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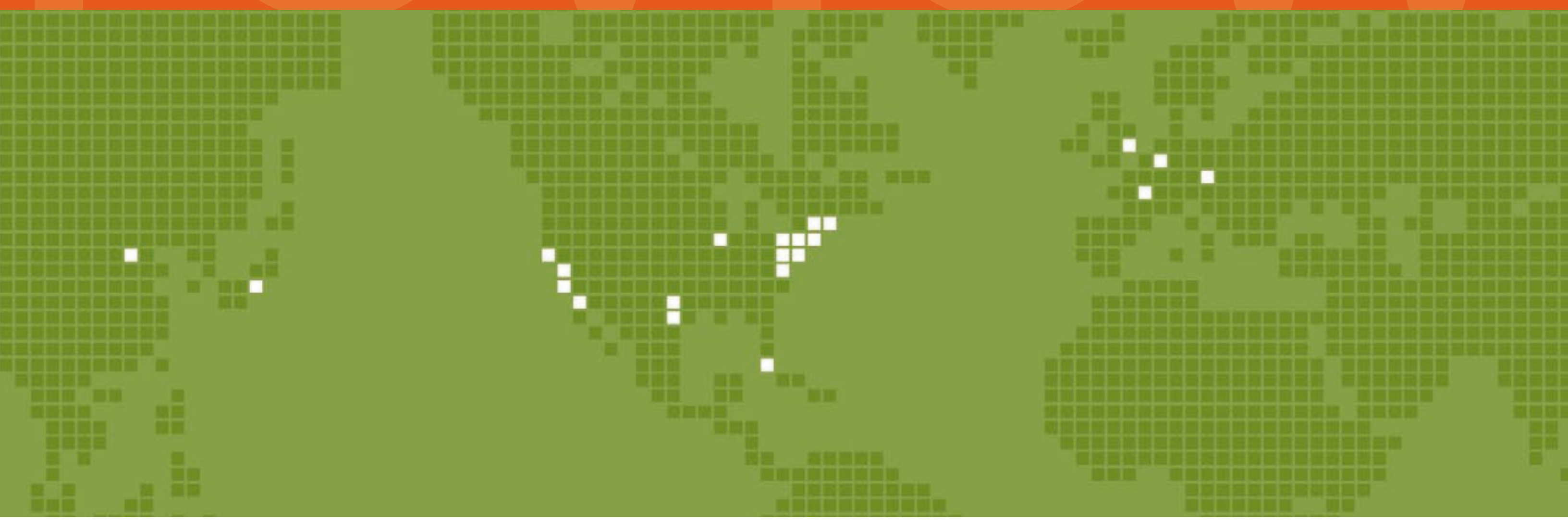

Recent SEC and SRO Enforcement Developments and Cases Regarding Broker-Dealers

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

The SEC

There have been a number of important enforcement developments this year at the Commission, including the SEC's first ever deferred prosecution agreement, the finalization of the Dodd-Frank whistleblower rules, and the continued focus on individual liability in enforcement actions. Moreover, a federal judge has raised substantial concerns about the SEC's practice of allowing defendants to neither admit nor deny the allegations in a settlement. For his part, the Director of the Division of Enforcement has harshly criticized certain defense counsel tactics and raised questions about multiple representations in investigations. All the while, the Commission continues to be active and aggressive in bringing enforcement actions.

These developments and cases are described in more detail on pages 2 through 50 of this Outline.

FINRA

FINRA's enforcement program has a new leader, new rules, revised Sanction Guidelines and a new disciplinary action database. FINRA also appears to be ahead of last year in bringing cases with large fines. It has brought cases in several traditional areas, but also opened new fronts in other investigations.

These developments and cases are described in more detail on pages 51 through 85 of this Outline.

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* This Outline was prepared by Ben A. Indek, Ivan P. Harris, Kevin T. Rover and Anne C. Flannery, partners, and of counsel Mary M. Dunbar, with substantial assistance from associates Casey P. Cohen, Clare M. Cusack, Alex B. Kaplan, Kerry J. Land, Nicholas J. Losurdo, Julie A. Marcacci, John C. Matthews, Julia N. Miller, Sarah S. Nilson, Rahul Rao, Todd Smith, E. Andrew Southerling and David A. Snider. As noted below, certain sections of the Outline were drawn from Law Flashes published by the Firm. The authors are grateful for the outstanding administrative assistance provided by legal secretary Mary-Elizabeth Denmark. Morgan Lewis served as counsel in certain actions described herein. This Outline summarizes cases through June, 2011.

