLC, optionsXpress, Inc., and Thomas E. Stern*, Admin. Proc. File No. 3-14853 (Apr. 19, 2012)

1. The SEC filed unsettled administrative proceedings against OX Trading LLC, optionsXpress, and their former CFO, Thomas E. Stern, alleging that they violated the broker-dealer registration provisions of the Exchange Act. The alleged violations stem from OX Trading's continued trading operations after terminating its membership with the Chicago Board Options Exchange ("CBOE") and deregistering with the SEC.

2. The SEC asserted that Stern, who also was OX Trading's chief compliance officer, terminated OX Trading's membership with the CBOE to avoid an annual examination by the CBOE. He also ended the firm's broker-dealer registration with the SEC. However,

after doing so, OX Trading allegedly continued trading through a customer account at optionsXpress.

3. According to the SEC Order, Stern later fabricated and backdated an allegedly exculpatory letter purporting to demonstrate that he had properly informed CBOE that OX Trading would deregister and become a customer of optionsXpress.

4. The SEC alleged that OX Trading violated Sections 15(a) and 15(b)(8) of the Exchange Act, and that Stern and optionsXpress caused and willfully aided and abetted OX Trading's violations.

Securities Exchanges and Alternative Trading Systems

Last year the SEC brought significant disciplinary actions against a securities exchange and another against an alternative trading system.

A. *In the Matter of New York Stock Exchange LLC, and NYSE Euronext*, Admin. Proc. File No. 3-15023 (Sept. 14, 2012)

1. The SEC instituted settled administrative and cease-and-desist proceedings against the New York Stock Exchange ("NYSE") for improperly sending market data to proprietary customers before sending that data to its consolidated feeds, which broadly distribute trade and quote data to the public. As a result of the NYSE's compliance failures, certain customers received an improper head start on valuable trading information.

2. The conduct at the heart of the SEC's case involved the NYSE's dissemination of best-price quotations and trade reports. Under Rule 603(a) of Regulation NMS, the NYSE is required to distribute this data on terms that are "fair and reasonable" and not "unreasonably discriminatory."

3. The SEC's Order found that the NYSE's use of proprietary feeds to disseminate data to its customers violated Regulation NMS. In particular, the NYSE maintained two proprietary feeds that were only available to NYSE's paying subscribers: Open Book Ultra, which sends real-time data about NYSE's entire order book, and PDP Quotes, which contains NYSE's quote for each security. Algorithmic traders in particular pay for this data in order to operate their high-frequency trading systems.

4. The SEC accused the NYSE of sending trade information through Open Book Ultra and PDP Quotes to its paying subscribers before the NYSE submitted that same data to the consolidated feeds. The disparities between the NYSE's provision of information to these two proprietary feeds and the NYSE's provision of information to

the consolidated feeds ranged from single-digit milliseconds to, on occasion, multiple seconds. The most pronounced differences occurred on May 6, 2010, the date of the "Flash Crash," when the NYSE experienced delays in sending data through the consolidated feeds of up to 5.3 seconds, but subscribers to NYSE's proprietary feeds continued to receive the same data in milliseconds.

5. The transmission disparities allegedly resulted from multiple causes. First, an internal NYSE system architecture gave one of the data feeds a faster path to customers than the path used to send data to the consolidated feed. Second, one of the proprietary feeds operated on a separate system and therefore was not affected when the NYSE's software experienced delays in transmitting data to the consolidated feed. Third, by not involving its compliance department in certain critical technology decisions, including the design, implementation, and operation of NYSE's market data systems, NYSE missed opportunities to avoid compliance failures. Further, the compliance department did not monitor the comparative speed of the transmission systems.

6. In an action which the SEC touted as "the first of its kind," the Commission charged the NYSE and its parent company, NYSE Euronext, with violating SEC Regulation NMS over an extended period of time beginning in 2008. NYSE agreed to a $5 million penalty and significant undertakings to settle the SEC's charges, which marked the first-ever SEC financial penalty against an exchange.

B. *In the Matter of eBX, LLC*, Admin. Proc. File No. 3-15058 (Oct. 3, 2012)

1. The SEC instituted settled administrative and cease-and-desist proceedings against eBX, LLC, a Boston-based broker-dealer and dark pool operator, for failing to protect the confidential trading information of its subscribers and failing to disclose to all subscribers that it allowed an outside firm to use their confidential trading information.

2. eBX operates LeveL ATS ("LeveL"), an alternative trading system ("ATS") which it marketed as a "dark pool" trading system. Dark pools do not display quotations to the public, meaning that investors who subscribe to a dark pool have access to potential trade opportunities that other investors using public markets do not. Under SEC Regulation ATS, an ATS operator must, among other things, establish adequate safeguards and procedures to protect subscribers' confidential trading information.

3. The SEC alleged that eBX violated Regulation ATS by inaccurately informing its subscribers that their flow of orders to buy or sell

securities would be kept confidential and not shared outside LeveL. Rather than protecting the confidentiality of its subscribers' orders, eBX outsourced the operation of LeveL to an outside technology firm which used information about LeveL subscribers' unexecuted orders for its own business purposes. The outside firm had a separate order routing business which was able to remember information about LeveL subscribers' unexecuted orders. The outside firm's order routing business thereby received an advantage over LeveL subscribers because it was able to use its knowledge of LeveL subscriber orders to make routing decisions for its own customers' orders.

4. For example, if the router knew that a buy order had been routed to LeveL, the outside firm would use that information to route a sell order to LeveL to obtain an execution. Conversely, if the outside firm knew that no buy order had been routed to LeveL, it would likely route any sell order it subsequently received to another destination. In addition, the router was aware of the prices and pricing attributes of orders resting in LeveL, and was programmed to use that information in determining whether to send an order to LeveL as opposed to another venue based on where it knew it might get a better price for its own customers' orders.

5. According to the SEC's Order, knowledge of the pricing information of orders resting in LeveL gave the outside firm's order routing business the ability to route orders to LeveL in situations where the resulting price could have been better for the order routing business' customer than prices available in other market centers. As a result of its privileged access to information about the orders that were submitted to, and executed in, LeveL, the order routing business was able to obtain a much higher fill rate for certain orders than any other LeveL subscriber's similar orders by increasing orders submitted to LeveL in circumstances where they were likely to be executed and decreasing orders submitted to LeveL in circumstances where they were less likely to be executed.

6. The SEC alleged that eBX violated Regulation ATS by failing to establish procedures to protect its subscribers' confidential trading information and for failing to amend its Form ATS to disclose that it shared unexecuted order information outside LeveL.

7. eBX agreed to pay an $800,000 penalty to settle the charges, was censured, and was ordered to cease-and-desist from committing or causing any future violations of Regulation ATS.

Short Selling

The Commission brought two cases involving complex short selling schemes. These cases are described below.

A. *In the Matter of optionsXpress, Inc., Thomas E. Stern, and Jonathan I. Feldman*, Admin. Proc. File No. 3-14848 (Apr. 16, 2012)

1. In an unsettled administrative proceeding, the SEC charged optionsXpress, an online brokerage and clearing agency, the firm's former CFO and a firm customer in a naked short selling scheme that allegedly violated Regulation SHO.

2. The SEC alleged that optionsXpress failed to satisfy its close-out obligations under Regulation SHO by repeatedly engaging in a series of sham "reset" transactions designed to give the illusion that the firm had purchased securities of like kind. These sham reset transactions were designed to avoid compliance with Regulation SHO's stock delivery requirements, and deprived buyers of prompt delivery of their shares.

3. In the sham resets, optionsXpress purportedly facilitated its customers' buying of shares, and those customers' simultaneous selling of deep in-the-money call options that were essentially the economic equivalent of selling shares short. The purchase of shares created the illusion that the firm had satisfied the close-out obligation; however, the shares that were ostensibly purchased in the reset transactions were never actually delivered to the purchasers because on the same day the shares were "purchased," the deep in-the-money calls were exercised, thereby effectively reselling the shares. The SEC alleges that the sham reset transactions impacted the market for certain issuers, accounting for up to 47.9% of the daily trading volume in the case of one such security. In 2009 alone, six optionsXpress customer accounts in total purchased approximately $5.7 billion worth of securities and sold short approximately $4 billion of options.

4. optionsXpress, along with its former CFO, Thomas E. Stern, allegedly engaged in the sham reset transactions along with a firm customer, Jonathan I. Feldman, who allegedly engaged in options transactions knowing that he had no intention of fulfilling his obligations under the contracts. optionsXpress and Stern were charged with violating Regulation SHO, while Feldman was charged with securities fraud.

5. In a related settled administrative proceeding, three other optionsXpress officials, including head of trading and customer service, Peter Bottini, and compliance officers Phillip J. Hoeh and

Kevin E. Strine, consented to an order that they cease and desist from committing or causing violations of Rule 204 under Regulation SHO.

B. *In the Matter of Jeffrey A. Wolfson, Robert A. Wolfson, and Golden Anchor Trading II, LLC (n/k/a Barabino Trading, LLC)*, Admin. Proc. File No. 3-14762 (July 17, 2012)

1. The SEC brought, and subsequently settled, charges against two short sellers and their trading firm arising from a complex scheme to evade the locate and close-out requirements of Regulation SHO.

2. The SEC charged that Jeffrey and Robert Wolfson violated Regulation SHO in connection with naked short sales. The Wolfson's allegedly improperly used the market-maker exception to Regulation SHO's locate requirement to avoid borrowing, arranging a borrow, or having reasonable grounds to believe that a security could be borrowed before effecting their short sales.

3. The Wolfsons engaged in naked short selling through "reverse conversion" or "reversal" transactions in hard to borrow threshold securities. In these transactions, the Wolfsons sold stock short while also selling a put option and buying a call option that each had the exact same expiration date and strike price. This option combination created a synthetic long position that hedged the short stock sale. All three trades – the short sale and the two options trades – were executed with the same broker-dealer counterparty.

4. The Wolfsons also engaged in a type of trade known as a "reset" in order to avoid closing out their short positions. When the Wolfsons had a close out obligation, they purportedly bought shares of that security while simultaneously buying from the same counterparty a short-term, deep in-the-money put option or sold a short term, deep in-the-money call option.

5. According to the SEC, this reset transaction created the illusion that the Wolfsons had satisfied the close-out obligation of Regulation SHO by purchasing shares. Because the purchase was married to an option trade that negated the purchase and returned the shares to the broker-dealer counterparty the next day, it was not a bona fide purchase transaction. However, the trade had the effect of rolling their close-out period for another 13 settlement days.

6. The order against Jeffrey Wolfson alleged that he earned $8,771,432 in net trading profits from this scheme between July 2006 and July 2007. From March 2007 to July 2007, Robert Wolfson and his trading company, Golden Anchor, allegedly

engaged in 300 of these transactions and earned $722,589 in net trading profits.

7. Although originally unsettled when the case was first brought in January 2012, the SEC announced in July that the Wolfsons had agreed to settle the cases against them. Robert Wolfson agreed to pay disgorgement of $8,771,432, prejudgment interest of $2,153,568 and civil penalties of $2.5 million. Jeffrey Wolfson and Golden Anchor agreed to pay, jointly and severally, disgorgement of $722,589, prejudgment interest of $177,411 and civil penalties of $200,000.

8. Jeffrey Wilson also agreed to cooperate with further SEC investigations relating to this matter, suggesting that the SEC's investigations in this area may continue.

Supervision

The SEC routinely brings supervisory cases against broker-dealers. Below are several actions against firms and individual supervisors. In particular, we provide the background and conclusion to the *Urban* case involving alleged failure to supervise by a legal officer.

A. *In the Matter of AXA Advisors, LLC*, Admin. Proc. File. No. 3-14708 (Jan. 20, 2012)

1. The SEC filed a settled administrative action against AXA Advisors, LLC ("AXA") alleging that between December 2005 and December 2008, AXA failed reasonably to supervise a registered representative who operated from a single-representative office.

2. The SEC Order alleged that the representative was supervised by AXA Advisors' branch office in Salt Lake City, Utah. During the three year period of his fraudulent conduct, the representative induced customers to redeem variable annuities (and to a lesser extent mutual funds), under the false representation that he would invest the proceeds on their behalf in other securities. After customers authorized the redemptions and received the proceeds, the representative induced the customers to wire the funds into an account which he controlled for his own personal benefit, or to write checks which he deposited into that account.

3. The SEC alleged that AXA failed to establish reasonable procedures to supervise the redemption of variable annuities. Further, AXA failed to establish reasonable procedures for supervising accounts of registered representatives who were on leave for an extended period of time, including absence due to disability. For a part of the time during which the representative

perpetrated his frauds, he was on disability leave or appealing a disability claim, apparently resulting in a lack of oversight of certain accounts that had no full time representative assigned to them.

4. In settling the matter, the SEC acknowledged remedial acts taken by AXA, including the creation of an automated system for reviewing redemptions of variable annuities and the creation of a report providing supervisory review of redemptions of variable annuities. The SEC also acknowledged AXA's cooperation during the investigation and AXA's prompt reimbursement of the losses experienced by its customers.

5. Without admitting or denying the allegations, AXA agreed to a settlement requiring it to engage an Independent Compliance Consultant to evaluate and, if appropriate, recommend enhancements to its supervisory and compliance practices for situations in which registered representatives are on extended leave. AXA also agreed to censure and to pay a civil penalty of $100,000.

6. In a related action, the SEC barred the representative, Leo T. Buggy, from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization and from participating in an offering of penny stock.

B. *In the Matter of Theodore W. Urban*, Admin. Proc. File No. 3-13655 (Jan. 26, 2012)

1. By way of background, in our 2009 Outline, we reported on settled proceedings brought against Ferris, Baker Watts, Inc. ("Ferris"), its former CEO, its former director of retail sales and a registered representative, Stephen Glantz ("Glantz"), who was engaged in market manipulation.

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

3. On September 8, 2010, following a lengthy hearing, Chief Administrative Law Judge Brenda Murray issued a fifty-seven page decision. Although Chief Judge Murray found that Urban "did not

have any of the traditional powers associated with a person supervising brokers," she nevertheless concluded that he was Glantz's supervisor because his "opinions on legal and compliance issues were viewed as authoritative and his recommendations were generally followed by people in [his firm's] business units, but not by Retail Sales." Chief Judge Murray determined, however, that Urban had acted reasonably under the facts and circumstances presented and dismissed the proceeding.

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

5. On January 26, 2012, the Commission announced that it was evenly divided as to whether the allegations against Urban had been adequately established, and so dismissed the case against him, invoking an internal procedural rule.[56] Thus, the Commission passed on an opportunity to clarify when someone becomes a supervisor for purposes of failure to supervise liability.

C. *In the Matter of JP Turner & Co., LLC and William Mello*, Admin. Proc. File No. 3-15014 (Sept. 10, 2012)

1. The SEC instituted settled administrative proceedings against JP Turner & Co., LLC ("JP Turner") and the firm's president, William Mello, for failing to supervise three of the firm's brokers with a view to preventing the fraudulent churning of customer accounts.

2. These supervisory charges stemmed from the actions of three registered representatives who collectively "churned" the accounts of seven customers by knowingly or recklessly engaging in excessive trading in disregard of the customers' investment objectives and financial needs for the purpose of generating commission business. The misconduct generated commissions,

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[56] Commission Rule of Practice 411(f), 17 C.F.R. § 201.411(f).

fees and margin interest totaling approximately $845,000. JP Turner retained approximately $200,000 of this amount.

3. During the time period of the brokers' misconduct, JP Turner used an automated system to detect excessive activity in customer accounts. JP Turner's system monitored accounts based primarily on "return on investment" ("ROI") levels, i.e., the level of fees and commissions as a percentage of account equity. However, the SEC found that JP Turner's surveillance system imposed few requirements on, and no meaningful guidance for, supervisors in terms of reviewing these accounts and taking meaningful action to investigate the trading activity. Among other things, the policies did not require supervisors to contact customers directly to inquire about the activity in the customers' accounts. Further, although the firm sent letters to customers whose activity was flagged by the surveillance system, JP Turner sent those letters only once a year, even if the customer appeared on the report repeatedly throughout the year.

4. In settling the SEC's charges, without admitting or denying the findings, JP Turner agreed to hire an independent consultant to review the firm's supervisory procedures to prevent future violations. The firm also paid $200,000 in disgorgement, plus a $200,000 penalty and $16,051 in prejudgment interest. Mello was suspended from associating in a supervisory capacity with a broker, dealer, or investment adviser for a period of five months and was required to pay a $45,000 penalty.

5. In separate actions, the SEC charged the three former brokers with "churning" the accounts of customers, and charged JP Turner's Head Supervisor, Michael Bresner, with failing to reasonably supervise two of the brokers. The brokers were charged with violating Section 17(a) of the Securities Act, and Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder. Bresner was charged with violating Section 15(b) of the Exchange Act for failing to reasonably supervise the brokers.

Enforcement Priorities for Broker-Dealers

Based on statements from SEC staff and Commissioners, market trends, recent cases, and current events, the SEC's 2013 enforcement priorities will likely be a mixture of familiar subject matters and new areas driven by changing technology and business methods. We believe the following list reflects some of the SEC's top priorities for broker-dealer enforcement this year:

- Municipal securities;
- Cyber attacks and security;

- Insider trading by Wall Street professionals;
- Failure to supervise by firms and individual managers;
- The Facebook IPO;
- Financial abuses against the elderly;
- Firms' use of social media;
- High-frequency and algorithmic trading, including abusive trading schemes;
- Broker-dealer trading systems and technology, including "kill switches," and controls over computer-trading code;
- Market structure, complex trading and ATS cases; and
- The sale of structured or complex products.

Enforcement Actions against Investment Advisers and Investment Companies[57]

Anti-Bribery and Pay-to-Play

The following case is an example of the SEC's interest in pay-to-play arrangements and alleged attempts to influence government officials' decisions regarding selection of an investment adviser for public funds.

A. *SEC v. Kwame M. Kilpatrick, et al.*, Case No. 12-cv-12109 (E.D. Mich., May 9, 2012)

1. The SEC filed an unsettled complaint alleging violations of Section 10(b) of the Exchange Act and Rules 10(b)(5)(a), (b), and (c) thereunder by former Detroit mayor Kwame Kilpatrick ("Kilpatrick") and former city treasurer Jeffrey Beasley ("Beasley") for soliciting and receiving perks from Mayfield Gentry Realty Advisors, LLC ("MGRA") and MGRA's CEO Chauncey Mayfield ("Mayfield"), investment advisers to Detroit's public pension funds (the "Funds"), in exchange for maintaining a relationship with the Funds and the management fees that resulted.

2. The SEC alleged that Kilpatrick and Beasley, as voting trustees to the Funds, solicited and received $125,000 worth of private jet travel and other perks paid for by MGRA while Mayfield was

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57 Unless otherwise apparent from the context of the descriptions of the actions, the cases described in this section are settlements in which respondents neither admitted nor denied the allegations against them. Certain cases fall outside of the SEC's FY 2012, but are included here for completeness.

seeking approval from the trustees to invest approximately $115 million from public pension funds in a security issued by an entity controlled by Mayfield.

3. As a result of the investments made by the pension funds, MGRA and Mayfield received millions of dollars in fees.

4. The SEC stated that the failure by Kilpatrick, Beasley, Mayfield, and MGRA to disclose these gifts and the resulting conflicts of interest constituted a breach of fiduciary duty and a fraud on the Funds.

5. In connection with this activity, the SEC alleged that Mayfield and MGRA also violated Section 10(b) of the Exchange Act and Rules 10(b)(5)(a), (b), and (c) thereunder, Sections 17(a)(1), (2) and (3) of the Securities Act, and Sections 206(1) and (2) of the Advisers Act, and that Kilpatrick and Beasley aided and abetted Mayfield and MGRA's Advisers Act violations.

6. In addition to seeking an injunction against future violations, disgorgement and civil monetary penalties against all four parties, the SEC is seeking to enjoin Kilpatrick and Beasley from participating in any decisions involving investments in securities by public pensions as a trustee, officer, employee, or agent.

Best Execution

The following case reflects the SEC staff's continuing interest in the use of affiliated broker-dealers and the potential impact of those arrangements on best execution.

A. *In the Matter of Tilden Louck & Woodnorth, LLC, LaSalle St. Securities, LLC, and Ralph B. Loucks*, Admin. Proc. File No. 3-15081 (Oct. 29, 2012)

1. The SEC initiated administrative proceedings against Tilden Loucks & Woodnorth, LLC ("TL&W"), a registered investment adviser, its affiliated broker-dealer LaSalle St. Securities, LLC ("LaSalle"), and TL&W's former senior vice president, Ralph B. Loucks ("Loucks"), alleging that TL&W obtained undisclosed compensation and violated its best execution obligations by charging increased commissions on trades executed through its affiliated broker-dealer.