Personnel Changes[1]

This year, there have been a number of significant personnel changes in the SEC's Enforcement, Risk, and Examination groups. These include the following:

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

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

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

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

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

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

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

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

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

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

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

- SEC Commissioner Kathleen L. Casey left the Commission on August 5, 2011 after completing her five-year term earlier in the year. In the press release announcing her departure, the Commission noted her active engagement on international matters, particularly her role as Chair of the International Organization of Securities Commission's Technical Committee and as the SEC's representative to the Financial Stability Board. In May, President Obama nominated a former SEC senior official, Daniel M. Gallagher, as Commissioner to replace Ms. Casey.

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

In addition to the foregoing individual personnel changes, it is important to note that the Division of Enforcement has hired various specialists to help it in its investigations. In particular, in February 2011, it was reported that Enforcement had recently hired 10 industry specialists to assist it with investigations, training, and initiative planning. The specialists include a former portfolio manager, a former trading desk head, and a former municipal bond trader.[2]

Enforcement Docket

Several metrics traditionally used to measure enforcement activity demonstrated that in FY 2010, the Division of Enforcement actively and aggressively pursued misconduct affecting the U.S. markets. As examples, last year the SEC brought 681 cases; this was its highest total since at least FY 2001. The SEC also brought 53 insider trading cases (up from 37 in FY 2009) that ensnared 138 defendants (versus 85 in FY 2009). For FY 2010, the SEC reported that it had obtained orders requiring payment of approximately $1.03 billion in penalties – almost three times the amount it had obtained in FY 2009.

Until the SEC's FY 2011 ends on September 30 and the Commission later releases its statistics, there is currently no publicly available data on the number of cases brought this year or the amount of fines imposed. Nevertheless, as early as February 2011, SEC Chairman Schapiro commented that the Commission's "pipeline of significant cases remains full."[3] It remains to be seen, however, if the Commission will ultimately bring more cases this year than last in light of the budget constraints that it operated under for many months. Those fiscal issues reportedly caused a slowdown in various investigations.[4]

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

[3] "Evolving to Meet the Needs of Investors," Address to Practising Law Institute's SEC Speaks in 2011 program (Feb. 4, 2011).

[4] *See* "U.S. Regulators Face Budget Pinch as Mandates Widen," by Ben Protess, *New York Times* (May 3, 2011).

Focus on Individuals

Over the last year, it appears that the SEC has continued to focus on the potential liability of individuals in its investigations as evidenced by the statistics. For example, in connection with financial crisis cases, through August 10, 2011 the Commission reported that it had charged 35 CEOs, CFOs, and other senior corporate officers. It also noted that 21 officer and director bars, industry bars, and Commission suspensions had been imposed on individuals.[5] This trend can also be seen in several cases summarized below, including those relating to alleged fraudulent sales practices, supervision, municipal bond transactions and privacy and confidentiality of customer information.

Cooperation Initiatives/New Enforcement Tools[6]

In 2010, the Commission announced a series of new measures designed to encourage individuals and companies to cooperate in Enforcement Division investigations and enforcement actions. As we summarized in our 2010 Year in Review, these initiatives include formal guidelines to evaluate and potentially reward cooperation by individuals, and incentives for individuals and companies to cooperate with the Division such as cooperation agreements, deferred prosecution agreements, and nonprosecution agreements. These tools seek to provide the SEC with some of the same methods available to federal prosecutors in fighting white collar crime, and are consistent with the philosophy that Enforcement Director Robert Khuzami and Deputy Enforcement Director Loren Reisner, both former federal prosecutors, have brought to the Division. Below are the developments in these areas that occurred in the first half of 2011.

Cooperation Agreements

The Enforcement Division has trumpeted its use of these cooperation tools during the first half of 2011. According to the most recently available statistics, the SEC has entered into approximately 25 cooperation agreements with individuals since its program began, and officials expect that number to increase as the program becomes more established.[7]

Deferred Prosecution Agreements

In May 2011, the SEC announced its first ever deferred prosecution agreement ("DPA") in connection with a Foreign Corrupt Practices Act ("FCPA") investigation

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

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

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

involving Tenaris S.A., a global steel pipe manufacturer and supplier. DPAs are formal written agreements in which the Commission agrees to forgo an enforcement action against a cooperator. These agreements are executed only if the individual or company agrees, among other things, to cooperate fully and truthfully, including producing all potentially relevant nonprivileged documents and materials, and to comply with express prohibitions and undertakings during a period of deferred prosecution, which generally should not exceed five years.