2. The SEC alleged that TL&W failed to disclose compensation it received by charging increased commissions on trades through LaSalle by inaccurately telling clients that they received a discount on LaSalle's commissions. TL&W's Forms ADV stated that its clients obtained a significant discount to LaSalle's retail brokerage charges when, according to the SEC, La Salle had no retail

brokerage commission schedules and TL&W set LaSalle's commissions to be significantly higher than the commissions LaSalle charged TL&W. The SEC further alleged that TL&W failed to seek best execution and made misleading statements in its Form ADV about its brokerage practices.

3. The SEC alleged that TL&W violated, and Loucks caused TL&W's violations of Sections 206(2) and 207 of the Advisers Act. The SEC sanctioned TL&W, LaSalle and Loucks with cease-and-desist orders and censured TL&W and Loucks. The SEC further ordered TL&W and LaSalle to disgorge $170,320 plus prejudgment interest, and ordered TL&W, LaSalle and Loucks to disgorge $16,288 plus prejudgment interest. Finally, TL&W and LaSalle were ordered to pay civil money penalties of $100,000 each and Loucks was ordered to pay a civil money penalty of $25,000.

4. TL&W agreed to revise its Form ADV and provide a copy of the revised Form ADV and the SEC order to its clients.

Compliance Policies and Procedures

Another continuing area for SEC enforcement cases has been advisers' failure to adopt and implement adequate policies and procedures. Many of these cases have their origin in examinations that resulted in deficiencies that were not corrected in a timely manner or that involved allegations of impeding examinations.

A. *In the Matter of Consultiva Internacional, Inc.*, Admin. Proc. File No. 3-14973 (Aug. 3, 2012)

1. The SEC instituted settled administrative and cease-and-desist proceedings against Consultiva Internacional, Inc. ("Consultiva"), alleging that Consultiva failed to adopt and implement written compliance policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules.

2. The SEC alleged that Consultiva failed to take necessary remedial steps to satisfy its compliance obligations following an SEC exam in September 2005 in which the SEC staff alerted Consultiva to numerous deficiencies regarding its compliance program, including the design of the firm's compliance manual, the competency of its Chief Compliance Officer, and inaccuracies and inconsistencies with its Form ADV.

3. The SEC also alleged that from June 2005 through December 2010, Consultiva failed to properly enforce its written code of ethics because it did not collect and retain the required periodic securities reports from Consultiva's access persons.

4. Although Consultiva's violations were purely procedural, the SEC alleged that Consultiva violated Sections 206(4) and 204A of the Advisers Act and Rules 206(4)-7 and 204A-1 thereunder.

5. The SEC imposed certain remedial actions and a cease-and-desist order, censured Consultiva, and ordered a civil money penalty of $35,000.

B. *SEC v. GEI Financial Services, Inc., Norman Goldstein, and Laurie Gatherum*, Civil Action No. 12-7927 (N.D. Ill. Oct. 3, 2012)

1. The SEC filed an unsettled complaint alleging that GEI Financial Services, Inc. ("GEI Financial") and its owners, Norman Goldstein ("Goldstein") and Laurie Gatherum ("Gatherum"), took over $92,000 in excessive performance fees and owed the GEI Health Care Fund $55,000 for capital withdrawals. GEI Financial was also cited for failing to have adequate policies and procedures or to meet disclosure requirements.

2. The SEC complaint alleged that the respondents improperly amended the partnership agreement for the fund and failed to provide the amended agreement to investors. These amendments included removing one of the performance hurdles for GEI Financial to receive performance-based fees, providing investors with quarterly statements instead of monthly statements, no longer disclosing the fees paid to GEI Financial on the statements and no longer providing the investors with audited financial statements.

3. The SEC further alleged that GEI Financial made capital withdrawals from the GEI Health Care Fund's brokerage account that exceeded the fees that GEI Financial was owed by approximately $100,000. At the time that the complaint was filed, GEI Financial allegedly owed the GEI Health Care Fund approximately $55,000 for these withdrawals.

4. The SEC alleged that Goldstein was barred from providing investment advisory services in the state of Illinois in 2011 based on an investigation of one of GEI Financial's affiliates. Goldstein continued to provide advisory services to GEI Financial and GEI Financial failed to disclose the sanctions levied against Goldstein to the investors.

5. The SEC complaint further alleged that GEI Financial's policies and procedures consisted solely of excerpts of Section 13 of the Exchange Act and a policy prohibiting insider trading, but not requiring employees to sign an acknowledgment. Although SEC examiners pointed out the deficiencies in GEI Financial's policies

and procedures and code of ethics, these deficiencies were not corrected when examiners returned in 2011.

6. The SEC also alleged that GEI Financial had not updated its Form ADV since 2008. GEI Financial also allegedly did not prepare or distribute its Form ADV Part 2 brochure.

7. The SEC alleged that these actions violated Sections 204, 204A, and 206(1), 206(2) and 206(4) of the Advisers Act and Rules 204-1, 204A-1, 204-2, 204-3, 206(4)-7, and 204(4)-8(a)(1) thereunder.

C. *In the Matter of Evens Barthelemy and Barthelemy Group*, Admin Proc. File No. 3-15102 (Nov. 20, 2012).

1. The SEC instituted a settled administrative proceeding against Barthelemy Group LLC ("Barthelemy Group"), a formerly SEC-registered investment adviser, and Evens Barthelemy ("Barthelemy"), the founder, sole owner, managing director and chief compliance officer of Barthelemy Group for registering Barthelemy Group as an investment adviser when it did not meet the qualifications to register.

2. In order to register with the SEC as an investment adviser, a firm needs to have over $25 million in assets under management or be required to register as an investment adviser in at least 30 states. The Barthelemy Group allegedly registered as an investment adviser even though it never had more than $5 million in assets under management and was only required to register as an investment adviser in 3 states.

3. The SEC alleged that Barthelemy claimed on the Barthelemy's Group's Form ADV that the Barthelemy Group had $26 million in assets under management because he included assets of clients that he hoped to convince to follow him from his previous employment.

4. Barthelemy also allegedly manipulated the custodial statements that he provided to SEC examiners in order to change the total amount of assets under management from $2.6 million to $26 million.

5. The SEC further alleged that Barthelemy Group had inadequate policies and procedures and that Barthelemy copied nearly verbatim the policies and procedures of a broker-dealer where he was previously employed and therefore these policies and procedures were not appropriately tailored for an investment advisory business. The SEC also alleged that Barthelemy Group failed to maintain records required under the Advisers Act.

6. According to the SEC, Barthelemy and Barthelemy Group violated Sections 203A, 204, 206(4) and 207 of the Advisers Act and Rules 204-2(a)(12)(iii), 204-2(a)(14)(i), and 206(4)-7 thereunder.

7. Barthelemy and Barthelemy Group agreed to settle the case. Barthelemy agreed to a bar from association with any firm in the securities industry, with a right to apply for reentry after two years. Barthelemy and Barthelemy Group agreed to amend Barthelemy Group's Form ADV to reflect the SEC's order with respect to the case, provide a copy of the Form ADV and order to each existing client and applicable state securities regulator, and post a copy of the order on Barthelemy Group's website. Barthelemy and Barthelemy Group were not required to pay a civil money penalty based on evidence that they presented that they did not have the ability to pay.

D. *In the Matter of EM Capital Management and Seth Richard Freeman*, Admin. Proc. File No. 3-15101 (Nov. 20, 2012)

1. The SEC instituted settled administrative proceedings against EM Capital Management and Seth Richard Freeman ("Freeman") for failing to timely respond to SEC examination requests.

2. As part of its examination of EM Capital Management, the SEC requested that the firm provide its financials to the staff in December 2010. After receiving a follow-up request in May 2011 for the firm's financials as well as other documents, the firm failed to provide several documents, including its financials as well as e-mails and documents relating to its management of a fund. The staff then sent a second follow-up request in July 2011 for the missing documents.

3. In May 2012, the SEC sent EM Capital Management a Wells Notice indicating that it was recommending an enforcement action. EM Capital Management produced the documents to the staff in September 2012.

4. Based on its allegations, the SEC charged that EM Capital Management and Friedman violated 204 of the Advisers Act and Rules 204-2(a)(1), (2), and (6) thereunder.

5. EM Capital Management and Freeman agreed to a cease-and-desist order, a censure, and to jointly and severally pay a civil money penalty of $20,000.

Failure To Disclose Conflicts Of Interest

The cases below highlight the SEC's focus on ensuring that investment advisers make full and fair disclosure of material facts that may affect the nature of the investment advisory relationship. The SEC has been particularly focused on situations where the investment adviser had a financial or other conflict of interest that allegedly affected the trading or investment decisions made on behalf of its clients or caused the investment adviser to benefit one client at the expense of another.

A. *In the Matter of Martin Currie Inc. and Martin Currie Investment Management Ltd.*, Admin. Proc. File No. 3-14873 (May 10, 2012)

1. The SEC filed a settled administrative proceeding against Martin Currie Inc. ("MCI") and Martin Currie Investment Management Ltd. ("MCIM") for allegedly using one of their U.S.-based registered investment company clients (the "China Fund") to rescue another client, a China-focused hedge fund (the "Hedge Fund"). The SEC also alleged that MCI and MCIM aided and abetted these violations.

2. The SEC alleged that MCI and MCIM made significant debt and equity investments in a single Chinese-based company (the "Company") on behalf of the Hedge Fund. The global financial crisis caused the Hedge Fund to have liquidity problems as a result of redemptions by its clients. At the same time, the Company needed cash to fund operations and make interest payments to bondholders, including the Hedge Fund.

3. The SEC alleged that MCI and MCIM caused the China Fund to make a significant convertible bond investment in a subsidiary of the Company after knowingly or recklessly misleading the China Fund's Board of Directors (the "Board") by not disclosing the benefit that the Hedge Fund would obtain from the transaction. The Company used this investment to redeem some of the Hedge Fund's bonds and to fund operations and make other debt service payments. The convertible bonds that MCI and MCIM caused the China Fund to invest in were later sold for approximately 50% of their face value.

4. The SEC alleged that MCI did not follow the China Fund's valuation procedures that called for fair valuation of bonds, withheld other relevant information and misled the China Fund's Board. This caused the China Fund's assets to be overvalued and led to material misstatements in the China Fund's annual, semi-annual and quarterly reports on Forms N-CSR and N-Q.

5. The SEC also alleged that MCIM improperly classified the convertible bonds as cash, which led to them being reported inaccurately in certain reports sent to Hedge Fund investors.

6. The SEC alleged that MCI violated Sections 206(1), (2), and (4) of the Advisers Act and Rule 206(4)-7 thereunder and that MCI violated Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder. The SEC also alleged that MCI and MCIM aided and abetted violations of Section 17(d) of the Investment Company Act and Rule 17d-1 thereunder.

7. MCI and MCIM consented to a cease-and-desist order, a censure, and a civil money penalty of $8,300,000.

8. In considering the settlement, the SEC took into account MCI and MCIM's cooperation with SEC staff, as well as remedial measures that the investment advisers took, including compensating the China Fund for net losses and associated expenses and enhancing their policies, procedures, and controls that govern compliance with the Advisers Act and the Investment Company Act.

B. *SEC v. Mark F. Spangler and The Spangler Group, Inc.*, Case No. 2:12-cv-00856 (W.D. Wash. May 17, 2012)

1. The SEC filed an unsettled complaint against Mark Spangler ("Spangler") and The Spangler Group (the "Group"), an investment adviser, for defrauding clients by secretly investing their money in two risky start-up companies that Spangler co-founded, investments which were inconsistent with the disclosed strategies and the clients' investment objectives.

2. The SEC alleged that Spangler raised money from investors for private funds that he claimed would be invested in publicly traded securities. The money raised was instead invested in two companies in which Spangler had a significant financial interest and for which he served as Chairman and, at times, as CEO.

3. Additionally, the SEC alleged that the two companies receiving the investors' money in turn paid the Group fees for financial and operational support that was not in actuality given. These fees were paid out of the money invested into the companies, were not disclosed to the investors, and were paid on top of management fees that the Group collected directly from the investors.

4. The SEC also alleged that Spangler did not disclose the conflict of interest that resulted from these investments in the Group's Form ADV, and thereby willfully made untrue statements of material fact.

5. The SEC is seeking to enjoin Spangler and the Group from future violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, Sections 206(1), (2), (4) of the Advisers Act and Rule 206(4)-8 thereunder, and Section 207 of the Advisers Act, disgorgement, and civil money penalties.

C. *In the Matter of MiddleCove Capital, LLC and Noah L. Myers*, Admin. Proc. File No. 3-14993 (Aug. 22, 2012)

1. The SEC initiated administrative and cease-and-desist proceedings against MiddleCove Capital, LLC ("MiddleCove") and Noah L. Myers ("Myers"), alleging that Myers, the sole owner of MiddleCove, unfairly allocated profitable trades to his accounts and unprofitable trades to the accounts of his advisory clients.

2. MiddleCove and Myers allegedly placed securities that they purchased in an omnibus account and waited until the end of the day before allocating them. Those securities that appreciated in value were allocated to day-trading accounts belonging to Myers and his family. Securities that depreciated in value during the day were allocated to client accounts.

3. Based on this alleged cherry-picking scheme, Myers realized ill-gotten gains of approximately $460,000 and caused losses in client accounts of more than $2 million

4. The SEC also alleged that Myers only ceased his cherry-picking activities after one of his employees threatened to contact the SEC.

5. In addition to alleging violations of Sections 206(1) and 206(2) of the Advisers Act for the cherry-picking scheme, MiddleCove also allegedly misrepresented its allocation process in its Form ADV in violation of Section 207 of the Advisers Act.

6. Both MiddleCove and Myers consented to a censure. MiddleCove consented to having its license revoked and Myers consented to a bar from association with the securities industry with a right to reapply after Myers met all of his obligations to pay restitution and arbitration awards. MiddleCove and Myers agreed to pay disgorgement of $462,022, prejudgment interest of $26,096, and a civil monetary penalty of $300,000.

D. *In the Matter of Focus Point Solutions, Inc., The H Group, Inc., and Christopher Keil Hicks*, Admin. Proc. File No. 3-15011 (Sept. 6, 2012)

1. The SEC initiated an administrative proceeding against two related advisers, Focus Point Solutions, Inc. ("Focus Point") and The H Group, Inc. ("The H Group"), and their principal, Christopher Keil

Hicks ("Hicks"), alleging failure to disclose multiple conflicts of interest in their advisory business.

2. The SEC alleged that Focus Point violated Sections 206(2) and 207 of the Advisers Act by failing to disclose compensation received through a revenue-sharing agreement with a broker-dealer under which Focus Point received a certain percentage of every dollar its clients invested in specified mutual funds, in exchange for performing custodial support service for the broker-dealer.

3. The SEC further alleged that Focus Point violated Section 15(c) of the Investment Company Act in connection with being hired as a subadviser to a mutual fund by failing to disclose information to the fund trustees about additional fees, other than the subadvisory fee, that it received from the fund's primary adviser.

4. The SEC lastly alleged that The H Group violated Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-6 thereunder by voting its client proxies in favor of a proposal to approve Focus Point as the mutual fund's subadviser.

5. The SEC censured and sanctioned the respondents with a cease-and-desist order and ordered Focus Point to disgorge $900,000 and to pay prejudgment interest of $25,813 and a civil money penalty of $100,000. The H Group and Hicks were ordered to pay civil money penalties of $50,000 each.

6. In considering the settlement, the SEC took into account the respondents' agreement to retain and implement the advice of an independent compliance consultant.

Insider Trading

The SEC has brought a number of insider trading cases against investment advisers, including cases involving an adviser's use of an expert network to obtain inside information.

A. *SEC v. H. Clayton Peterson et al.*, 11-cv-5448 (S.D.N.Y. 2012); *In the Matter of Drew Clayton Peterson*, Admin Proc. File No. 3-14930 (June 27, 2012). *In the Matter of Drew K. Brownstein*, Admin. Proc. File No. 3-14929 (June 27, 2012).

1. The SEC filed suit against former Mariner Energy, Inc. ("Mariner"), its Director, H. Clayton Peterson ("Clayton Peterson"), and his direct and indirect tippees, Drew Clayton Peterson ("Drew Peterson"), Drew K. Brownstein ("Brownstein"), and Big 5 Asset Management, LLC ("Big 5") for an alleged insider trading scheme.

2. The SEC alleged that Clayton Peterson, having learned through confidential board meetings that Mariner was about to be acquired by Apache Corporation, tipped his son, Drew Peterson about the acquisition. Drew Peterson, a managing director of a registered investment adviser, used this information to trade Mariner securities for his own accounts, for his family members, his investment club and investment clients, and to tip certain friends, including Brownstein. Drew Peterson's trading and the trading of his tippees, excluding Brownstein, resulted in profits of $205,416.

3. Brownstein allegedly used the material nonpublic information he received from Drew Peterson to trade shares for his own account, for his family members and for hedge funds managed by Big 5, Brownstein's registered investment advisory firm. As a result of this information, Brownstein earned approximately $4.6 million for Big 5 hedge funds, $305,050 for his family members and $130,671 for himself.

4. The court entered final judgments against Clayton Peterson and Drew Peterson permanently enjoining them from violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and ordering them to pay, on a joint and several basis, disgorgement of $205,416 plus prejudgment interest of $13,603. The court's judgment against Clayton Peterson also barred him from serving as an officer or director of a public company.

5. The court also entered a final judgment against Brownstein, permanently enjoining him from violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and ordering him to pay disgorgement of $435,722 and prejudgment interest of $23,427.

6. The court entered a judgment against Big 5 permanently enjoining it from violations of Section 10(b) of the 1934 Act and Rule 10b-5 thereunder, and ordering it to pay, on a joint and several basis with Brownstein, disgorgement of $4,148,262 and prejudgment interest of $274,709.

7. In related criminal cases, Drew Peterson and Brownstein each pled guilty to one count of securities fraud.

8. The SEC also issued orders on consent in related administrative proceedings pursuant to Section 203(f) of the Advisers Act barring Drew Peterson and Brownstein from associating with any firm in the securities industry.

B. *SEC v. CR Intrinsic Investors, LLC, Mathew Martoma, and Dr. Sidney Gilman*, Case No. 12 CV 8466 (S.D.N.Y. Nov. 20, 2012)

1. The SEC filed a complaint against CR Intrinsic Investors ("Intrinsic"), Mathew Martoma ("Martoma") and Dr. Sidney Gilman ("Gilman") as a result of Intrinsic's trading of shares of a drug corporation ahead of a negative public announcement, based on information received from Gilman.

2. The SEC alleged that through an expert network firm, Martoma, a portfolio manager for Intrinsic, an unregistered investment adviser, obtained information regarding the clinical trials of an Alzheimer's drug being developed by Elan Corporation, PLC and Wyeth ("Elan and Wyeth") from Gilman, the chairman of the committee overseeing the drug's clinical trial, prior to its public announcement.

3. The SEC further alleged that based on this information, Martoma liquidated Intrinsic's position in Elan and Wyeth stock, in addition to taking substantial short positions on it, while also causing similar positions to be taken by an affiliated investment adviser. The SEC alleged that through these trades, Intrinsic and its affiliated investment adviser reaped profits and avoided losses of over $276 million.

4. The SEC alleged that as a result of these violations, Martoma received a $9.3 million bonus and Gilman over $100,000 in consulting fees, in connection with their trading based on and sharing of material nonpublic information.

5. The SEC alleged that these actions constitute violations of Sections 17(a) and 10(b) of the Exchange Act and Rule 10b-5 thereunder.

6. The SEC proceeding against Intrinsic and Martoma is still pending. Gilman agreed to pay approximately $234,000 in disgorgement and prejudgment interest and was also sanctioned with a permanent injunction against violations of the federal securities laws. This agreement is subject to court approval.

C. *SEC v. Tiger Asia Management, LLC, et al.*, Civil Action No. 12-cv-7601 (Dec. 13, 2012)

1. The SEC brought charges against Sung Kook Hwang ("Hwang"), the founder and portfolio manager of Tiger Asia Management and Tiger Asia Partners (together, "Tiger"), alleging that Hwang committed insider trading and manipulated the prices of publicly traded Chinese bank stocks. It also brought charges against Raymond Y.H. Park ("Park"), portfolio manager of the two hedge funds involved in the scheme.

2. The SEC alleged that Hwang and Tiger used nonpublic information from private placements for Bank of China stock and China Construction Bank stock to make short sales of the stock several days before the private placement. Hwang and Tiger allegedly profited $16.3 million by using discounted private placement shares to cover the short sales.

3. The SEC also alleged that Hwang, Tiger and Park attempted to manipulate the month-end closing prices of Chinese bank stocks in which the hedge funds managed by Park had large short positions. Hwang, Tiger and Park entered losing trades in an attempt to lower the price of the bank stocks and therefore increase the value of the short positions held by the two hedge funds. This increase in the value of the short positions in turn raised the management fees received by Tiger Asia Management. The SEC alleged that this scheme netted Tiger Asia Management an additional $496,000 in fees.

4. The SEC charged Hwang, Tiger and Park with violations of Section 10(b) and Rule 10b-5 thereunder and Section 17(a) of the Securities Act. In addition, Hwang and Tiger were charged with violations of Sections 206(1), 206(2), and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder.

5. Hwang and Tiger agreed to pay prejudgment interest and disgorgement totaling $19,048,787 and each agreed to pay an $8 million civil penalty for a total payment of $44 million. Park agreed to disgorge $39,819 and to pay a $34,897 civil money penalty.

Market Manipulation

The following cases illustrate various examples of allegations of investment advisers engaging market manipulation, including the practice of “marking the close” and short sales that violate Rule 105 under Regulation M.

A. *SEC v. RKC Capital Management, LLC, RKC Capital, LLC, and Russell K. Cannon*, Case No. 2:12-cv-00408-BCW (D.C. Utah Apr. 30, 2012)

1. The SEC filed an unsettled complaint against RKC Capital Management, LLC, RKC Capital, LLC (together, “RKC”), and RKC’s founder and manager Russell K. Cannon (“Cannon”), alleging that they artificially inflated the value of assets under management of RKC Matador Fund LLC (“Matador”), a hedge fund that RKC and Cannon managed, in order to attract investments and charge excessive advisory fees.

2. The SEC alleged that RKC and Cannon were "marking the close" of a stock that comprised more than 50% of Matador's assets under management. RKC and Cannon manipulated the stock price by placing large purchase orders of the stock at the end of the trading day in order to push the price higher.

3. This activity often occurred on the last trading day of the month, in what the SEC alleged was an attempt to maximize monthly performance returns to increase the management and monthly incentive fees that RKC and Cannon collected.

4. The SEC also alleged that RKC and Cannon instructed Matador's fund administrator to set the price of the stock above the market price when their attempts at marking the close were unsuccessful in driving up the price.

5. As a result of RKC and Cannon's activity, the SEC alleged that the advisory fees received from Matador and Matador's assets under management were both inflated.

6. The SEC alleged that RKC and Cannon's actions constituted a violation of Sections 206(1), (2), and (4) of the Advisers Act and Rule 206(4)-8 thereunder, Sections 17(a)(1), (2), and (3) of the Securities Act, and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

B. *In the Matter of Eric David Wanger and Wanger Investment Management, Inc.*, Admin. Proc. File No. 3-14676 (July 2, 2012).

1. The SEC initiated an administrative proceeding against Wanger Investment Management, Inc. ("Wanger Investment Management"), a registered investment adviser, and Eric David Wanger ("Wanger"), the owner, chief compliance officer and president of Wanger Investment Management, alleging that Wanger "marked the close" for certain securities owned by Wanger Long Term Opportunity Fund II, LP (the "Fund"), engaged in improper principal transactions with the Fund, and failed to timely file Forms 4 with the SEC.

2. The Fund, which Wanger founded and managed, invested heavily in small and microcap companies with very thin trading volume. The SEC alleged that, from January 2008 through September 2010, Wanger executed, at inflated prices, at least 15 trades in thinly traded securities owned by the Fund at the end of the day of the final trading session of a month or quarter. This activity inflated the Fund's performance between 3.6% and 5,908.71% and its value between 0.24% to 2.56%.

3. The SEC also alleged that Wanger, acting through Wanger Investment Management, engaged in numerous improper principal transactions with the Fund, including transferring monies from the Fund's brokerage account to Wanger Investment Management's bank account to pay operating expenses and payroll and transferring securities on numerous occasions between Wanger's individual account and the Fund's account, in each case without providing written disclosure to the Fund or obtaining the Fund's consent.

4. The SEC also alleged that Wanger, who served as a member of the Board of Directors of a company in which the Fund was a 10% owner, failed to timely file the requisite Forms 4 with the SEC regarding at least 8 personal transactions in the company's securities and 40 of the Fund's transactions in the company's securities.

5. According to the SEC, Wanger's conduct constituted violations of Section 17(a) of the 1933 Act, Section 10(b) and 16(a) of the 1934 Act and Rules 10b-5 and 16a-3 thereunder, and Sections 206(1), 206(2), 206(3), and 206(4) of the Adviser Act and Rule 206(4)-8 thereunder.

6. Wanger settled with the SEC, agreeing to a cease-and-desist order, a one year bar from associating with any firm in the securities industry, a $75,000 civil money penalty and payment of prejudgment interest of $122 and disgorgement of $2,269.

C. *In the Matter of Wesley Capital Management, LLC*, Admin. Proc. File No. 3-14962 (July 26, 2012)

1. The SEC instituted settled administrative and cease-and-desist proceedings against Wesley Capital Management, LLC ("Wesley"), alleging that Wesley purchased securities in public follow on offerings by Duke Realty Corporation and Host Hotels & Resorts, Inc. after having sold short the securities of both issuers during the five business days prior to the pricing of the public offerings.

2. The SEC alleged that Wesley realized profits of $142,124 by participating in these offerings.

3. The SEC alleged that these transactions constituted a violation of Rule 105 of Regulation M.

4. The SEC noted that after the alleged conduct, Wesley developed and implemented policies and procedures pertaining to compliance with Rule 105 of Regulation M.

5. The SEC imposed a cease-and-desist order, censured Wesley, and ordered Wesley to pay disgorgement in the amount of $142,124, plus prejudgment interest of $15,165 and a civil money penalty of $75,000.

Misappropriation of Client Assets and Fraudulent Trading Schemes

One of the most common areas of enforcement actions for the SEC continues to be cases where investment advisers allegedly misappropriate client assets and engage in fraudulent trading schemes that result in using client assets for their own personal benefit. The following three cases are examples of the many SEC actions brought in this area.

A. *SEC v. Brian Raymond Callahan, Horizon Global Advisors Ltd. and Horizon Global Advisors, LLC*, Civil Action No. 12-cv-1065 (E.D.N.Y. Mar. 28, 2012)

1. The U.S. District Court for the Eastern District of New York issued an order granting a preliminary injunction and other relief against Brian Raymond Callahan ("Callahan") and Callahan's investment advisory firms, Horizon Global Advisors, Ltd. ("HGA Ltd.") and Horizon Global Advisors, LLC ("HGA LLC").

2. The SEC's complaint alleged Callahan defrauded investors in five offshore funds and misappropriated client assets. According to the SEC complaint, from at least 2005 to January 2012, Callahan operated five funds through HGA Ltd. and HGA LLC and raised almost $75 million from investors, promising them that their money would be invested with New York-based hedge funds and that these investments would be liquid and diversified.

3. The complaint alleged Callahan improperly diverted investors' money to his brother-in-law's real estate project, which was facing foreclosure, in return for unsecured, illiquid promissory notes. Additionally, the promissory notes reflected amounts that far exceeded the amount Callahan gave to the real estate project, which allowed Callahan to overstate the assets of management he was managing and the management fees he would collect. Callahan also commingled and misused a portion of investor assets to pay certain other investors seeking redemptions from other Callahan funds and to make a down payment on a multimillion dollar cooperative unit in Callahan's name.

4. Callahan also failed to disclose to investors that he was barred by FINRA from associating with any FINRA member in 2009.

5. Callahan refused to testify in the SEC's investigation and informed investors about the investigation, but gave false assurances that no laws had been broken.

6. In March 2012, the Court issued an order preliminarily enjoining Callahan and his advisory firms with violating Sections 17(a)(1), (2) and (3) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 206(1), 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder. The order also froze the defendants' assets, required them to repatriate any assets located outside of the United States and prohibited the defendants from soliciting or accepting any new investments.

7. The SEC proceeding against Callahan and his advisory firms is still pending.

B. *SEC v. GLR Capital Management, LLC, GLR Advisors, LLC, Geringer, Luck & Rode LLC, John A. Geringer, and Relief Defendant GLR Growth Fund, L.P.*, Case No. 12-02663 (N.D. Cal. May 24, 2012)

1. The SEC filed an unsettled complaint against GLR Capital Management LLC ("GLR Capital"), an investment adviser, one of its principals, John Geringer ("Geringer") and two other entities controlled by Geringer based on allegations that they defrauded investors of the GLR Growth Fund (the "Fund") by using false and misleading marketing materials to raise money for the Fund that he then operated in a Ponzi-style fashion.

2. The SEC complaint alleged that, beginning in 2005 and continuing through early 2012, Geringer raised over $60 million for the Fund. Geringer induced these investments through marketing materials claiming that the Fund had achieved steady annual returns every year, including during the financial crisis, through investing in publicly traded securities, options, and commodities. The SEC alleged that both claims were false, as the trading strategy produced negative returns and the Fund had begun investing heavily in two illiquid private startup companies in 2009. The SEC alleged that money used to pay investors came from money raised by new investors, rather than from profits as a result of Geringer's trading strategy.

3. In conjunction with the fraudulent marketing materials, the SEC alleged that Geringer also distributed false documents, including false account summaries, tax returns, and brokerage account statements, in order to make it appear that his trading in the Fund's brokerage accounts was successful. Additionally, the SEC alleged that Geringer prepared and mailed periodic account statements to investors claiming "MEMBER NASD AND SEC APPROVED,"

despite the fact that the SEC never approved the Fund and the Fund and its affiliated companies were not NASD members.

4. The SEC is seeking to enjoin the defendants from future violations of Section 17(a) of the Securities Act, Sections 10(b) and 26 of the Exchange Act and Rule 10b-5 thereunder, Sections 206(1), (2), and (4) of the Advisers Act, and Rule 206(4)-8 thereunder. The SEC also seeks disgorgement and to levy civil money penalties.

C. *In the Matter of Peter Madoff*, Admin. Proc. No. 3-14963 (July 26, 2012); *SEC v. Peter Madoff*, 12-Civ-5100 (S.D.N.Y. June 29, 2012)

1. The SEC initiated settled administrative proceedings against Peter Madoff ("Madoff") in connection with the Bernard L. Madoff Investment Securities LLC ("BMIS") case.

2. The SEC noted that on June 29, 2012, Madoff pled guilty to committing fraud, making false statements to regulators, and falsifying books and records in order to create the false appearance of a functioning compliance program over the fraudulent investment advisory operations at BMIS.

3. In the court case, the SEC alleged that Madoff, who served as Chief Compliance Officer and Senior Managing Director at BMIS from 1969 to 2008, created compliance manuals, written supervisory procedures, reports of annual compliance reviews, and compliance certifications to merely paper the firm's file and that no policies and procedures were ever implemented, and none of the reviews were actually performed.

4. The SEC also alleged that Madoff created false broker-dealer and investment adviser registration applications and falsified the firm's books and records.

5. The SEC alleged that Madoff's actions violated and aided and abetted violations of Section 10(b) of the 1934 Act and Rule 10b-5 thereunder, Section 207 of the Advisers Act of 1940, Sections 15(b)(1), 15(c) and 17(a) of the 1934 Act and Rules 10b-3, 15b3-1 and 17a-3 thereunder, and Sections 204, 206(1), 206(2), 206(4) and 207 of the Advisers Act and Rules 204-2 and 206(4)-7 thereunder.

6. The SEC issued an administrative order that bars Madoff from associating with any firm in the securities industry or from participating in a penny stock offering, with a right to apply for reentry.

7. Madoff pleaded guilty to separate criminal charges brought by the U.S. Attorney's Office and was sentenced to 10 years in prison.

Misrepresentations and False Statements

The SEC continues to be focused on ensuring that investment advisers and their personnel do not make misleading statements in order to attract and retain clients or investors. This year, the SEC was particularly focused on so-called "skin in the game" cases in which investment advisers and their personnel represented that they were investing their own money along with clients.[58]

A. *In the Matter of Quantek Asset Mgmt., LLC, Bulltick Capital Markets Holdings, LP, Javier Guerra, and Ralph Patino*, Admin. Proc. File No. 3-14893 (May 29, 2012)

1. The SEC filed a settled administrative proceeding against hedge fund manager Quantek Asset Management, LLC ("Quantek"), its parent Bulltick Capital Markets Holdings, LP ("Bulltick"), Javier Guerra ("Guerra"), and Ralph Patino ("Patino") (collectively, "Defendants") over allegations that Quantek, Guerra, and Patino misrepresented the extent to which Quantek's principals had invested in Quantek's funds and that the Defendants made misrepresentations about related-party transactions between Quantek and Bulltick.

2. According to the SEC order, fund investors generally consider manager co-investments to be "an important way to align the adviser's interest with their own, resulting in stronger discipline and risk management." The SEC order alleged that the misstatements in this case were made predominantly in response to due diligence questionnaires and side letter agreements.

3. Additionally, the SEC order alleged that Quantek misled investors about the rigor of its investment process, telling investors that all investments required approval by a committee of principals who reviewed formal memoranda explaining each proposed investment before it was made. In actuality, Quantek did not prepare these memos for each transaction, instead allegedly creating some of them when investors requested copies.

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[58] Please refer to the case summaries for *In the Matter of Daniel Bogar, Bernerd E. Young and Jason T. Green*, Admin. Proc. File No. 3-15003 (Aug. 31, 2012); *In the Matter of Jason A. D'Amato*, Admin. Proc. File No. 3-15004 (Aug. 31, 2012); *In the Matter of Jay T. Comeaux*, Admin. Proc. File No. 3-15002 (Aug. 31, 2012); *SEC v. Mizuho Securities USA Inc.*, 12-cv-5550 (S.D.N.Y. July 18, 2012) and *In the Matter of OppenheimerFunds, Inc. and OppenheimerFunds Distributor, Inc.*, Admin Proc. File No. 3-14909 (June 6, 2012) for additional examples of cases against investment advisers involving alleged misrepresentations and false statements.

4. The SEC also alleged that Quantek, Bulltick, Guerra, and Patino misled investors about related-party loans made by the funds to Bulltick and other affiliates. Although the funds' offering documents permitted related-party loans, Quantek's loans to Bulltick, its parent company, were not properly documented or secured. When investors inquired about these loans, Quantek and Bulltick employees prepared certain missing loan documents.

5. The SEC order charged the Defendants with violating or aiding and abetting violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act, Section 206(4) of the Advisers Act and Rules 206(4)-7 and 206(4)-8 thereunder, and Section 204 of the Advisers Act and Rule 204-2(a)(7) thereunder.

6. The Defendants consented to a cease-and-desist order, a censure of Quantek and Bulltick, an industry bar of five years for Guerra and one year for Patino, disgorgement of a total of $2,056,446 and prejudgment interest of $219,585 for Quantek and Guerra, and civil money penalties of $375,000 for Quantek, $300,000 for Bulltick, $150,000 for Guerra, and $50,000 for Patino.

B. *In the Matter of Anthony Fields, CPA d/b/a Anthony Fields & Associates and d/b/a Platinum Securities Brokers*, Admin. Proc. File No. 3-14684 (Dec. 5, 2012)

1. On January 4, 2012,[59] the SEC initiated an administrative proceeding against a registered investment adviser, Anthony Fields & Associates ("AFA"), alleging that AFA, through its principal Anthony Fields, made multiple fraudulent offers of fictitious securities through LinkedIn and other social media websites.

2. The SEC alleged that Fields made multiple fraudulent offers of fictitious bank guarantees and medium-term notes on LinkedIn. Fields allegedly also made false representations on his Form ADV, representing that he had $400 million in assets under management when in fact he had none. The SEC also alleged that Fields failed to adopt or implement written compliance policies and procedures.

3. Fields also allegedly made false statements on AFA's and Platinum's websites, stating, among other things, that Platinum was a registered broker-dealer and that it had a $50 billion contract to trade U.S. Treasury Securities. Platinum's website also falsely stated that Platinum was a primary dealer authorized by the

[59] In connection with the publication of the January 4, 2012 administrative proceeding, the Office of Compliance Inspections and Examinations issued a National Examination Risk Alert on Investment Adviser Use of Social Media, available at: http://www.sec.gov/about/offices/ocie/riskalert-socialmedia.pdf.

Federal Reserve Bank of New York to buy and sell securities directly for the U.S. Treasury.

4. In a subsequent ALJ decision on December 5, 2012, AFA's registration as an investment adviser was revoked and Fields was barred from the securities industry. Fields was also ordered to cease-and-desist from violations of Sections 17(a)(1) and 17(a)(3) of the Securities Act, Section 15(a) of the Exchange Act, Sections 203A, 206(1), 206(2), 206(4), and 207 of the Advisers Act and Rules 206(4)-1(a)(5) and 206(4)-7 thereunder, and to pay a civil money penalty of $150,000.

C. *In the Matter of Aladdin Capital Management LLC and Aladdin Capital LLC*, Admin. Proc. File No. 3-15134 (Dec. 17, 2012)

1. The SEC initiated an administrative proceeding against a registered investment adviser, Aladdin Capital Management LLC ("Aladdin Management") and a formerly registered broker-dealer, Aladdin Capital LLC ("Aladdin Capital"), alleging that they failed to co-invest with clients in the equity tranche of certain collateral debt obligations ("CDOs") in contrast to representations that they made to clients.

2. The SEC alleged that Aladdin Management failed to

3. co-invest in CDOs alongside at least three Multiple Asset Securitized Tranche ("MAST") participating clients. Specifically, when marketing the MAST program to clients, Aladdin Management and Aladdin Capital represented that they would invest the equivalent of at least 10% of the client's investment in the same equity tranche of the CDO in which their clients were investing. According to the SEC order, this representation was one of the most powerful statements Aladdin Management could make because it showed that the manager had "skin in the game" and "that its financial interests were aligned with those of its clients." Aladdin Capital received a 10% placement fee for placing interests in the CDOs.

4. Aladdin Management made the co-investment representations in marketing materials and continued to make those statements after clients invested in the MAST program. In addition, investment reports sent to participating clients also represented that Aladdin Management was invested alongside the clients. However, Aladdin Management never invested in the subject CDOs.

5. The SEC alleged that Aladdin Capital violated Section 17(a)(2) of the Securities Act and that Aladdin Management violated Section 206(2) of the Advisers Act.

6. Aladdin Management was ordered to cease-and-desist from committing or causing any violations or any future violations of Section 206(2) of the Advisers Act. Aladdin Management and Aladdin Capital were ordered to pay disgorgement in the amount of $900,000 plus prejudgment interest of $268,831, and a civil money penalty of $450,000.

7. In an associated case, *In the Matter of Joseph A. Schlim*, Admin. Proc. File No. 3-15135 (Dec. 17, 2012), the former CFO of Aladdin Capital and Aladdin Management, Joseph Schlim ("Schlim"), was found to have violated Section 17(a)(2) of the Securities Act and Section 206(2) of the Advisers Act for failing to direct Aladdin Management to co-invest in the CDOs as described above. Schlim was ordered to cease-and-desist from committing or causing any violations or any future violations of Section 17(a)(2) of the Securities Act and Section 206(2) of the Advisers Act, and was ordered to pay a civil money penalty of $50,000.

Performance Advertising

Advertising has long been a high priority for both the SEC examination and enforcement staff. These cases highlight a particular focus on misrepresentations involving historical performance, including the back tested performance and past specific recommendations.[60]

A. *In the Matter of GMB Capital Mgmt LLC, GMB Capital Partners LLC, Gabriel Bitran and Marco Bitran*, Admin Proc. File No. 3-14854 (Apr. 20, 2012)

1. The SEC initiated an administrative proceeding against GMB Capital Management LLC ("GMB Management"), a registered investment adviser, GMB Capital Partners LLC ("GMB Partners"), an unregistered investment adviser, Gabriel Bitran ("Gabriel") and Marco Bitran ("Marco"), alleging that the defendants misled investors about the hedge fund's investment strategy and past performance.