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

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

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

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

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

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

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

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

Dodd-Frank Whistleblower Provisions[8]

On May 25, 2011, the Commission voted to approve final rules to implement the SEC whistleblower provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), enacted by Congress on July 21, 2010. The vote was split, with three Commissioners voting in favor of implementation and two voting against. According to the majority of the Commissioners, the final rules attempt to balance the tension between encouraging whistleblowers to come forward to the SEC while simultaneously discouraging them from bypassing internal company compliance programs. The dissenting Commissioners disagreed, taking the position that the failure to require mandatory internal reporting would have a detrimental effect on internal compliance and spur whistleblowers to bypass those internal mechanisms in favor of directly reporting to the SEC.

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

Whistleblowers Protected from Retaliation

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

However, the final rules also require that, to be afforded protection from retaliation, the whistleblower must possess a "reasonable belief" that the employer is violating the securities laws. The SEC has defined "reasonable belief" in three ways: (1) specific, credible, and timely information; (2) information related to a matter already under investigation by the SEC, but that makes a

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

"significant contribution" to the investigation; or (3) information that was provided through the employer's internal compliance mechanisms, which is subsequently reported to the SEC by the employer, and which satisfies the first or second prong of the definition. This standard is a significant change from the proposed rules (which included no such requirement), and the final rules echo and cite to specific comments and proposals that Morgan Lewis submitted to the Commission on December 17, 2010.

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

Rules Relating to Eligibility for an Award

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

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

Reporting Through Internal Compliance Procedures

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

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

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

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

Original and Voluntary Information

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

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

Misconduct and Aggregation

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

Impact on FCPA Investigations

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

Impact on Covered Entities

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

It is too early to tell whether the final rules will lead to a flood of tips to the SEC that may lack depth and credibility, or if the rules will enhance the quality of information and enforcement. Since the passage of the Dodd-Frank Act, the SEC has reported that it has seen an increase in high-quality tips. It remains to be seen, however, whether increased publicity around whistleblower awards will have an adverse impact on the quality of the reports the SEC receives.

Insider Trading and Parallel Proceedings

Although federal criminal prosecutors have made major headlines in the insider trading area this year, the SEC continues to be active and aggressive in pursuing such cases. Indeed, Mr. Khuzami stated in late March that the SEC "continue[s] to vigorously enforce insider trading laws."[9] This outline summarizes several insider trading cases involving financial professionals.

Many insider trading cases involve both criminal and SEC charges. Speaking generally about the close collaboration between the DOJ and the SEC, Deputy Director of the Division of Enforcement Lorin Reisner commented in June that of the Commission's highest priority cases, approximately 55% to 65% have "some type" of parallel criminal investigation.[10]

The Rajaratnam Criminal Conviction

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

Although most of the defendants in these civil and criminal actions settled, Rajaratnam elected to take his criminal case to trial. Following a two-month trial, Rajaratnam was convicted on May 11, 2011 on all 14 counts of conspiracy and securities fraud leveled against him. Following the verdict, U.S. Attorney Preet Bharara noted that since the beginning of 2010, his office had charged 47 people with insider trading. Rajaratnam was the 35th to be convicted.

Developments in Administrative Proceedings

Penalties in Cease-and-Desist Proceedings

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

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

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

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

Collateral Bars

In April, an SEC administrative law judge held that certain of the collateral bar provisions in Dodd-Frank could not be applied retroactively to conduct that preceded the passage of the Act.[11] In an administrative proceeding involving John W. Lawton, who had pled guilty to mail and wire fraud, the SEC sought a collateral bar based on Lawton's conduct while associated with an unregistered investment adviser that occurred before Dodd-Frank was signed into law. Before Dodd-Frank, Section 203(f) of the Advisers Act only permitted the SEC to suspend or bar a person from association with an investment adviser. Dodd-Frank amended Section 203(f) to authorize the Commission to suspend or bar a person from association with an investment adviser, broker, dealer, municipal securities dealer, municipal advisor, transfer agent, or Nationally Recognized Statistical Rating Organization ("NRSRO").

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

Immunity Requests

In addition to the cooperation tools announced in 2010, the SEC amended its rules in June 2011 and delegated authority to the Enforcement Director to submit witness immunity requests to the U.S. Attorney General and, upon approval, grant immunity to witnesses in SEC investigations in order to compel those individuals to give testimony.[12] In its order amending the rules, the SEC stated that the delegation is intended to "enhance the Division's ability to detect violations of the federal securities laws, increase the effectiveness and efficiency of the Division's investigations, and improve the success of the Commission's enforcement actions." The amendment to the SEC's rules will last for 18 months, at which time the Commission will evaluate whether to extend the delegation to issue immunity orders.