2. The SEC alleged that Gabriel founded GMB Management in 2005 for the stated purpose of managing hedge funds using quantitative models he developed to trade primarily Exchange Traded Funds ("ETFs"). He and his son Marco solicited potential investors through misrepresentations that touted the firm's use of a proprietary optimal pricing model, the funds' performance track records, and Gabriel's involvement in the management of the

[60] Please refer to the case summary for *In the Matter of Jason A. D'Amato*, Admin. Proc. File No. 3-15004 (Aug. 31, 2012) for an additional case involving the use of back tested performance.

funds. The defendants raised over $500 million for eight hedge funds and various managed accounts over a period of three years.

3. Contrary to the defendants' representations, the performance track records of the funds were based on back tested hypothetical simulations instead of actual performance. Further, the funds were invested almost entirely in illiquid investments in other hedge funds instead of in ETFs selected based on Gabriel's unique quantitative strategy. Additionally, in May 2008, Gabriel and Marco divided GMB's business. Marco advised the hedge funds under a new entity, GMB Partners, and Gabriel managed the other clients through GMB Management. The defendants continued to inform potential investors that GMB Partners' hedge funds were managed by Gabriel, even though he had no involvement in the investment process.

4. During an SEC examination of GMB, the defendants provided the staff with trading logs purporting to show ETF trades for positions between 1998 and 2005. In fact, there was no actual trading during that time period. In addition, GMB failed to produce client correspondence, including e-mails, requested by the SEC staff.

5. The SEC charged the defendants with violating Section 17(a)(2) of the Securities Act and Section 10(b) of the Exchange Act. The SEC also charged GMB Management, Gabriel and Marco with violating Sections 206(1), 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder, and charged GMB Partners with violating Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder. GMB Management was also charged with violating Section 204(a) and Rule 204-2(a)(16) thereunder. The SEC also charged Gabriel and Marco for aiding and abetting all such violations.

6. The SEC sanctioned the defendants with a cease-and-desist order and barred Marco and Gabriel from associating with any firm in the securities industry. GMB Management and GMB Partners were censured. The defendants were ordered to be jointly and severally liable for disgorgement in the amount of $4.3 million, and Marco and Gabriel were ordered to each pay a civil money penalty of $250,000.

B. *In the Matter of Stock Markets Institute, Inc. and Sergey Perminov*, Admin. Proc. File No. 3-15038 (Sept. 21, 2012)

1. The SEC initiated administrative proceedings against Stock Markets Institute, Inc. ("SMI"), a registered investment adviser, and its president and majority owner, Sergey Perminov ("Perminov"), alleging that SMI made misrepresentations and omissions of

material fact regarding the performance returns generated by the trading alerts published in paid subscription newsletters and implemented through "auto-trading" strategies.

2. SMI allegedly misstated the success of its auto-trading strategies published in its newsletters by failing to disclose a number of trade alerts that resulted in significant losses. When the losing trading alerts were factored into the performance results for one of the newsletters, the effect was an average loss per trade of 28%, rather than the average gain of 16.5% touted by SMI.

3. SMI also allegedly inflated the number of winning trades by reporting trades made by different broker-dealers in connection with a single winning trade alert as separate trades. In addition, SMI did not include losses from options positions that were "rolled" into a new position by closing out both legs of the existing spread and entering into new option trades.

4. The SEC alleged that SMI violated and that Perminov aided and abetted and caused SMI's violations of Sections 206(2) and (4) of the Advisers Act and Rules 206(4)-1(a)(2) and 206(4)-1(a)(5) thereunder by misstating the success of its auto-trading strategies and making other misleading statements.

5. The SEC sanctioned SMI and Perminov with censures and cease-and-desist orders. The SEC further ordered civil money penalties of $75,000 for SMI and $40,000 for Perminov.

6. SMI further agreed to make available to subscribers complete performance histories of its newsletters, to establish internal compliance procedures, and to retain an independent compliance consultant to perform annual reviews of SMI's internal controls, policies and procedures, performance representations, and advertising materials for a period of two years.

C. *In the Matter of BTS Asset Management, Inc.*, Admin. Proc. No. 3-15082 (Oct. 29, 2012)

1. The SEC initiated administrative proceedings against BTS Asset Management, Inc. ("BTS") alleging that BTS made materially misleading statements in its advertising materials.

2. The SEC alleged that BTS's advertisements for its High Yield Bond Fund Program ("HYP") claimed that BTS had experienced "no down years" or negative returns since 1981 based on the performance of a model portfolio when in fact approximately half of HYP's clients experienced a down year in 2004. According to the SEC, the advertisements failed to disclose with sufficient

prominence and detail that, in 2004, a significant number of HYP clients would have experienced investment results that were materially different from the results portrayed in the model.

3. The SEC alleged that BTS violated Section 206(4) of the Advisers Act and Rule 206(4)-1(a)(5) thereunder. The SEC sanctioned BTS with a censure and a cease-and-desist order and ordered BTS to pay a civil money penalty of $200,000.

4. BTS agreed to provide clients with a copy of its Form ADV that incorporates information about the SEC order and to post the order on its website. BTS also undertook to retain and implement the advice of an independent compliance consultant responsible for conducting a review of BTS's advertising policies and procedures.

D. *In the Matter of New England Investment and Retirement Group, Inc. and Nicholas John Giacoumakis*, Admin. Proc. File No. 3-15137 (Dec. 18, 2012)

1. The SEC initiated an administrative proceeding against New England Investment and Retirement Group, Inc. ("NEINV") and its principal, President, and sole owner Nicholas Giacoumakis ("Giacoumakis") alleging that NEINV and Giacoumakis provided back tested performance reports to clients and prospective clients without disclosing that the results were hypothetical.

2. The SEC alleged that NEINV and Giacoumakis distributed performance presentations that purported to compare the historical performance and risk of NEINV's models with industry benchmarks. However, NEINV generated the reports by inputting its current holdings into the model and projecting how those holdings would have performed in prior periods. NEINV did not disclose that these results were hypothetical and not based on actual past performance. In at least one instance, a NEINV adviser allegedly represented to a perspective client that the reports were based on historical performance.

3. In addition, the SEC alleged that NEINV provided performance reports for certain portfolios to clients and perspective clients that showed performance for periods that preceded the creation of the portfolio without disclosing that the results were hypothetical.

4. Additionally, the SEC alleged that NEINV's Compliance and Procedures Manual described the SEC rule regarding performance reporting and SEC staff statements, but did not contain specific policies or procedures regarding compliance with the requirements for the presentation of performance information. The SEC also cited NEINV for failing to take any steps to implement the

performance reporting procedures in its Compliance and Procedures Manual or to prevent the violations that occurred.

5. The SEC alleged NEINV and Giacoumakis violated Section 206(4) of the Advisers Act and Rules 206(4)-1(a)(5) and 206(4)-7 thereunder and that NEINV additionally violated Section 206(2) of the Advisers Act.

6. NEINV consented to including in its Form ADV sections of the order and a notice that the entire order will be available on NEINV's website and to sending a copy of the Form ADV to each of its existing clients. NEINV also agreed to post the order on its website for six months, retain an Independent Compliance Consultant to review the NEINV compliance policies and procedures and report its findings and recommendations to the SEC and to certifying compliance with the above undertakings in writing. NEINV also consented to a cease-and-desist order and a censure. Giacoumakis consented to a cease-and-desist order. Both NEINV and Giacoumakis consented to being jointly and severally liable for a $200,000 civil money penalty.

Select Investment Company Cases

These cases highlight the Asset Management Unit's continued focus on investment company matters, including the operation of business development companies, valuation and mutual fund fee arrangements.

A. *SEC v. AMMB Consultant Sendirian Berhad*, 12-cv-01052 (D.D.C. June 26, 2012); Lit. Rel. No. 22402 (June 27, 2012)

1. The SEC filed a settled action in the U.S. District Court for the District of Columbia against AMMB Consultant Sendirian Berhad ("AMC"), a Malaysian investment adviser, alleging that for more than a decade, AMC charged a U.S. registered fund for advisory services that AMC did not provide.

2. AMC served as a subadviser to the Malaysia Fund, Inc. (the "Malaysia Fund"), a closed-end fund that invests in Malaysian companies. The SEC alleged that AMC misrepresented its services during the Malaysia Fund's annual advisory agreement review process each year for over 10 years and collected fees for advisory services that it did not provide.

3. According to the SEC, AMC submitted a report to the Malaysia Fund's board of directors each year that falsely claimed that AMC was providing specific advice, research, and assistance to the Fund's primary adviser for the benefit of the fund, when, in reality, AMC's services were limited to providing two monthly reports based

on publicly available information that the primary adviser did not request or use.

4. The SEC's complaint alleged that AMC breached its fiduciary duty with respect to compensation under Section 36(b) of the Investment Company Act. The SEC also alleged that AMC violated Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-7 thereunder and Section 15(c) of the Investment Company Act.

5. In settling the case, AMC agreed to a judgment barring it from committing similar violations in the future, to disgorge $1.3 million of its advisory fees paid by the fund, and to pay a $250,000 penalty.

B. *In the Matter of Peak Wealth Opportunities, LLC and David W. Dube, CPA*, Admin. Proc. File No. 3-14979 (Aug. 10, 2012)

1. The SEC initiated unsettled administrative and cease-and-desist proceedings against Peak Wealth Opportunities, LLC ("Peak Wealth"), a registered investment adviser, and David W. Dube, CPA ("Dube"), the president and sole managing member of Peak Wealth.

2. From April 2008 to June 2010, Peak Wealth served as investment adviser to a mutual fund, the StockCar Stocks Index Fund (the "Fund").

3. The SEC's Order alleges that, beginning in 2008, the Fund's board of directors began raising concerns about Peak Wealth's ability to meet its contractual expense cap obligations to the Fund, Peak Wealth's failure to reimburse the Fund as required in 2008 and 2009, the Fund's portfolio manager's concerns about lack of communication with Peak Wealth and Dube, and Peak Wealth's and Dube's failure to respond to the Board's request for materials in conjunction with the approval of the Fund's advisory contract. In June 2010, the board of the Fund terminated Peak Wealth's advisory agreement and voted to liquidate the Fund's assets and to deregister the company.

4. The SEC's Order further alleges that Peak Wealth continued to be registered as an investment adviser with the SEC after its advisory contract was terminated and had not filed a Form ADV since September 2008.

5. The SEC alleges that Peak Wealth willfully violated Section 15(c) of the Investment Company Act, and Sections 203A and 204 of the Advisers Act and Rules 203A-1(b)(2), 204-1(a)(1) and 204(a)(1), (2), (4), (5), and (6) thereunder. The SEC also alleges that Dube willfully aided and abetted and caused Peak Wealth's violations.

C. *In the Matter of J. Kenneth Alderman, et al.*, Admin. Proc. File No. 3-15127 (Dec. 10, 2012)

1. The SEC initiated an unsettled administrative proceeding against J. Kenneth Alderman, Jack R. Blair, Albert C. Johnson, James Stillman R. McFadden, Allen B. Morgan Jr., W. Randall Pittman, Mary S. Stone, and Archie W. Willis III (together, "Directors"), eight former members of the boards of directors overseeing five open and closed-end investment companies (the "Funds") for violating their asset pricing responsibilities.

2. During the relevant period, Morgan Asset Management, Inc. served as investment adviser and Morgan Keegan & Company Inc. served as fund accountant (together, "Morgan Keegan"). Morgan Keegan and others were the subject of a settled administrative proceeding (Admin. Proc. File No. 3-13847 (June 22, 2011)) based on the underlying facts herein.

3. The SEC's Order alleged that between January 2007 and August 2007, significant portions of the Funds' portfolios contained below-investment-grade debt securities, some of which were backed by subprime mortgage-backed securities and subordinated tranches of various securitizations, for which market quotations were not readily available. As a result, a large percentage of the Funds' portfolios was required to be fair valued as determined in good faith by the Funds' boards.

4. The SEC alleged that the Directors delegated their responsibility to determine fair value to a valuation committee of the Funds' investment adviser without providing any meaningful methodology or specific direction regarding how those determinations should be made for specific portfolio assets or classes of assets.

5. Further, the SEC alleged that the Directors made no meaningful effort to learn how fair values were actually being determined. They received, at best, limited information from the valuation committee on the factors considered in making fair value determinations and almost no information explaining why particular fair values were assigned to portfolio securities, but did not ask specific questions on how the Funds' assets were being valued and how those values were being tested. Moreover, the Directors did not continuously review the appropriateness of the method to be used in valuing each issue of security in the company's portfolio.

6. The SEC alleged that, as a result of the failure of the Directors to adopt and implement reasonable fair valuation practices, the net asset values ("NAVs") of the Funds were materially misstated. Consequently, the prices at which each Fund sold, redeemed, and

repurchased its shares were also inaccurate. The SEC alleged that at least one registration statement and other reports filed with the SEC by the Funds contained materially misstated NAVs.

7. The SEC alleged that the Directors caused the open-end Funds' violation of Rule 22c-1, and the Funds' violation of Rules 30a-3(a) and 38a-1 under the Investment Company Act.

D. *In the Matter of Top Fund Management, Inc. and Barry C. Ziskin*, Admin. Proc. File No. 3-15154 (Dec. 21, 2012)

1. The SEC filed a settled administrative proceeding against Top Fund Management, Inc. ("TFM") and Barry C. Ziskin ("Ziskin") alleging that TFM and Ziskin caused Z Seven Fund ("ZSF"), a fund that TFM and Ziskin managed, to purchase options for speculative purposes, contrary to ZSF's stated investment policy.

2. The SEC alleged that since 2008, ZSF's prospectuses and statements of additional information described ZSF's investment objective as long-term capital appreciation, with its principal investment strategy being investing, during normal market conditions, at least 80% of its total assets in domestic and foreign common stocks and securities immediately convertible into common stocks. Disclosures in ZSF's prospectuses and statements of additional information stated that options trading could only be used for hedging purposes and that the investment restrictions could only be changed with shareholder authorization.

3. Despite these disclosures, TFM and Ziskin invested a large amount of the fund's assets in put options on stock index ETFs and stock index futures. By 2010, ZSF's options portfolio comprised 75% of the fund's total net assets, with the investment eventually leading to large fund losses. The SEC alleged that this options trading went beyond hedging and amounted to speculation, as ZSF's option contracts at various points in time were enough to protect a portfolio more than 2.5 times the value of ZSF's equity portfolio.

4. The SEC alleged that these actions violated or caused the fund to violate Sections 206(1), (2), and (4) of the Advisers Act and Rule 206(4)-8(a) thereunder, Section 17(a)(3) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 34(b) and 13(a)(3) of the Investment Company Act.

5. TFM and Ziskin consented to a cease-and-desist order and Ziskin to an industry bar. Both TFM and Ziskin submitted sworn Statements of Financial Condition citing inability to pay a civil money penalty.

Valuation of Assets

The SEC has continued to be active in bringing cases against investment advisers based on their failure to properly value securities held by clients. The SEC had a particular focus on fund advisers that allegedly were hiding losses or increasing fees by overvaluing illiquid securities.[61]

A. *In the Matter of UBS Global Asset Management (Americas) Inc.*, Admin. Proc. File No. 3-14699 (Jan. 17, 2012)

1. The SEC initiated an administrative proceeding against a registered investment adviser, UBS Global Asset Management (Americas) Inc. ("UBSGAM"), alleging that it failed to value certain fixed income securities in accordance with fair valuation policies of certain registered funds advised by UBSGAM.

2. In particular, the SEC alleged that UBSGAM failed to price recently purchased fixed income securities at the price that they were purchased, as set forth in the funds' fair valuation policies and procedures. Instead, UBSGAM valued the fixed income securities based solely on the valuations provided by broker-dealers or a third-party pricing service.

3. This resulted in the fixed income securities being overvalued, in some instances, by 1000% or more. Due to the alleged failure to properly fair value the fixed income securities, the NAVs of the funds were misstated by between one cent and ten cents per share during a several day period in June 2008.

4. The SEC found that UBSGAM aided and abetted the funds' violation of Rule 22c-1 under the Investment Company Act, which prohibits selling, redeeming, or repurchasing any redeemable security except at a price based on the current NAV of such security. The SEC also found that UBSGAM aided and abetted the Funds' violation of Rule 38a-1 under the Investment Company Act by failing to adequately implement valuation procedures.

5. UBSGAM consented to a cease-and-desist order, was censured and agreed to pay a civil money penalty of $300,000.

B. *In the Matter of Lisa B. Premo*, Admin. Proc. File No. 3-14697 (Jan. 17, 2012)

1. The SEC initiated unsettled administrative proceedings against Lisa B. Premo, a lead portfolio manager of the Evergreen Ultra Short

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[61] Please refer to the case summary for *In the Matter of J. Kenneth Alderman, et al.*, Admin. Proc. File No. 3-15127 (Dec. 10, 2012) for an additional case involving valuation.

Opportunities Fund (the "Fund"), alleging that Premo breached her fiduciary duties to the Fund by failing to disclose that a CDO in which the Fund invested defaulted and would no longer make payments to the Fund.

2. The SEC alleged that when the Fund's third party pricing vendor, S&P, lowered the price of the CDO from $96.72 to $72.89, Premo told the Fund's valuation committee that S&P's quote did not reflect the fair value of the CDO and recommended that the valuation committee override the price with a value based on quotes from the market. Based on the recommendation of Premo and the portfolio management team, the valuation committee relied exclusively on quotes from a single broker-dealer from Florida for several illiquid securities held by the fund, including the CDO.

3. Premo learned from a senior portfolio manager for the fund that the CDO's trustee stated in an e-mail that the CDO experienced an event of default. Shortly thereafter, Premo was informed that the holders of a senior tranche of the CDO decided to accelerate which meant that the fund, as a holder of a lower tranche, would stop receiving payments. Premo did not inform the valuation committee of these developments.

4. When the valuation committee learned of default months later, the valuation committee assigned a value of $0 to the CDO, resulting in a decrease of $6.98 million in the value of the fund. The valuation committee also stopped relying on the other quotes from the broker-dealer from Florida to price its illiquid securities, which resulted in a drop in NAV of the fund of $0.12 per share and the eventual liquidation of the fund.

5. The SEC alleged that Premo violated Sections 206(1) and 206(2) of the Advisers Act by failing to disclose to the valuation committee that the CDO experienced an event of default, acceleration, and cash flow stoppage. As a result of the same conduct, the SEC alleged that Premo willfully aided and abetted Evergreen Adviser's violations of Sections 206(1) and 206(2) of the Advisers Act. The SEC also alleged that Premo willfully aided and abetted and caused the Fund's violation of Rule 22c-1 under the Investment Company Act, which requires registered funds to sell and redeem shares only at a price based on the current NAV of the shares.

C. *SEC v. James Michael Murray*, Civil Action No. CV-12-1288 (N.D. Cal. Mar. 15, 2012)

1. The SEC filed an unsettled complaint charging James Michael Murray with defrauding investors by providing them with a false audit report that overstated the performance of a fund.

2. The SEC alleged that Murray provided investors with an audit report prepared by an independent auditor, Jones, Moore & Associates ("JMA"). JMA was actually a shell company created and controlled by Murray. The report also had numerous misstatements about JMA, including that twelve of the persons listed as JMA's accounting professionals either did not exist or were unlicensed principals of JMA.

3. The audited reports also overstated the fund's investment gains by approximately 90%, its income by approximately 30%, its member capital by approximately 18% and its total assets by approximately 10%.

4. The SEC charged Murray with violating Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder. The U.S. Attorney's Office for the Northern District of California also filed criminal charges against Murray.

D. *In the Matter of David Mark Bunzel*, Admin. Proc. File No. 3-14908 (June 6, 2012)

1. The SEC initiated an administrative proceeding against David Mark Bunzel ("Bunzel"), the principal of an unregistered investment adviser, Irvine Capital Management, LLC, for providing a misleading valuation for the primary asset held by two hedge funds (the "Irvine Funds"), charging the Irvine Funds a management fee in excess of the disclosed amount, and failing to cause a timely annual audit of the Irvine Funds.

2. After acquiring the stock of a private company, Bunzel valued the stock based on the price that the issuer sold the security in private securities transactions rather than the market price.

3. In August 2008, Bunzel increased the valuation of the common stock of a private company, which constituted a large portion of the Irvine Funds' assets, from $60,000 per share to $112,800 per share on the basis of discussions the issuer had with another shareholder to repurchase 10% of its shares at $120,000, an increase in the issuer's assets under management in 2008, an increase in the issuer's revenues, and comparisons to established large publicly traded money managers.

4. The SEC alleged, however, that by December 31, 2008, there was no reasonable basis to support Bunzel's valuation. Specifically, the discussions regarding the share repurchase at $120,000 per share had ceased by October 2008, the issuer's assets under management had substantially decreased and comparable financial sector stocks had substantially decreased in value.

5. In 2010, Bunzel hired two valuation firms which valued the issuer at $50,000 and $60,000 per share as of December 31, 2008. Based on these valuations, Bunzel lowered his valuation of the shares to $60,000 per share.

6. The SEC alleged that, between 2007 and 2009, Bunzel charged limited partners in the Irvine Funds a management fee of 2% even though the funds' offering documents disclosed a management fee of 1.5%. Shortly after the SEC Enforcement Staff's investigation began, Bunzel credited the excess management fees back to the limited partners of the Irvine Funds.

7. The SEC further alleged that Bunzel failed to complete, as required in the Irvine Funds' offering documents, timely audits of the funds. Specifically, the audits for fiscal year 2007 were not completed until late 2010 and there were no audits conducted for fiscal years 2008 and 2009.

8. Based on this activity, the SEC alleged that Bunzel violated Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder.

9. Bunzel agreed to a cease-and-desist order, a 12-month suspension from associating with any firm in the securities industry and payment of a $100,000 civil money penalty.

E. *SEC v. Yorkville Advisors, LLC, Mark Angelo and Edward Schinik*, Civil Action No. 12-cv-7728 (S.D.N.Y. Oct. 17, 2012)

1. The SEC filed an unsettled civil enforcement action against the advisory firm Yorkville Advisors, LLC ("Yorkville") and its executives alleging that they overvalued assets under management and the reported returns of hedge funds in order to hide losses and increase their fees.

2. Yorkville would typically obtain convertible debentures, convertible preferred stock and promissory notes from issuers that were not listed on exchanges in exchange for lending money to the issuers. Yorkville would then generate profits by exercising any convertible instruments and selling the securities. This strategy was successful until 2008 when deteriorating market conditions caused the securities obtained by Yorkville to become illiquid. In addition, many of the issuers that received loans from Yorkville stopped paying interest due to their worsening condition.

3. Yorkville's valuation procedures required assets to be valued by market quotations. If quotes were not available, the valuation procedures required the assets to be valued by third party valuations and only if these valuations were not available by good

faith determination by the general partner based on a series of objective and subjective factors.

4. The SEC alleged that the respondents failed to adhere to Yorkville's stated valuation policies by failing to seek third party valuations and simply valuing the convertible debentures, convertible preferred stock and promissory notes at their face value instead of their market value. The respondents also failed to take into consideration the collateral underlying the securities or negative information that was being released about the issuers.

5. In addition, the respondents allegedly withheld adverse information about investments from Yorkville's auditors, and misled investors about the funds' liquidity, the collateral underlying the funds' investments, and Yorkville's use of a third-party valuation firm.

6. The SEC further alleged that these alleged misrepresentations enabled Yorkville to charge the funds excessive fees based on the value of its assets under management.

7. Based on their actions, the SEC alleged that Yorkville and its executives violated Sections 206(1), (2) and (4) of the Advisers Act and Rule 206(4)-8 thereunder, as well the Securities Act and Exchange Act.

Enforcement Priorities Regarding Investment Advisers and Investment Companies

Based upon our review of currently available information, we believe the following list reflects some of the SEC's top priorities for investment adviser and investment company enforcement:

- Conflicts of interest related to the management of private equity funds, including relationships with portfolio companies, the allocation of expenses between the management company and the funds, preferential treatment of clients (e.g., improper allocation of broken deal expenses and organizational costs to co-mingled funds).

- False or misleading claims in marketing materials designed to solicit new clients or retain existing clients, including claims regarding the performance track record, representations that the investment advisers and their personnel were investing their own money along with clients (so-called "skin in the game"), the operation of the investment process and the nature of the due diligence conducted.

- Conflicts of interest arising from affiliations between investment advisers and broker-dealers, including incentives for an investment adviser to use an affiliated broker-dealer and the impact on best execution.

- Mutual fund fee arrangements, including board oversight and the efficacy of the 15(c) contract approval and renewal process.
- Valuation, including methodology for fair valuing illiquid or hard-to-price assets, oversight of the valuation process by funds boards and compliance with valuations procedures.
- Financial or other conflicts of interest that affect the trading or investment decisions an investment adviser makes on behalf of its clients, including by entering into related-party transactions or allocating investment opportunities in a manner that benefits the adviser, its personnel or particular clients at the expense of other clients.
- Compliance infrastructure, including the adoption and implementation of appropriate written compliance policies and procedures, cooperation with SEC staff during examinations and remediating examination deficiencies.
- Custody of client assets, including review of independent audits of private funds for consistency with the Advisers Act custody rule requirements.
- Consistency of investment objectives and disclosures with investment decisions and other portfolio decision-making practices.
- Misappropriation of client assets and fraudulent trading schemes.
- Insider trading, including the use of expert networks, information barriers for material non-public information and front running.

Personnel Changes

Unlike the SEC, the senior staff at FINRA did not experience much change last year. One notable exception was the September 2012 departure of FINRA Vice Chairman Stephen Luparello after more than 16 years at FINRA and the NASD. Mr. Luparello had broad responsibility at FINRA, overseeing its regulatory operations, including the Departments of Enforcement, Market Regulation, and Member Regulation.

Enforcement Statistics

Last year, FINRA reported two records in its enforcement program: it brought more disciplinary actions (1,541) and ordered more restitution to investors ($34 million) than ever before. In fact, the traditional metrics used to measure FINRA's enforcement activity showed increases from 2011.

In 2012, FINRA filed 1,541 new disciplinary actions against firms and individuals, up from 1,488 cases in the prior year – an increase of 3.6% and a record since FINRA was established in 2007. FINRA also resolved 1,370 formal actions last year; in 2011, it had concluded 1,287 such cases. Last year, FINRA expelled 30 firms from its membership (compared to 21 in the prior year), barred 294 people (versus 329 in 2011) and suspended 549 individuals (an increase over the 475 such actions in the prior year).[62]

FINRA reported that in 2012 it had imposed fines of more than $68 million versus almost $63 million in the prior year. FINRA also ordered firms and individuals to provide more than $34 million in restitution to customers; in 2011 all such orders totaled $19 million. The 2012 restitution figure was a record and represents an almost 79% increase year-over-year.[63]

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[62] FINRA Press Release, "2012: FINRA Year in Review."

[63] *Id.*

In line with the increased number of cases and overall fine levels, our analysis reflects that cases with significant penalties against firms increased in 2012 when compared to 2011, as shown in the following table.[64]

Fine Range	2008	2009	2010	2011	2012
$100,001 to $250,000	45	34	27	24	27
$250,001 to $500,000	10	20	13	23	24
$500,001 to $750,000	4	6	7	7	8
$750,001 to $1,000,000	2	3	3	5	6
$1,000,001 to $1,500,000	2	4	1	1	1
$1,500,001 or more	0	6	2	10	13
Total	63	73	53	70	79

In sum, FINRA brought more cases, subjected a significant number of registered representatives to harsh discipline, levied higher fines, and ordered a record amount of money to be returned to injured investors.

As can be seen, FINRA increased the number of cases in which it imposed fines greater than $100,000 to 79 from 70 in the prior year. That represents an almost 13% increase. This increase is particularly noteworthy at the highest level. FINRA imposed fines greater than $1.5 million in 13 cases compared to 10 such cases in 2011 (an increase of 30%).

Referrals of Potential Fraudulent Conduct

In its year-end press release, FINRA highlighted the breadth of the civil and criminal actions by other regulators that stemmed from referrals made by its Office of Fraud Detection and Market Intelligence (“OFDMI”). The OFDMI has created an insider trading and fraud monitoring program across almost all equity markets in the United States. In 2012, OFDMI referred 692 matters concerning possible fraudulent misconduct to the SEC and other law enforcement agencies. Last year’s referrals included 347 insider trading matters and 260 fraud referrals. As a result of these referrals, the SEC brought many actions, including in such areas as PIPEs, microcap fraud, insider trading, and market manipulation.[65]

Credit for Extraordinary Cooperation

In Regulatory Notice 08-70, FINRA described four types of “extraordinary cooperation” that could result in credit being given to a firm (or an individual) in

[64] 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 2012.

[65] FINRA press release “2012: FINRA Year in Review.”

determining the resolution of an investigation. Those categories are as follows: (i) self-reporting; (ii) extraordinary actions to correct policies, procedures and systems; (iii) extraordinary remediation to clients; and (iv) providing substantial assistance to FINRA staff during an investigation.

Although we have not undertaken an empirical analysis of all of FINRA's settlements, anecdotally it appears that the staff is willing to include references to firm-initiated actions in its settlements and to note the fact that such steps had been taken into account by FINRA in resolving the matter. For example, at least eight cases described in the summaries below contain such information.

Targeted Examination Letters and Sweeps

In 2011, FINRA posted only two Targeted Examination Letters on its website versus four in the prior year. In 2012, five such letters were published by FINRA.

- In July 2012, FINRA posted a letter indicating that it was engaging in a review of firms' identification and management of conflicts of interests. The staff requested that firms submit the following information: (i) summaries of the most significant conflicts currently being managed; (ii) the types of reports/documents prepared at the conclusion of a conflicts review; (iii) the identity of persons and departments responsible for conflicts reviews; and (iv) the identity of the persons who receive final reports/documentation of a conflicts review. In connection with this sweep, FINRA requested to meet with senior executives and compliance staff to discuss how firms approach identifying and mitigating conflicts of interest. At such meetings, the firms were asked to present on the most significant conflicts they managed and the protocol in place to identify and assess potential conflicts between the firm and its clients' interests.

- In September 2012, the Trading Examination Unit of the Market Regulation Department announced that it was conducting an inquiry regarding Alternative Trading Systems ("ATS"). To commence that inquiry, the staff sent a detailed 18-item request to firms. FINRA asked for the following key information and documents: (i) identification of any ATS affiliated with or operated by the firms; (ii) copies of most recent Form ATS filed with the SEC; (iii) marketing materials or responses to client inquires regarding ATS operation; (iv) written supervisory procedures relating to ATS and Fair Access Procedure; (v) the levels of access available to ATS clients; (vi) identity of personnel or business units with access to client information in any ATS of the firm; and (vii) the percentage of broker-dealer and non broker-dealer ATS subscribers. FINRA also asked whether firms act as principals on ATS transactions, whether firms' ATS send or receive indications of interest, whether firms' affiliated ATS interact with other ATS, and to explain in detail firms' interaction with ATS's order flow, how the firms' trading systems handle odd-lot quantities, how customer errors or ATS errors are handled and how the firms generate compensation from each ATS. Lastly, FINRA asked firms to

explain the nature and resolution of all complaints received regarding orders sent to any ATS affiliated with them.

- Also in September 2012, FINRA's Advertising Regulation Department began an inquiry concerning nontraded REIT ("NTR") communications. Among other things, the request sought copies of advertisements and sales literature relating to NTRs, an "Approval and Recordkeeping" Excel spreadsheet with certain data (e.g., description of communication, dates and method of distribution, date of approval and name of approving principal) for all advertisements and sales literature related to NTRs, evidence regarding the written approval by a registered principal of advertisements and sales literature, offering documents, and the firms' written supervisory procedures "concerning the production, approval and distribution of NTR communications" in effect between January 1, 2012 and June 30, 2012.

- FINRA's Trading and Market Making Surveillance Examinations group of the Market Regulation Department announced in October 2012 that it was commencing a review regarding FINRA Rule 5320 (Prohibition Against Trading Ahead of Customer Orders). In a detailed request, the staff asked for documents and information from firms, including, among other things, descriptions of systems of controls, the method, surveillance and copies of written supervisory procedures established to ensure compliance with Rule 5320; copies of notices to customers regarding protections they are entitled to under Rule 5320; and information regarding any and all Rule 5320 breaches identified between December 2011 and June 2012.

- In November 2012, FINRA, along with the SEC and CFTC, began an inquiry regarding the impact of Hurricane Sandy on firms' operations and abilities to conduct business (both securities and future business) when business continuity plans ("BCP") were enacted. The staff sent a detailed 31-item request to firms asking questions regarding firms' BCPs and their effectiveness when put in place in connection with Hurricane Sandy; the firms' plans and procedures in place to allow for continued trading after Hurricane Sandy and testing of the procedures during BCP; firms' abilities to communicate with customers during the contingency event and customers' access to funds; as well as whether the Hurricane resulted in financial/regulatory consequences such as requests for regulatory relief, settlement, clearing, and books and records issues.

FINRA Takes Action Against Ongoing Frauds

According to its year-end press release, in several cases in 2012, FINRA was the first regulator to address ongoing frauds by stepping in promptly.[66] Such actions

66 *Id.*

are consistent with FINRA's focus on quickly identifying and halting such conduct.

On November 2, 2012, FINRA filed a complaint against WR Rice Financial Services, LLC ("WR Rice") and its owner Joel I. Wilson, alleging that the firm, Wilson and other registered representatives misrepresented or omitted material facts when it sold more than $4.5 million in limited partnership interests to approximately 100 investors with mostly low-to-moderate incomes. FINRA also alleged that Wilson and WR Rice promised that the money they raised from investors would be invested in land contracts on residential real estate, which would pay a 9.9 percent interest rate. In actuality, according to FINRA, those investors funds were used to make loans to companies Wilson owned or controlled. Further, WR Rice and Wilson allegedly did not disclose to investors that Wilson extended those loans when they could not be paid when they came due. Wilson was also charged with providing falsified documents to FINRA and failing to provide full and complete testimony to FINRA during its investigation.

Also on November 2, 2012, FINRA filed a temporary cease-and-desist order to stop additional alleged fraudulent activities by WR Rice Financial Services and Wilson and to prevent the conversion of investors' funds and assets.

In November 2012, FINRA expelled Hudson Valley Capital Management ("Hudson Valley") and barred its CEO, Mark Joseph Gillis, alleging that the firm's customers had been defrauded. Specifically, FINRA charged that Hudson Valley, through Gillis, used a firm account to improperly day trade millions of dollars of stock to get around net capital and minimum account equity requirements. Gillis also profited personally from these trades by using his personal account as the counterparty to certain transactions with the firm account. FINRA alleged that when Gillis allocated shares from the firm account to his personal account, he marked up or marked down the share prices to his advantage so that he could transfer funds from the firm account to his own account.

When his day-trading resulted in substantial losses in the firm account, Gillis engaged in a variety of unauthorized trading in customer accounts, fraudulent post-execution trade allocation, and conversion of customer funds to cover the losses. These actions resulted in customer losses and a net capital deficiency for Hudson Valley of more than $350,000.

In November 2012, FINRA filed a complaint against Roman Sledziejowski, the president and owner of the brokerage firm TWS Financial, LLC, alleging a fraudulent scheme targeting the Polish community in Brooklyn, New York. Specifically, FINRA alleged that Sledziejowski converted or misused approximately $4.8 million from three clients for his own use by instructing clients to wire money from their accounts to the account of Innovest Holdings LLC. In some cases, Sledziejowski transferred funds from the clients' TWS Financial accounts without their knowledge. In order to cover up the fraud, he provided clients with falsified account statements. More than $3 million of the client funds

are currently unaccounted for. Sledziejowski has refused to testify or answer questions related to these issues. On November 9, 2012, TWS Financial applied to withdraw its broker-dealer registration.

Cooperation with Foreign Regulators

Similar to the SEC, during the last several years, FINRA has executed agreements with various foreign regulators to improve its cooperation with such authorities. In 2011, FINRA signed a Memorandum of Understanding ("MOU") with the Ontario Securities Commission. Last year, FINRA did the same with another Canadian province, Alberta. The MOU creates a framework for improving the ability of the Alberta Securities Commission and FINRA to oversee the large U.S. and Canadian markets and firms.

In November 2012, FINRA signed MOUs with the Netherlands Authority for the Financial Markets and the Japanese Securities Dealers Association. Both of these agreements demonstrate FINRA's continuing effort to cooperate and share information with international regulators.

Current FINRA Broker-Dealer 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.[67]

- Structured and complex products sold to retail clients, including firm due diligence, the training provided to registered representatives and principals and the supervision of such sales;
- Single registered representative cases involving petty theft from firms or clients, dishonesty, cheating on expense reimbursements, unapproved private securities transactions, etc.;
- Fraudulent conduct by firms and/or individuals;
- High-frequency and algorithmic trading;
- Options origin codes focusing on instances where orders are incorrectly coded as customer orders rather than firm or broker-dealer orders;
- Variable annuity sales practices and supervision;
- Cyber security and data breaches and losses;
- Nontraded REITs, including due diligence by firms and the suitability of recommendations by registered representatives;

[67] Several of these priorities are mentioned in FINRA's 2013 Annual Examination Priorities Letter posted to its website on January 11, 2013.

- Cross-market trading abuses;
- Manipulative trading activity, including frontrunning, market-on-close orders and wash sales; and
- Conflicts of interest.

Broker-Dealer Enforcement Actions[68]

Advertised Trade Volume

In 2008, the NASD completed a sweep regarding advertised trade volume in which it sanctioned 19 firms. Here are two recent cases.

A. *Jefferies & Company, Inc.* ("Jefferies") (Feb. 15, 2012)[69]

1. FINRA settled a matter with Jefferies in which FINRA alleged that Jefferies substantially overstated its advertised trade volume to three private service providers and experienced related supervisory deficiencies.

2. FINRA alleged that from January 2008 through August 2008, in 248 instances involving 135 securities, the firm's aggregate trade volume reported to three private service providers substantially exceeded the firm's executed trade volume. For example, on one trade date when the firm did not execute any trades for a particular security, the firm published a trade volume of 277,777 shares in that security.

3. FINRA acknowledged that Jefferies had established a supervisory system to review advertised trade volume in January 2007, prior to entering into a December 2007 settlement (noted below) involving similar allegations. However, FINRA alleged that Jefferies failed to implement the supervisory system during the review period and failed to pursue or redress a number of red flags relating to potential overstatements of advertised trade volume by the firm's traders, including: (a) failing to take reasonable steps in response to the firm's December 2007 settlement for instances of overstated advertisements, including failing to give appropriate training to the firm's traders and their supervisors; and (b) failing to properly follow up on or to remediate at least 15 instances of potential over-

[68] 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.

[69] In general, the case dates represent the date on which FINRA accepted the Letter of Acceptance, Waiver and Consent ("AWC"), or when available, the date of FINRA's press release announcing the case.

advertising detected during the review period by a trading supervisor.

4. Jefferies consented to a censure and a fine of $550,000.

5. In setting the sanction, FINRA acknowledged certain mitigating factors, including that Jefferies conducted an internal investigation upon receiving FINRA's initial inquiry letter, provided a written summation of the results of that investigation, allowed FINRA access to related documentation, and imposed significant disciplinary actions against three traders responsible for the inflated advertisements and their designated supervisor.

6. FINRA also noted that Jefferies and FINRA had entered into a settlement in 2007 in which Jefferies was censured and fined $50,000 for overstating trade volume in one equity security to three private service providers and for related supervisory deficiencies.

B. *Deutsche Bank Securities Inc.* ("DBSI") (Dec. 14, 2012)

1. FINRA settled a matter with DBSI in which FINRA alleged that DBSI substantially overstated its advertised trade volume to three private service providers and experienced related supervisory deficiencies.

2. FINRA alleged that, in 98 instances from January 1, 2008 through June 15, 2012, the firm's aggregate trade volume manually advertised by traders to three private service providers substantially exceeded the firm's executed trade volume for that security. The overstatements ranged from 1.3% to 9900%.

3. FINRA also alleged that from October 15, 2010 through June 15, 2012, the firm's systems failed to accurately advertise trade volume. FINRA alleged that more than four billion shares (approximately four percent of the firm's trade volume during the period) that were ineligible for advertisement were advertised.

4. According to FINRA, DBSI failed to establish and implement a supervisory system that was reasonably designed to ensure compliance with regulatory requirements for accuracy in the firm's advertisements of executed trade volume. Specifically, FINRA alleged that (a) from January 1, 2008 through September 4, 2008, DBSI's written supervisory procedures did not contain a statement of the supervisory step(s) to be taken in reviewing manually advertised volume; (b) from January 1, 2008 through July 31, 2008, the DBSI employee responsible for the supervisory review of advertised trade volume was not made aware that advertisements were being manually entered by traders; and (c) from October 15,

2010 through June 15, 2012, although DBSI's surveillance was designed to ensure that volume eligible for advertisement matched the volume actually advertised, the system was not designed to detect instances in which activity not eligible for advertisement was incorrectly being deemed eligible.

5. DBSI consented to a censure, a fine of $1.25 million, and an undertaking to revise the firm's supervisory procedures with respect to advertising trade volume.

6. In setting the sanction, FINRA acknowledged certain mitigating factors, including that DBSI conducted an internal investigation following FINRA's initial inquiry, provided FINRA with a written summation of the results of that investigation, imposed disciplinary actions against some of the traders responsible for a portion of the inflated advertisements, and self-reported the remainder of the violations to FINRA.

7. FINRA also noted that DBSI and FINRA had entered into a settlement in December 2007 in which DBSI was censured and fined $150,000 for overstating trade volume in one equity security to three private service providers and for related supervisory deficiencies.

Anticompetitive Activities

Over the last several years, FINRA has brought several cases regarding alleged Anticompetitive activities in the credit default swap area. Here is a case from 2012.

A. *GFI Securities LLC* ("GFI")*, Michael Scott Babcock* ("Babcock")*, Donald Patrick Fewer* ("Fewer")*, Stephen Falletta* ("Falletta")*, and Lainee Dale Steinberg* ("Steinberg") (collectively, the "GFI Brokers") (Feb. 27, 2012)

1. FINRA settled a matter with GFI in which FINRA alleged that in 2005 and 2006, the GFI Brokers sought to frustrate their customers' efforts to obtain competitive brokerage rates on credit default swap ("CDS") transactions through collusive interactions.

2. FINRA alleged that the GFI Brokers received commission reduction proposals for CDS transactions from four GFI customers, and colluded with their counterparts at competing firms in an effort to keep customers from obtaining CDS brokerage services at more favorable rates.

3. For example, FINRA alleged that a customer proposed a new fee schedule to a number of firms with which it did CDS business in order to reduce the broker fees that the customer paid, which

precipitated a flurry of communications among brokers at the affected firms in which they informed each other of their intentions regarding how they would respond to the proposed fee reductions. FINRA alleged that the communications indicated that the GFI Brokers were aware of the impropriety of their acting in concert to frustrate the customer's proposal.

4. FINRA also alleged that GFI failed to review employees' Bloomberg messages, document such reviews, and document that it conducted any supervisory reviews of other instant messaging forms of communications during the relevant period.

5. As such, FINRA concluded that GFI engaged in anticompetitive conduct through which it benefitted at its customers' expense, lacked reasonable supervisory procedures to prevent the misconduct, and failed adequately to supervise the activities of the GFI Brokers so as to follow up on red flags and prevent such misconduct.

6. GFI consented to a censure and a $2.1 million fine.

7. FINRA separately settled matters against Babcock (fined $100,000 and suspended for two months), Fewer (fined $100,000 and suspended from acting in a supervisory capacity for 30 days), Falletta (fined $200,000 and suspended for two months), and Steinberg (fined $125,000 and suspended for three months).

Anti-Money Laundering ("AML")

AML matters are a steady part of FINRA's enforcement docket.

A. *Raymond James Financial Services, Inc.* ("Raymond James") (Mar. 29, 2012)

1. FINRA settled a matter against Raymond James in which it alleged that the firm failed to implement AML policies and procedures that were reasonably designed to detect and cause reporting of suspicious activity in the accounts of one of its customers, JR.

2. According to FINRA, between January 5, 2005 and July 11, 2007, JR used his brokerage accounts at the firm to conduct a Ponzi scheme that resulted in losses of approximately $17.8 million to the customers who gave him funds. To do so, JR transferred funds to his Raymond James brokerage accounts and then wrote monthly checks from those accounts to his customers. Many of the checks were for the same round dollar amounts each month.

3. FINRA alleged that during the relevant period, JR's accounts frequently triggered firm exception reports due to his large volume of check writing, large cash deposits, and suspicious wire transfers.

4. When asked about the activity by the firm's AML officer on three occasions, the registered representative handling JR's accounts explained that the cash flow in the accounts was due to the client's dealings in real estate and cars. No one at Raymond James sought further explanation of the suspicious activity or conducted an adequate review of the checks written from the accounts. Additionally, the branch manager was not informed about the suspicious activity.

5. FINRA also alleged that during the relevant time some red flags discovered by the various departments of the firm were not properly evaluated, including: (a) a Grand Jury Subpoena that was received by the registered representative regarding JR's activities; (b) a civil complaint by one of JR's relatives alleging conversion of funds; (c) the fact that JR had asked the branch manager about the possibility of investing on behalf of others using his accounts; and (d) the fact that JR told branch personnel that he had committed fraud. However, information about these various red flags was not appropriately shared within the firm.

6. FINRA stated that the firm had devoted inadequate resources to the AML program in light of the limitations in its review processes. Specifically, the AML program relied on the AML officer's manual review of approximately 15 different exception reports to detect suspicious activity at the branches. The reports covered only specific time periods (e.g., 30 or 90 days) and were limited in that multiple reports were not centralized and could not be combined for review. The AML officer also had oversight of more than 2,000 independent contractor offices.

7. The firm consented to a censure, a fine of $400,000 and an undertaking to review its AML policies, systems, procedures and training.

8. On July 17, 2007, JR pleaded guilty to charges concerning selling unregistered securities, perjury and forgery. JR was sentenced to 20 years in prison and ordered to pay $17.8 million in restitution to approximately 200 customers who had provided him with money.

Arbitration

Last year, FINRA brought a litigated case involving customer arbitration agreements. There was also a settled matter regarding arbitration disputes with employees.

A. *Charles Schwab & Company, Inc.* ("Schwab") (Feb. 1, 2012)

1. FINRA filed a complaint against Schwab on February 1, 2012 in which FINRA alleged that Schwab improperly included a class action waiver in its customer account agreement.

    (a) Specifically, FINRA alleged that in October 2011, Schwab amended its customer account agreement to include a waiver of class action or representative action provision (the "Class Action Waiver"). The Class Action Waiver was part of the firm's predispute arbitration agreement and was sent to almost seven million Schwab customers.

    (b) According to FINRA, the Class Action Waiver contained two provisions that violate FINRA rules. First, FINRA alleged that the Class Action Waiver improperly included language requiring customers to waive their right to bring or participate in class actions against Schwab. Second, FINRA asserted that the Class Action Waiver improperly included language requiring customers to agree that arbitrators have no authority to consolidate more than one party's claims.

2. On February 1, 2012, Schwab filed an action in the United States District Court for the Northern District of California seeking a declaratory judgment that FINRA may not enforce FINRA rules regulating broker-dealers to bar a new provision in Schwab's customer account agreements that waives any right to participation in class action litigation and requires individual arbitration of claims.

    (a) Schwab contended that FINRA rules, properly interpreted, do not prohibit class action waivers and, in the alternative, even if intended to do so, their enforcement would impermissibly violate the Federal Arbitration Act. Schwab also requested injunctive relief barring FINRA from further pursuing disciplinary proceedings against Schwab based on the Class Action Waiver.

3. FINRA filed a motion to dismiss the District Court action, which the District Court granted on May 11, 2012 without leave to amend. The District Court found that Schwab's failure to exhaust its administrative remedies under the Exchange Act barred the action.

4. There has been no reported decision in connection with FINRA's complaint against Schwab.

B. *Merrill Lynch, Pierce, Fenner & Smith Inc.* ("Merrill Lynch") (Jan. 25, 2012)

1. FINRA settled a matter against Merrill Lynch in which FINRA alleged that Merrill Lynch failed to arbitrate disputes with employees relating to retention of company bonuses in violation of FINRA rules and the Code of Arbitration Procedures.

2. According to FINRA, in January 2009, after merging with Bank of America, the firm implemented a bonus program to retain certain high-producing registered representatives. The firm's bonus program involved a lump sum payment to each of those employees, accompanied by a promissory note. A separate agreement provided that the firm would pay a portion of the loan on behalf of the employee for each month the employee remained with the firm, until the loan was fully repaid. In the event that the employee was terminated, filed for bankruptcy, or became insolvent, all outstanding principal and interest on the loan would become immediately due and payable. The firm paid $2.8 billion in retention bonuses structured as loans to over 5,000 registered representatives.

3. FINRA alleged that the promissory notes required the registered representatives to agree to submit to New York state court actions for disputes and collection on the notes, which would limit the ability of the employees to assert counterclaims. According to FINRA, the program was structured to appear as if the funds for the program came from a nonregistered affiliate of the firm, when in fact the funds came from the firm's parent company. This would allow the firm to pursue recovery of amounts due on the loans in expedited hearings in New York state courts and avoid the Code of Arbitration Procedures requirement to arbitrate disputes with associated persons.

4. FINRA alleged that after a number of registered representatives left Merrill Lynch without repaying the full amounts due on the loans, the firm filed 90 actions in New York state court to collect amounts due under the promissory notes in violation of FINRA rules that require firms to arbitrate disputes with employees.

5. Merrill Lynch consented to a censure and a fine of $1 million.

6. In setting the sanction, FINRA noted that the firm had previously been fined $250,000 in 2004 for failing to comply with discovery obligations in FINRA arbitration proceedings.

High-Frequency Trading

High-frequency trading has garnered significant media and regulatory attention. Below is an enforcement matter in this area.

A. *OCTEG, LLC* (“OCTEG”) (Mar. 8, 2012)

1. FINRA, on behalf of The NASDAQ Stock Market LLC, settled a matter with OCTEG in which FINRA alleged that the firm failed to establish and maintain a reasonable supervisory system, including written supervisory procedures and operational risk control systems concerning the oversight and operation of high-frequency and algorithmic trading.

2. This matter arose out of FINRA’s Department of Market Regulation review of OCTEG’s trading, placement of orders, operational risk control systems, and written supervisory procedures related to high-frequency and algorithmic trading activity for the period of May 7, 2010 through December 2011.

3. OCTEG consented to a censure and a fine of $450,000. Additionally, the firm agreed to comply with a number of undertakings, including retaining an independent consultant to review the firm’s written supervisory procedures and the sufficiency of compliance and supervisory resources in connection with those procedures.

4. In determining the sanction, FINRA noted that OCTEG previously consented to a censure, a $10,000 fine and an undertaking to revise its written supervisory procedures for violations related to its supervision and prevention of clearly erroneous transactions.

Leveraged and Inverse Exchange-Traded Funds

Since 2009, regulators have been focused on firms’ practices with respect to leveraged, inverse, and inverse-leveraged exchange-traded funds (“Non-Traditional ETFs”). In May 2012, FINRA brought four cases involving the sale of such ETFs and imposing a total of $9.1 million in fines and restitution.

A. *Citigroup Global Markets Inc.* (“Citigroup”) (May 1, 2012); *Morgan Stanley & Co. LLC* (“Morgan Stanley”) (May 1, 2012); *UBS Financial Services Inc.* (“UBS”) (May 1, 2012) and *Wells Fargo Advisors, LLC, Wells Fargo Advisors Financial Network, LLC and Wells Fargo Investments, LLC* (collectively, “Wells Fargo”) (May 1, 2012)

1. FINRA settled matters with Citigroup, Morgan Stanley, UBS and Wells Fargo in which it alleged that from January 2008 through July 2009, the firms violated suitability and supervision rules in

connection with the sale of leveraged, inverse, and inverse-leveraged Non-Traditional ETFs.

2. Non-Traditional ETFs seek to deliver multiples and/or the inverse of the underlying index or benchmark that they track. According to FINRA, because these ETFs reset daily and are designed to achieve their stated objectives on a daily basis, investors were subject to the risk that the performance of these investments over longer periods would differ significantly from the underlying index or benchmark.

3. Certain customers of the four firms with conservative risk tolerance profiles and/or a primary investment objective of income held Non-Traditional ETFs for several months.

4. FINRA alleged that prior to June 2009, the firms failed to maintain and enforce a supervisory system tailored to address the unique features and risks of Non-Traditional ETFs and also failed to provide adequate training to registered representatives and supervisors regarding these features and risks. FINRA further alleged that the firms violated NASD and FINRA rules by allowing their registered representatives to recommend Non-Traditional ETFs without performing reasonable diligence to understand the risks and features associated with them.

5. FINRA noted that over the relevant period the firms' customers bought and sold the following amounts of Non-Traditional ETFs: Wells Fargo – $9.9 billion, Citigroup – $7.9 billion, then Morgan Stanley – $4.78 billion, and UBS – $4.5 billion.

6. The firms each consented to a censure, a fine and restitution. Specifically, the firms agreed to the following: (a) Wells Fargo – a fine of $2.1 million and restitution of $641,489; (b) Citigroup – a fine of $2 million and restitution of $146,431; (c) Morgan Stanley – a fine of $1.75 million and restitution of $604,584; and (d) UBS – a fine of $1.5 million and restitution of $431,488.

Markups and Markdowns

FINRA continues to focus on charges to customers, as evidenced by the below settlement.

A. *Citi International Financial Services LLC* ("CFSC") (Mar. 19, 2012)

1. FINRA settled a matter with CFSC in which it alleged that (a) from July 1, 2007 through September 30, 2010, CFSC bought or sold corporate and U.S. Government agency bonds from or to its customers at prices that were not fair, taking into consideration all

of the relevant circumstances, including market conditions, expenses involved and that CFSC was entitled to a profit; and (b) from April 2009 through June 2009, CFSC failed to use reasonable diligence to ascertain the best inter-dealer market for corporate bond transactions so that its customers' prices were as favorable as possible based on prevailing market conditions.

2. According to FINRA, the results of seven separate reviews of CFSC's bond transactions by FINRA Fixed Income staff showed that alleged excessive markups/markdowns ranged from 2.73% to more than 10%.

3. Additionally, FINRA alleged that during the time period above CFSC failed to establish and implement a supervisory system that was reasonably designed to achieve compliance with applicable requirements and obligations concerning fair pricing and best execution with respect to fixed income transactions.

4. According to FINRA, (a) the firm's supervisory system was not designed to review markups/markdowns that were below 5%, but that nonetheless could have been excessive; (b) a pricing grid that the firm utilized for calculation and review of markups/markdowns, which was based on a percentage of the bonds' par values instead of a percentage of actual principal values, contributed to the firm's failure to detect excessive markups/markdowns; and (c) the firm's supervisory procedures did not account for applicable best execution obligations for transactions the firm executed through a third-party clearing agent.

5. CFSC consented to a censure, a fine of $600,000 ($350,000 related to the alleged combined fixed income fair pricing and best execution violations and $250,000 related to the alleged supervision violations), an undertaking to revise its written supervisory procedures concerning fair pricing and best execution of fixed income transactions, and an order to pay restitution of $648,080 plus interest to more than 3,600 of its customers.

6. In setting the sanction, FINRA noted that it initially proposed that the firm pay $145,000 in restitution. Subsequently, CFSC, acting on its own accord, conducted an internal review of the bond prices it charged to customers during the relevant period and determined to pay the restitution amount set forth above.

Mortgage-Backed Securities

Like the SEC, FINRA has brought a number of cases in the mortgage-backed securities area. The below case is similar to three enforcement actions in 2011.

A. *Citigroup Global Markets Inc*. ("Citigroup") (May 22, 2012)

1. FINRA settled a matter with Citigroup in which it alleged that the firm: (a) provided inaccurate mortgage performance and static pool information regarding certain subprime residential mortgage-backed securitizations ("RMBSs") on the firm's Regulation AB website; (b) failed to establish and maintain sufficient supervisory and operations policies with regard to the posting and accuracy of the performance data; (c) failed to establish and maintain sufficient supervisory policies regarding independent price verification for certain CDOs; (d) failed to adequately document price verification of CDOs; (e) failed to establish reasonable supervisory procedures to determine the appropriateness of certain repricings of RMBSs in customer accounts; and (f) failed to supervise and document the supervision of certain margin haircuts.

2. Regulation AB requires that certain performance data in connection with an RMBS be disclosed at the time of the offering and periodically thereafter. The data should include, among other things, present delinquencies, percentage of delinquencies of the aggregate mortgage pool, and present and cumulative losses.

3. According to FINRA, during the period of January 2006 through October 2007, Citigroup posted inaccurate performance data and static pool information to the Regulation AB website of Citigroup Inc., and maintained this inaccurate data until May 2012, even after receiving numerous notices that the data was or may have been inaccurate. FINRA alleged that the inaccuracies were found in information regarding loan delinquencies, bankruptcies, foreclosures and real estate owned, which, in some instances, may have affected investors' assessment of the value of the securitizations.

4. FINRA also alleged that Citigroup failed to supervise the pricing of certain CDOs, as it lacked written policies and procedures addressing independent price verification of these very illiquid assets. According to FINRA, the firm failed to document its pricing verification process for securities in that certain subprime securities were omitted from the firm's stale price reports (a report that identified securities for which price change was reflected in the firm's pricing database for a number of days), and the firm could not show that it had utilized stale prices for those securities.

5. FINRA further alleged that in instances when customers questioned the accuracy of a margin call resulting from the firm's pricing of an RMBS security, the firm repriced the security to eliminate the margin call, and failed to document supervisory approval of the

repricing and maintain records of the margin call as originally calculated.

6. Citigroup consented to a censure and a fine of $3.5 million.

Municipal Securities

The cases below resulted from a FINRA sweep regarding certain municipal securities underwriting activities.

A. *Citigroup Global Markets Inc.* ("Citigroup"); *Goldman, Sachs & Co.* ("Goldman Sachs"); *J.P. Morgan Securities LLC* ("J.P. Morgan"); *Merrill Lynch, Pierce, Fenner & Smith Incorporated* ("Merrill Lynch"); *Morgan Stanley & Co. LLC* ("Morgan Stanley") (Dec. 27, 2012)

1. FINRA settled cases against five firms – Citigroup, Goldman Sachs, J.P. Morgan, Merrill Lynch, and Morgan Stanley – in which it was alleged that the firms unfairly obtained reimbursement from the proceeds of municipal securities offerings for fees paid to a municipal securities association.

2. FINRA alleged that between January 2006 and December 2010, the firms made payments to the California Public Securities Association ("Cal PSA"), a municipal securities association that kept its members apprised of legislative and regulatory developments concerning the municipal securities industry. It also engaged in political activity through the use of two political action committees, commenting on draft legislation and retained a lobbyist to represent its interests in California state government.

3. FINRA alleged that the firms' practice of passing along the Cal PSA fees to issuers as underwriting expenses of negotiated municipal and state bond offerings was unfair because the fees were not expenses of conducting each underwriting. Further, the requests for reimbursement were unfair because they were not accompanied by adequate disclosure to issuers concerning the nature of the fees. Additionally, FINRA alleged that the firms' reimbursement request practices resulted in the proceeds of municipal and state bond offerings going to an organization that engages in political activities.

4. FINRA also alleged that the firms failed to adopt and maintain reasonable written supervisory procedures for reviewing and adequately disclosing the Cal PSA and other municipal securities associations' fees for which they requested reimbursement from the proceeds of municipal and state bond offerings. Further, Citigroup, Goldman, Merrill Lynch, and Morgan Stanley did not have adequate systems and written supervisory procedures to review and monitor

how the municipal securities associations used the money that the firms provided to them.

5. The firms consented to censure as well as fines and restitution totaling approximately $4.48 million as follows: Citigroup – $888,000 fine and $391,106 in restitution; Goldman Sachs – $568,000 fine and $115,997 in restitution; J.P. Morgan – $465,700 fine and $166,676 in restitution; Merrill Lynch – $787,000 fine and $287,200 in restitution; and Morgan Stanley – $647,700 fine and $170,054 in restitution.

Mutual Funds

The below matter relates to the pricing of certain mutual fund orders.

A. *Pruco Securities, LLC* ("Pruco") (Dec. 26, 2012)

1. FINRA settled a matter with Pruco in which it alleged that from late 2003 to June 2011, the firm improperly priced mutual fund orders for customers who placed orders via facsimile or mail (paper orders), causing customers to receive inferior prices for their shares.

2. An SEC rule requires that mutual fund orders be priced prior to 4 p.m. on the day the order is received and complete. Pruco employees in the firm's COMMAND unit (a retail back office operations group) mistakenly believed that they could use "best efforts" and up to two business days to process mutual fund paper orders and that paper orders could be priced on the date the order was processed, even if a complete order had been received on an earlier date. Due to this practice, on certain occasions between late 2003 and June 2011, customers received an inferior price on their orders.

3. Pruco discovered this issue in June 2011 after an inquiry was made to COMMAND employees concerning a faxed order that had not been executed until the day after it was received. As a result of this inquiry, Pruco and a third party firm reviewed over 1.8 million paper orders. Pruco determined that 730,765 of those orders were processed and priced an average of one to two days after the orders had been received.

4. FINRA alleged that from at least late 2003 until June 2011, Pruco failed to have an adequate supervisory system and written procedures to prevent the pricing errors, finding that COMMAND's practices and codified internal guidelines reflected these mistaken beliefs. The firm did not have formal written procedures regarding the pricing of mutual fund orders and did not provide its employees

with any training or training materials regarding paper mutual fund pricing requirements.

5. Pruco agreed a censure, fine of $550,000, and restitution of $10.7 million plus interest to approximately 37,000 accounts representing approximately 34,000 customers. The firm also agreed to calculate restitution for up to 3,240 additional customers.

6. In determining the sanctions, FINRA took into consideration that the firm self-reported the pricing issue, undertook an internal review, implemented changes to its policies and procedures and commenced restitution to the affected customers. FINRA also noted that the firm had settled a 2008 matter for $100,000 relating to the sale of Class B mutual fund shares.

Options Origin Codes

Last year, FINRA investigated a matter relating to options origin codes. According to the 2013 FINRA examination priorities letter, the scrutiny in this area is likely to continue this year.

A. *Goldman, Sachs & Co.* ("Goldman") (Jul.-Sept. 2012)

1. Eight U.S. option exchanges settled matters with Goldman in which they alleged that Goldman improperly marked certain option orders on behalf of broker-dealers and market-makers as "customer" orders. FINRA investigated the matters on behalf of six of the exchanges.

2. U.S. option exchange rules require that members record a particular code to identify the origin of the order (e.g., customer, broker-dealer or market-maker). These codes determine, among other things, applicable transaction fees. The codes are also important for the exchanges' audit trails.

3. By way of example, with respect to NYSE Amex Options and NYSE Arca Options, FINRA alleged as follows:

(a) From January 2004 to June 2011, Goldman's "G2" order entry system only allowed option orders to be coded as "firm," "broker-dealer," or "customer" – it did not allow for an order to be marked as "market maker." G2 also defaulted to "customer" if another category was not selected. Goldman's "Stride" order entry system coded all orders as "customer" and did not permit an alternative code to be entered.

(b) According to FINRA, as a result of the coding deficiencies, Goldman marked numerous option orders with improper

origin codes, which prevented the exchanges from receiving proper transaction fees, because "customer" orders were charged less than for other market participants or were free, and which adversely impacted the exchanges' ability to surveil for and detect potentially improper conduct.

(c) FINRA cited insufficient coordination and inadequate communication among different groups involved in the development of the order entry systems, including compliance, sales, and sales technology, as having contributed to the deficiencies. FINRA also pointed to a lack of awareness by the systems' developers of the significance of order origin codes.

(d) Additionally, FINRA alleged that, between October 2005 and September 2008, Goldman failed to adequately respond to "red flags" related to the improper origin coding and failed to remediate the coding deficiencies until after June 2011.

(e) According to FINRA, Goldman's supervisory system failed to (i) reasonably address order origin code requirements in the development and programming of order entry systems, (ii) maintain written supervisory procedures reasonably designed to comply with the exchanges' rules related to order origin codes, (iii) adequately train employees regarding the significance of order origin codes with respect to order entry systems, (iv) adequately supervise employees regarding proper marking of origin codes, and (v) adequately respond to "red flags" related to the proper coding of order origin codes.

(f) In setting sanctions, FINRA took into account (i) the significant subsequent remedial measures Goldman implemented, including system enhancements and the development of training for system users, (ii) payment by Goldman to the exchanges of the shortfall in transaction fees, and (iii) that Goldman informed the exchanges in August 2010 of the systems issues that it identified and cooperated with FINRA throughout the investigation.

4. Goldman consented to a censure and a total fine of $6.75 million, which was apportioned among the eight exchanges.

Record Retention

For years, regulators including FINRA have brought cases involving the retention of e-mail communications. Below is another example of these kinds of matters.

A. *Citigroup Global Markets Inc.* ("Citigroup") (Dec. 2, 2011)

1. FINRA settled a matter with Citigroup in which FINRA alleged that from October 2008 to December 2009, Citigroup failed to retain millions of e-mails, including e-mails that potentially impacted Citigroup's ability to respond to e-mail requests in FINRA investigations and other matters.

2. Citigroup used 58 mail servers in North America and three of these servers malfunctioned, causing Citigroup to fail to properly transmit e-mails to the archive for approximately 2,800 of its associated persons. FINRA noted that it was not possible to quantify the number of e-mails that were not retained, but alleged that it was in the millions based on a three-month sample of e-mail usage rates by the affected associated persons.

3. FINRA alleged that Citigroup failed to comply with recordkeeping rules and detect and remedy deficiencies in its e-mail retention systems due to insufficient quality assurance tests conducted prior to migrating live users onto its upgraded e-mail archiving system.

4. In addition, FINRA alleged that Citigroup's e-mail retention deficiencies potentially impacted at least five FINRA investigations.

5. Citigroup consented to a censure and a $750,000 fine. FINRA noted that Citigroup self-reported the e-mail issues. In addition, FINRA noted that Citigroup's predecessor firm, Salomon Smith Barney Inc., had consented to a $1.65 million fine in a prior e-mail retention disciplinary matter.

Regulation SHO

FINRA and the SEC have focused in recent years on short selling cases, including matters under Regulation SHO.

A. *Interactive Brokers LLC* ("Interactive") (June 6, 2012)

1. FINRA settled a matter with Interactive in which FINRA alleged that Interactive (i) violated SEC Orders prohibiting short sales in securities of certain publicly traded companies; (ii) violated SEC rules by failing to effect timely buy-ins for certain positions; and (iii) failed to implement adequate supervisory procedures reasonably designed to comply with the SEC's buy-in rules.

2. From September 18, 2008 through October 8, 2008, SEC Orders were in effect that prohibited short sales in any publicly traded securities of 799 financial firms. According to FINRA, during that period Interactive executed 4,996 customer short sales in the securities of 180 of the financial firms, thereby earning approximately $6,000 in commissions.

3. The SEC also enacted a series of rules beginning on September 17, 2008 that required broker-dealers to timely buy-in certain fail-to-deliver positions. FINRA alleged that between September 17, 2008 and October 16, 2008, when the applicable rule required that fail-to-deliver positions resulting from short sales be closed out no later than the start of regular trading hours on the day following settlement (i.e., T+4), Interactive created a policy that permitted the close-out of such failures to occur shortly after the market's open.

4. FINRA also alleged that between October 17, 2008 and December 31, 2011, Interactive failed to timely close out approximately 34,000 short sales positions in violation of SEC rules.

5. According to FINRA, between October 17, 2008 and December 31, 2011, the firm also failed to put in place a supervisory system reasonably designed to achieve compliance with SEC buy-in rules. In May 2010, FINRA notified Interactive that its policy was deficient because it did not require timely close-outs of short sales. Although the firm took steps to address the deficiency, it failed to timely close out fail-to-deliver in short sales approximately 4,000 times between June 3, 2010 and December 31, 2011.

6. Interactive consented to a censure and a fine of $550,000, which included the disgorgement of approximately $6,000 in commissions the firm received.

Regulatory Reporting

FINRA routinely brings disciplinary actions regarding reporting items on Forms U-4 and U-5. Below is such a matter, which also includes allegations regarding the filing of copies of non-NASD/FINRA arbitration, civil and criminal complaints.

A. *Merrill Lynch, Pierce, Fenner & Smith Inc.* ("Merrill Lynch") (Sept. 24, 2012)

1. FINRA settled a matter with Merrill Lynch in which FINRA alleged that the firm (i) failed to make or timely make required filings or acknowledgments of customer complaints and related statistical information, certain arbitrations and civil litigations, and related Forms U-4 and U-5; (ii) failed to file or timely file copies of NASD/FINRA arbitrations and civil and criminal complaints that it

received, and the related Forms U-4 and U-5; and (iii) failed to establish and implement supervisory systems and procedures concerning those issues.

2. According to FINRA, in 2009, following Merrill Lynch's merger with Bank of America, Merrill Lynch detected and self-reported a backlog in researching and resolving approximately 1,500 customer complaints received between 2005 and 2009. FINRA alleged that the review of the backlog and other complaints received between January 2010 and August 2011 revealed that between 2007 and 2011, Merrill Lynch failed to file and/or timely file over 650 required reports related to customer complaints involving allegations of theft, misappropriation or forgery; complaints settled for more than $15,000 against the firm's employees or $25,000 against the firm; quarterly reports of customer complaints; and the related Forms U-4 and U-5. FINRA further alleged that the firm also failed to acknowledge and/or timely acknowledge receipt of almost 300 customer complaints. According to FINRA, the firm failed to make the required filings between 23% and 63% of the time, which interfered with the information FINRA uses to initiate investigations and thereby protect investors and market integrity.

3. FINRA further alleged that between July 2007 and September 2010, the firm did not file or timely file copies of approximately 300 non-NASD/FINRA arbitrations and civil and criminal complaints that it received. During periods between July 1, 2007 through June 11, 2009 and October 24, 2009 through February 22, 2010, the firm failed to make these filings 100% of the time. The firm also failed to file or timely file required Forms U-4 and U-5 28% to 79% of the time it was required to do so.

4. FINRA also alleged that Merrill Lynch failed to establish and maintain an adequate supervisory system concerning these issues. According to FINRA, the Intake Group in the firm's Office of General Counsel was responsible for the initial handling of customer complaints and distributing them to appropriate sub-groups. The group was also responsible for reviewing non-FINRA arbitrations and civil matters against registered persons that were received by the firm. The Intake Group was not adequately trained and/or supervised in connection with certain functions related to customer complaints reporting and tracking. In addition, the firm's quarterly reporting procedures were also defective because they failed to include customer complaints that were received before the end of the quarter but not entered into the relevant firm database until after certain reporting information had been gathered. Further, there was no single department responsible for monitoring compliance with the reporting and filing obligations. FINRA noted

that the firm's failure to supervise the reporting processes may have obscured risks and potential harm to investors.

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

Research Reports

Below is another case in a long line of actions regarding research report disclosures.

A. *Citigroup Global Markets Inc.* ("Citigroup") (Jan. 18, 2012)

1. FINRA settled a matter with Citigroup in which it alleged that the firm failed to make certain required disclosures in research reports published between January 2007 and March 2010, failed to comply with certain undertakings relating to research reports made in a prior settlement, and failed to adequately supervise its research disclosures.

2. Citigroup failed to disclose that it managed or comanaged certain public securities offerings in the subject companies, received investment banking revenue from the covered companies, made a market in the securities of the covered companies, and/or had a financial interest or beneficial ownership in the covered companies. The failure to make the required disclosures was primarily due to programming and technical errors and deficiencies in the database that Citigroup used to make such disclosures. Specifically, FINRA alleged that Citigroup did not make the following disclosures, as required:

   (a) Citigroup relied on data received from a third-party vendor to make the required disclosures regarding its capacity as manager or comanager. The vendor's security identification data did not match the security data maintained in Citigroup's disclosure management system and, as a result, was not incorporated into the firm's disclosures. Therefore, during the period of January through November 2007, the required disclosures were missing in approximately 8% of the 80,000 research reports issued each year by the firm.

   (b) In approximately 330 research reports issued during September 2009 to March 2010, Citigroup failed to disclose investment banking revenue it received from covered companies because the firm did not take into account the investment banking revenue from transactions conducted outside the firm's investment banking department.

(c) During the period from December 2009 to June 2010, the firm failed to disclose that it was a market-maker in the covered stock of approximately 800 research reports because security identification data received from an affiliate did not match the data in the firm's disclosure management system.

(d) From 2007 through 2009, five research analysts inadvertently failed to disclose to Citigroup that they or a member of their households owned an interest in securities of the covered companies, causing Citigroup's failure to disclose those interests in its research reports.

(e) From January to May 2007, FINRA further alleged that Citigroup failed to properly match data regarding ownership concentrations that it received from an internal source with its disclosure management system for 1,800 covered companies. As a result, the disclosures were not made for approximately 1% of the 29,000 research reports issued during that time.

(f) During the period November 2008 to July 2009, FINRA alleged that Citigroup failed to provide conflict disclosures and price charts on four types of quantitative research due to human and/or technical error. During the period January 2007 to August 2009, Citigroup failed to provide required conflicts disclosures regarding ETFs in 240 research reports. Prior to May 2010, Citigroup also failed to provide three-year price charts for 185 covered stocks due to an inaccurate link on its website.

3. FINRA also alleged that due to programming and human errors in the firm's disclosure management system, Citigroup research analysts also failed to make the required disclosures between January 2007 and March 2010 regarding public appearances.

4. Further, according to FINRA, Citigroup failed to comply with the undertaking requirements from the 2006 Research Analyst Settlement, which required three specific disclosures on the front page of Citigroup's research reports. As a result of certain programming changes, from May 2007 to May 2009, Citigroup failed to provide a required disclosure regarding the availability of independent research regarding 139 issuers in approximately 815 research reports. Additionally, as a result of certain format changes, Citigroup failed to make certain required first-page disclosures in 42 research reports from November 2009 to January 2010.

5. FINRA also alleged that because Citigroup failed to monitor the timeliness and accuracy of the data communications from third-party and internal sources upon which the disclosure management system relied, Citigroup did not adequately supervise the implementation of research disclosures.

6. Citigroup consented to a censure and a fine of $725,000. In determining the sanctions, FINRA took into consideration the fact that Citigroup self-reported several of the disclosure deficiencies, took remedial action and conducted internal reviews, and engaged an independent consultant to review the disclosure management system and make recommendations for improvement. FINRA also noted that the firm had consented to sanctions in two previous research-related disciplinary actions.

Structured Products

The sale of structured products to retail customers has been and continues to be a focus at FINRA. Below are two cases in this area.

A. *Morgan Stanley & Co. LLC* ("Morgan Stanley") (Jan. 5, 2012)

1. FINRA settled a matter with Morgan Stanley in which FINRA alleged that from September 2006 to August 2008, Morgan Stanley failed to have a reasonable supervisory system and procedures in place to notify supervisors whether structured product purchases complied with Morgan Stanley's internal guidelines related to concentration and minimum net worth.

2. FINRA noted that Morgan Stanley's customers effected approximately 224,000 structured products purchases, of which more than 28,000 were in net amounts that exceeded 25% of the customers' disclosed liquid net worth and more than 2,600 were effected by customers with a stated net worth that was less than the $100,000 minimum.

3. FINRA alleged that, after reviewing a sample of structured product purchases, it uncovered 14 unsuitable recommendations for eight customers that were inconsistent with the customers' financial situation and investment objectives.

4. In addition, FINRA alleged that Morgan Stanley's daily transaction reports for structured product purchases did not reflect evidence that supervisory action was taken in connection with the specific nonconforming purchases.

5. Morgan Stanley consented to a censure and a fine of $600,000. The decision noted that the firm had previously entered into

settlements with the eight customers relating to the 14 transactions and paid those customers $329,000.

B. *Merrill Lynch, Pierce, Fenner & Smith Incorporated* ("Merrill Lynch") (June 11, 2012)

1. FINRA settled a matter with Merrill Lynch in which FINRA alleged that from January 2006 to March 2009, Merrill Lynch failed to have a reasonable supervisory system in place to review potentially unsuitable concentration levels in structured products in customer accounts.

2. During that time period, Merrill Lynch customers effected approximately 650,000 structured product purchases, of which more than 50% involved structured product offerings issued by the parent company of Merrill Lynch.

3. To supervise retail sales, the firm relied on automated exception-based reporting systems to flag accounts and/or transactions that met certain criteria. According to FINRA, prior to March 2009, none of the systems specifically monitored for potentially unsuitable concentration levels in structured products in customer accounts.

4. Merrill Lynch consented to a censure and a fine of $450,000.

Suitability

FINRA routinely brings cases involving suitability. Below are descriptions of two settlements and one litigated matter.

A. *David Lerner Associates, Inc.* ("DLA")*, David Lerner* ("Lerner")*, and William Mason* ("Mason") (Oct. 22, 2012)

1. FINRA settled a matter with DLA, Lerner (the firm's founder, President and CEO), and Mason (the firm's head trader) in an action related to nonpublicly traded Apple REITs involving suitability and supervision violations. The settlement also consolidated numerous matters, including a municipal and CMO markup case, a pending enforcement investigation of more recent municipal and CMO markups, and 10 pending market regulation matters involving municipal markups identified through surveillance reviews.

2. According to FINRA, DLA marketed and sold REITs without performing adequate due diligence, especially in light of certain red flags and DLA's role as sole underwriter, in violation of its suitability obligations.

3. FINRA also alleged that DLA provided performance figures for REITs that were misleading, failed to disclose material information and inaccurately mischaracterized information.

4. According to FINRA, DLA also gave seminar presentations to investors related to REITs that were not fair and balanced and omitted numerous facts and qualifications that caused the communications to be misleading. In addition, Lerner sent letters to DLA's customers to counter negative media attention directed at DLA, and these letters, which were "correspondence" under FINRA's rules, omitted material information, which caused them to be misleading. The letters also contained exaggerated, false and misleading statements regarding REITs.

5. FINRA also alleged that, at seminars, in seminar materials, and in letters to customers, DLA and Lerner made untrue representations of material fact or omissions of material fact regarding the prior performance, steady distribution rates, unchanging valuations, and prospects of REITs, and that this was done either with the intent to defraud investors or with recklessness, but were at least made negligently.

6. According to FINRA, DLA also charged excessive markups and markdowns and/or failed to meet its obligation to provide a fair and reasonable price to customers at the time of the transaction for thousands of municipal security transactions. FINRA also alleged that DLA charged excessive markups on hundreds of CMO transactions, which resulted in sales of CMOs to retail customers at prices that were not fair. Further, FINRA alleged that DLA failed to show the terms and conditions and the time of the receipt on the memorandum on 1,634 brokerage orders in municipal bonds.

7. DLA agreed to (i) a censure and fine of over $2.3 million; (ii) pay restitution of $12 million; (iii) provide certain written reports and documentation to FINRA; (iv) certain undertakings related to its advertising, sales literature and public appearances, including related to its internal policies and procedures and its supervisory structure as well as filing certain materials with FINRA's Advertising Regulation Department; and (v) retain, and pay for, independent consultants to conduct certain reviews.

8. Lerner agreed to (i) a suspension from association with any FINRA member firm in any capacity for a period of one year and, thereafter, to a suspension from acting in any principal capacity with any FINRA member firm for two years; (ii) to requalify for the Series 7 and 24 licenses prior to reassociating with any FINRA member firms as a General Securities Representative or General

Securities Principal, respectively; and (iii) a fine of $250,000 for the purpose of restitution to DLA's customers.

9. Separately, Mason, DLA's Head Trader, was censured and fined $200,000 and suspended for six months from the securities industry for his role in charging excessive municipal and CMO markups. Those sanctions resolved a May 2011 complaint (amended in December 2011) as well as an earlier action in which a FINRA hearing panel found that the firm and Mason charged excessive municipal and CMO markups.

B. *Brookstone Securities, Inc*. ("Brookstone"), *Anthony Lee Turbeville*, *Christopher Dean Kline*, and *David William Locy* (Jun. 4, 2012)

1. In this contested action, a FINRA Hearing Panel ruled that from July 2005 through July 2007, Brookstone, through its Chief Executive Officer ("CEO") and one of its brokers, intentionally made fraudulent misrepresentations and omissions and made unsuitable recommendations to elderly and unsophisticated customers, ranging in age from 68 to 98 years old, regarding the risks associated with investing CMOs. The hearing panel also found that Brookstone, through its CEO, intentionally used misleading communications, and through its Chief Compliance Officer ("CCO") failed to conduct any meaningful supervision of discretionary accounts.

2. The Hearing Panel found that the CEO and broker led customers to believe that the CMOs were government-guaranteed bonds that preserved capital and generated 10% to 15% returns and failed to tell its customers that CMOs are highly risky securities that are subject to dramatic changes in maturity, cash flow, and liquidity based on relatively minor changes in interest rates.

3. During the relevant time period, Brookstone made $492,500 in commissions on CMO bond transactions in the discretionary accounts of seven customers, while those same customers lost $1,620,100.

4. The Hearing Panel found that during the relevant period the CCO also was the supervisor of the CEO and the broker, and the CCO "should have been a line of defense" against the misconduct but instead failed to review the discretionary accounts or monitor the trading in them or respond to red flags concerning suitability. Under the firm's written supervisory procedures, the CCO also was required to contact discretionary account customers annually to determine their level of satisfaction, but failed to do so. As such, the Hearing Panel found that the CCO was as culpable as the CEO and broker.

5. The Hearing Panel censured and fined Brookstone $1 million and ordered full restitution to the customers of $1,620,100; of the restitution amount, $440,600 was imposed jointly and severally with the CEO and $1,179,500 was imposed jointly and severally with the broker. The Hearing Panel also (i) barred the CEO and broker from the securities industry, and (ii) barred the CCO from acting in a supervisory capacity, suspended him from acting in any capacity for two years, and fined him $25,000. In setting the sanction, the Hearing Panel noted that the firm had consented to a fine of $200,000 in 2011 for willful misrepresentations to customers, among other things.

C. *Merrill Lynch, Pierce, Fenner & Smith Incorporated* ("Merrill Lynch") (Aug. 29, 2012)

1. FINRA settled a matter with Merrill Lynch in which FINRA alleged that between October 2006 and February 2009, Merrill Lynch, through a former broker, recommended to at least 12 customers (all of whom were retired or unemployed and most of whom were elderly, conservative, and/or unsophisticated investors), 37 unsuitable short-term transactions in Closed-End Funds ("CEFs") and Unit Investment Trusts ("UITs"), which were generally intended as longer-term investments.

2. In addition, FINRA alleged that Merrill Lynch, through the former broker, recommended the unsuitable use of margin to finance seven customers' purchases and sales of securities, including the short-term trading of UITs and CEFs.

3. During this time, Merrill Lynch and the former broker earned approximately $47,000 in commissions and margin interest from the unsuitable short-term trading for these customers, during which time these customers lost over $430,000.

4. FINRA noted that one widowed customer in her eighties with a very conservative investment objective incurred $32,000 in losses and generated $4,800 in commissions on positions in CEFs and UITs, and a widower in his eighties who indicated an aversion to debt had a margin balance of $250,000, which was over one-third of his account's value, for which he was required to pay over $10,000 in margin interest.

5. FINRA alleged that Merrill Lynch failed to respond to exception reports or detect a pattern that suggested that the former broker was engaging in unsuitable short-term trading of CEFs and UITs and transactions on margin. FINRA also alleged that the firm did not speak with any of the 12 customers about the short-term trading or margin activity until they began complaining in April 2008.

6. Merrill Lynch consented to a censure and a $400,000 fine, disgorgement of approximately $47,000 in commissions, and an undertaking to pay approximately $130,000 in customer restitution for uncompensated losses.

Supervision

In addition to the scrutiny of underlying conduct, FINRA regularly assesses the adequacy of firms' supervision in connection with its investigations. Outlined below are six supervision cases.

A. *Merrill Lynch, Pierce, Fenner & Smith Inc.* ("Merrill Lynch") (Dec. 7, 2011)

1. FINRA settled a matter with Merrill Lynch in which it alleged several supervisory violations in the period of 2006 to 2009 concerning the firm's total return swap transactions.

2. The total return swap transactions at issue were designed and structured to generate a tax benefit for certain off-shore clients by providing an untaxed "dividend enhancement" or "yield enhancement" payment on securities that the clients did not hold on the dividend record date of the underlying securities. A yield enhancement payment would be improper if a client retained beneficial ownership of the securities throughout the term of the swap. A major factor in determining the propriety of payment was whether the client was subject to market risk during the transaction.

3. According to FINRA, the firm failed to have written supervisory procedures regarding total return swaps until October 2006. Thereafter, the written procedures required swaps on which the underlying security was a single stock to be held open for a year. Other swaps had to be held open for 15 days, and, if a swap was initiated with shares "crossed in" from the client to the firm, the swap had to be held open for at least 25 days. Early terminations had to be recorded in an exceptions log for compliance review.

4. FINRA alleged that no exceptions logs were kept, and there was no supervisory review or documented approval of early terminations. The firm did not begin to enforce the 15-day holding period until in or about 2008. Records regarding early terminations began to be kept in February 2008, and the firm did not use exception reports to identify early swap terminations until May 2009.

5. During 2006 and 2007, 598 swaps were open for less than 45 days – 215 of those were open for less than 25 days, and 78 of those were open less than 15 days. FINRA alleged that these short-term swap transactions bracketed the dividend record date, enabling clients to reestablish their original securities position while limiting

market risk. A few counterparties conducted a significant portion of this trading, but the firm failed to provide an adequate level of supervision.

6. FINRA further alleged that the firm's sales literature informed clients that they could continue exposure to the security by purchasing it, or by entering into a second swap. However, the firm did not monitor whether counterparties were buying shares to reestablish their original positions.

7. Contrary to firm policy, clients also allegedly were allowed to open swaps on a volume-weighted average price ("VWAP") basis and close on a market-on-close ("MOC") basis. Due to the firm's failure to enforce its policy, clients were able to use the MOC price of the underlying security to calculate the swap termination payment, which allowed them to reestablish their securities positions at minimal market risk.

8. FINRA alleged that because of the firm's supervisory failures, the firm could not show the propriety of the yield enhancement payments because it could not demonstrate that the clients did not have beneficial ownership of the security during the swap and were exposed to market risk in reestablishing the position when the swap ended.

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

B. *Department of Enforcement v. X,* Hearing Panel Decision (Dec. 30, 2011)[70]

1. In December 2011, a Hearing Panel found that the Department of Enforcement ("Enforcement") had failed to prove by a preponderance of evidence that X, the CCO of a broker-dealer, had failed to supervise a registered representative who had engaged in numerous unsuitable variable annuity exchanges and made misrepresentations and omissions of material fact on forms provided to clients and the firm. The Hearing Panel therefore dismissed the complaint.

2. According to the decision, Enforcement had filed a complaint in June 2010 alleging that the registered representative ("K"), the manager of the principal review desk ("B"), and X violated certain FINRA rules arising from K's variable annuity business. K and B settled before the proceeding went to a hearing.

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[70] Although the date of this case is December 30, 2011, the redacted decision was not included on FINRA's website until 2012.

3. The only charge against X was that he failed to supervise K in violation of NASD Rules 3010 and 2110. Although Enforcement acknowledged that X was not a business line supervisor of K, it alleged that he should be deemed a supervisor because of his "involvement with K's variable annuity exchanges," citing the SEC report of investigation, *John H. Gutfreund*, 51 SEC 93 (1992).

4. During the relevant time period, X oversaw a 13-person Compliance Department and was a nonvoting member of the firm's Risk Management Committee. He was not an officer of the broker-dealer and he reported on a dual basis to the General Counsel and to the President of the firm. The firm's written supervisory procedures provided that the Compliance Department had advisory and monitoring functions. The Hearing Panel found that neither X, nor his department had supervisory responsibility for the firm's registered representatives or their supervisors.

5. The Hearing Panel found that K's supervisors (B and another person) had developed concerns about K's exchanges of numerous variable annuities after moving to the firm and learning he could not transfer annuities already held by his clients because they were proprietary to his former firm. They consulted X, as CCO, about an aspect of their concerns, and X recommended a course of action the supervisors agreed to take.

6. The Hearing Panel found that while the supervisors followed some aspects of X's recommendation, including speaking with a sample of K's customers to make sure they understood the nature of the surrender charges incurred from the exchanges, they never conveyed to X the true extent of K's misconduct or that some customers did not understand the product, let alone the surrender charges.

7. The Hearing Panel found that the facts presented were completely distinguishable from those in *Gutfreund* and that X "did not have 'the responsibility, ability or authority' to affect [K]'s conduct and thus, did not become his supervisor." Accordingly, the complaint against X was dismissed.

C. *Morgan Stanley Smith Barney LLC* ("Morgan Stanley") (June 18, 2012)

1. FINRA settled a matter with Morgan Stanley in which it alleged that Morgan Stanley failed to establish and maintain a supervisory system that was reasonably designed to detect and prevent the execution of unauthorized proprietary trades made by a junior trader that exceeded position limits.

2. According to FINRA, on July 14, 2009, a junior trader at Morgan Stanley responsible for trading federal agency products in a cash book and futures contracts in a futures book accumulated an approximately $744 million futures position by the end of the trading day. The trader's position was more than double the firm's Agency Desk limit of $350 million and several times over his position limit of $116 million.

3. At the end of the day on July 14, 2009, the junior trader informed his trading manager via e-mail that he had incurred approximately $520,000 in net losses on the Agency Desk. After the e-mail was sent, the trader continued to trade remotely overnight, increasing his futures position to $1.33 billion until the market turned against him. The firm identified a risk anomaly and traced it to the trader on the morning of July 15, 2009.

4. FINRA alleged that because the firm did not have adequate safeguards or controls in place to identify the trader's limit-exceeding position by the end of the trading day or to prevent him from further exceeding his limit while trading remotely, Morgan Stanley violated NASD and FINRA rules and realized approximately $14.9 million in losses as a result of these proprietary positions. Specifically, the trading manager did not regularly monitor traders' positions on a real-time basis. The trading desk also did not have a consolidated view such that trading activities across products and systems could be monitored. Therefore, real-time monitoring was difficult at the desk level. In addition, the firm did not have adequate off-premises or after-hours trading policies or controls to prevent traders from exceeding position limits overnight.

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

6. In determining the sanction, FINRA took into consideration that the firm self-reported the issue and provided substantial assistance to FINRA during the investigation.

D. *Merrill Lynch, Pierce, Fenner & Smith Incorporated* ("Merrill Lynch") (June 21, 2012)

1. FINRA settled a matter with Merrill Lynch in which it alleged that that the firm experienced supervisory failures that resulted in overcharging customers over $32 million in unwarranted fees; failed to provide timely and accurate trade confirmations and account statements; and failed to deliver certain proxy and voting materials, margin risk disclosure statements, and business continuity plans.

2. According to FINRA, from April 2003 to December 2011, Merrill Lynch overcharged approximately 94,577 customer accounts unwarranted fees totaling approximately $32,174,369. These overcharges resulted in certain circumstances from the improper coding of data in Merrill Lynch's databases and were related to matters such as (a) billing for ineligible securities (e.g., securities affiliated with Merrill Lynch); (b) not applying the proper fee schedule for accounts holding 100% fixed income securities; (c) billing at a rate that exceeded an identified maximum in customer disclosures; (d) not rebating sub-accounting fees on no-load mutual fund transactions; (e) failing to include certain assets when determining aggregate account value for billing purposes; (f) incorrectly applying a flat rate to all of a customer's accounts instead of just to a new account of the customer; (g) billing at a rate that exceeded the rate identified on account enrollment documents; and (h) billing for wire transfer fees despite certain disclosure statements not adequately disclosing such charges.

3. Additionally, FINRA alleged that, between July 2006 and November 2010, Merrill Lynch did not send 10,647,187 trade confirmations for 232,356 customer accounts due to coding errors and other deficiencies.

4. FINRA also alleged that, between 1992 and June 2011, Merrill Lynch did not include or accurately state whether it acted as principal or agent on trade confirmations and account statements relating to mutual fund transactions that it sent to at least 526,405 customer accounts for 7,538,005 transactions.

5. FINRA also alleged that, between 2007 and 2010, Merrill Lynch directly or indirectly failed to deliver proxy materials to customers or their advisers relating to at least 8,983 accounts.

6. FINRA further alleged that, between October 2001 and March 31, 2010, Merrill Lynch failed to send margin risk disclosure statements to 6,957 customers who opened Cash Management and Working Capital Management accounts. According to FINRA, the failure to send margin risk disclosure statements was caused by a coding issue that resulted in Merrill Lynch's "welcome kit" not being sent to the customers.

7. FINRA also alleged that, between August 2004 and June 2010, Merrill Lynch failed to send business continuity plans to 16,711 customers who opened Cash Management and Working Capital Management accounts. According to FINRA, the failure to send business continuity plans also was caused by a coding issue that

resulted in Merrill Lynch's "welcome kit" not being sent to the customers.

8. Merrill Lynch consented to a censure and a fine of $2.8 million.

9. In setting the sanction, FINRA took into account (a) the internal review that Merrill Lynch conducted, through which it self-identified the violations, (b) the remedial measures that Merrill Lynch took to corrects its systems and procedures, and (c) Merrill Lynch's efforts to provide remediation to customers. FINRA also considered three prior disciplinary sanctions, including a $250,000 fine in 2008 for overcharging customers $15 million in certain mutual fund transfer transactions.

E. *Merrill Lynch, Pierce, Fenner & Smith Incorporated* ("Merrill Lynch") (Aug. 3, 2012)

1. FINRA settled a matter with Merrill Lynch in which FINRA alleged that from September 2008 through March 2010, a registered representative of Merrill Lynch converted approximately $887,931 from 13 customers by initiating approximately 45 wire transactions and five checks, which were disbursed out of the customers' accounts and deposited into a bank account that the registered representative apparently controlled.

2. FINRA alleged that the disbursements ranged in size from $1,200 to $102,000, and although the name of the receiving account listed on the transaction matched the customer's name, the destination account number was one of two bank accounts that the registered representative apparently controlled.

3. In addition, FINRA alleged that Merrill Lynch's supervisory control system failed to include a policy or procedure requiring a review to detect or prevent multiple transmittals of funds from multiple customers going to the same third-party accounts or exception reports that would have identified multiple customer wires going to the same third-party account.

4. As such, FINRA concluded that Merrill Lynch failed to establish, maintain, and enforce a supervisory system that was reasonably designed to adequately monitor the transmittals of funds from the accounts of customers to third-party accounts and outside entities.

5. Merrill Lynch consented to a censure and a $450,000 fine.

6. FINRA separately noted that the registered representative was barred from associating with any FINRA firm in any capacity and that Merrill Lynch had repaid each of the affected customers.

F. *Guggenheim Securities, LLC* ("Guggenheim"), *Alexander Rekeda and Timothy Day* (Oct. 11, 2012)

1. Guggenheim settled a matter in which FINRA alleged that between March 2008 and October 2009, Guggenheim failed to supervise two CDO traders who tried to conceal a trading loss on a collateralized loan obligation ("CLO").

2. In October 2008, Guggenheim bought into its inventory a position in a "junk" rated tranche of a CLO after a failed trade and, in order to avoid the appearance of a loss on the position and to encourage a hedge fund customer to purchase the CLO at an inflated price, the head of the CDO Desk and another trader on the desk misrepresented to the hedge fund that the CLO was part of a "package" of securities offered by a third party. The traders agreed to reimburse the hedge fund for the overpayment (of approximately $950,000) through other transactions, including:

   (a) Adjustments in the hedge fund's favor on six riskless-principal trades totaling $612,105. The traders reduced the final trade prices for the transactions to the price it cost Guggenheim to acquire the securities, causing the CDO Desk to forfeit the profits it would have made on the trades. The traders then tracked the adjustments on a spreadsheet, which they periodically e-mailed to the hedge fund to keep track of paying off the overpayment.

   (b) The traders arranged for, without any principal approval, forgiveness of $188,825 in settlement fees owed by the hedge fund under the terms of the structuring agreement of a transaction.

   (c) The traders arranged for a cash payment of $150,648 to be paid to the hedge fund by wire transfer.

3. FINRA found that although its written procedures required that a firm principal review and approve blotters for each trading desk, including trade adjustments, such a review was not consistently performed. Original trade blotters did not show evidence of principal review and revised trade blotters were not consistently reviewed by a designated principal. As a result of the firm's failure to establish and maintain an adequate system of supervisory review, the firm's principals did not review the adjustments to the CLO price or the prices on the six other trades through which the traders reimbursed the hedge fund.

4. FINRA also found that Guggenheim inadequately supervised the outgoing e-mail correspondence of the CDO Desk. During the

relevant period, the firm randomly chose for review less than one e-mail per day sent or received by a member of the CDO Desk. As a result, Guggenheim failed to review the many e-mails concerning the traders' misstatements and negotiations with the hedge fund regarding the overpayment and price adjustments.

5. According to FINRA, between July 2007 and October 2008, Guggenheim failed to identify in its written supervisory procedures the designated supervisor responsible for supervising various members of the CDO Desk.

6. In addition, from April 2007 through March 2010, Guggenheim did not maintain written procedures concerning markups and commissions for riskless principal trades. During that period, the firm relied on unwritten policies, which required that a markup or markdown be no more than 3.5% on either side of the transaction (5% for customer-to-dealer transactions). Approval was to be obtained for any charges higher than those amounts. Further, while the firm's written supervisory procedures for markups generally included the factors listed in FINRA's interpretive materials, the procedures did not provide any guidance regarding how those factors should be applied in determining markups, markdowns and commissions.

7. Guggenheim agreed to a censure, a fine of $800,000, and an undertaking requiring the engagement of an independent consultant to review its policies, systems and procedures concerning the supervisory issues that were the subject of this matter.

8. FINRA also sanctioned the two traders involved. Alexander Rekeda, the former head of Guggenheim's CDO Desk, was suspended for one year and fined $50,000. Timothy Day, a trader on Guggenheim's CDO Desk, was suspended for four months and fined $20,000.

TRACE Reporting

Automated reporting such as TRACE and OATS has been the subject of regulatory interest for a number of years. Below is a case regarding TRACE and the Real-time Transaction Reporting System.

A. *Citigroup Global Markets Inc.* ("Citigroup") (Aug. 14, 2012)

1. FINRA settled a matter with Citigroup in which FINRA alleged that in connection with 10 separate reviews by FINRA staff during certain periods between July 2002 and December 2010, Citigroup

failed to report as required information to TRACE or the Real-time Transaction Reporting System ("RTRS"). Specifically:

- During the period July 2007 through September 2007, the firm did not report to TRACE the correct contra-party's identifier for 151 transactions in TRACE-eligible securities.

- During the period April 2009 through June 2009, Citigroup failed to report to TRACE 193 trades within 15 minutes of the execution time. The firm also failed to report the correct trade execution time for 193 transactions and did not show the correct execution time on the memoranda of brokerage orders.

- During the period July 2009 through September 2009, the firm did not report to TRACE 7,975 transactions within 15 minutes of the execution time. Additionally, during this time period, Citigroup reported 1,473 transactions that were not required to be reported.

- During the period October 2009 through December 2009, the firm failed to report to TRACE 114 block transactions within 15 minutes of the execution time. The firm also did not report the correct execution time for 22 block transactions and failed to show the correct execution time of 40 transactions on the memoranda of brokerage orders.

- During the period July 2002 through November 2010, Citigroup did not report to TRACE the correct settlement date modifiers for certain corporate fixed income securities (7,732 transactions during the period March 2010 to September 2010). Also during this period, the firm failed to report to TRACE certain transactions between the firm and an affiliate (9,531 transactions between November 2009 and November 2010).

- Between October 2010 and December 2010, the firm failed to report to TRACE 103 S1 block transactions in certain corporate debt securities within 15 minutes of the execution time. In the same period, Citigroup also failed to report the correct execution times for 29 block transactions in certain corporate debt securities and failed to show the correct execution time of 53 block transactions on the memoranda of brokerage orders.

- During the period June 2009 to June 2010, Citigroup did not report to the RTRS information regarding 30,000 purchase and sale transactions in municipal securities between the

firm and one contra-party broker-dealer. The firm also failed to report the correct Market Participant Identifier to the RTRS in 5,000 municipal securities transaction reports.

- Between April 1, 2008 and June 30, 2008, Citigroup failed to use reasonable diligence to determine the best inter-dealer market and to buy or sell in that market for 26 transactions.

- For five transactions during the period April 2008 through June 2008, Citigroup purchased and/or sold municipal securities for its own account from/to a customer account at an aggregate price that was not fair and reasonable under the relevant circumstances.

- In eight transactions during the period July 2008 through September 2008, the firm bought/sold corporate bonds to/from customers at prices that were not fair under the relevant circumstances.

2. Citigroup consented to a censure and a fine of $900,000, and was required to pay $32,355 plus interest in restitution to customers.

3. In determining the sanction, FINRA took into account the remedial efforts Citigroup undertook to improve its supervisory procedures and systems for fixed income reporting, including implementing enhanced staff training regarding TRACE compliance, using an outside vendor to verify TRACE information, and hiring an independent consultant to review the firm's TRACE reporting. Citigroup also voluntarily self-reported to FINRA some of the violations.

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