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

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

Commissioner Paredes Sounds a Cautionary Note Regarding SEC Enforcement

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

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

Commissioner Paredes also observed that the SEC should give "meaningful credit" to those who cooperate with its investigations. In elaborating on what constitutes "meaningful" credit, Commissioner Paredes opined that the SEC "cannot be stingy" and that parties should receive "enough credit to make cooperating worth it."[13]

Criticism of Defense Counsel Tactics and Multiple Representations

In a June 1, 2011 speech to the Criminal Law Group of the UJA-Federation of New York, Mr. Khuzami addressed a number of defense counsel tactics that he deems to be of concern.[14] As he has in the past, Mr. Khuzami focused part of his speech on multiple representations and the potential conflicts they present. Although he made clear that multiple representations are permissible, Mr. Khuzami noted that he finds it troubling when multiple witnesses represented by the same counsel give highly consistent and not so obvious interpretations of the same events and documents. Although the SEC's means of addressing these concerns may be limited, Mr. Khuzami stated that the staff intends to raise its concerns more frequently with counsel, and may question witnesses about their awareness of potential conflicts inherent in multiple representations. He also

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[13] Available at: http://www.sec.gov/news/speech/2011/spch050611tap.htm.

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

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

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

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

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

The Enforcement Division's focus on defense counsel behavior comes at the same time that the SEC has instituted proceedings against defense counsel for unprofessional conduct. In November 2010, the SEC issued an opinion barring Steven Altman, an attorney who represented a witness in an SEC proceeding, from appearing or practicing before the SEC.[15] According to the opinion, during the course of several telephone calls, Altman told counsel representing two respondents in an SEC administrative proceeding that Altman's client would avoid service of an SEC subpoena in return for a monetary payment and other benefits from the respondents. Unknown to Altman, the respondents' counsel recorded the telephone calls and provided the recordings to the SEC.

Judicial Criticism of SEC Settlement Practices

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

In recounting the procedural facts of the case, the Court noted:

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

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

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

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

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

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

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

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

SEC Enforcement Priorities Regarding Broker-Dealers

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

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

Enforcement Actions[16]

Auction Rate Securities

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

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

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

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

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

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

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

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

special arbitration process with those eligible customers who claim additional damages.

B. *SEC v. Morgan Keegan & Company, Inc.* ("Morgan Keegan"), --- F. Supp. 2d ---, 2011 WL 2559362 (N. D. Ga.) (June 28, 2011)

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

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

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

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

5. The SEC has reportedly decided to appeal this decision.

Fraudulent Trading Schemes

The Commission has historically aggressively pursued fraudulent trading schemes. To date this year, the SEC has repeatedly shown that it will continue to do so.

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

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

2. The SEC alleged that from September 2005 to September 2007, Florian Homm and Todd Ficeto conducted the scheme through their broker-dealer Hunter World Markets, Inc. ("HWM"), with the assistance of Colin Heatherington (a trader), by taking microcap companies public through reverse mergers and manipulating upwards the stock prices of these thinly traded stocks before selling their shares at inflated prices to eight offshore hedge funds controlled by Homm. Allegedly, the defendants used a number of classic manipulative techniques such as placing matched orders, placing orders that marked the close or otherwise set the closing price for the day, and conducting wash sales.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Insider Trading

The SEC, often in conjunction with the DOJ, continues to aggressively prosecute insider trading by Wall Street professionals. In recent months, the United States Attorney for the Southern District of New York announced criminal charges in a seemingly wide-ranging insider trading investigation relating to the work of a so-called "expert networking" firm. The SEC has also brought charges in this area.

A. *SEC v. Mark Anthony Longoria, Daniel L. DeVore, James Fleishman, Bob Nguyen, Winifred Jiau, Walter Shimoon, Samir Barai, Jason Pflaum, Barai Capital Management, Noah Freeman, and Donald Longueuil*, 11-Civ-00753 (S.D.N.Y. Feb. 8, 2011)

1. On February 3, 2011, the SEC brought a civil injunctive action against four consultants and two employees of Primary Global Research ("PGR") in connection with an alleged insider trading scheme. The consultants are: Mark Anthony Longoria (a manager in AMD's desktop global operations group), Daniel L. DeVore (a global supply manager at Dell), Walter Shimoon (a vice president of business development for components in the Americas at Flextronics), and Winifred Jiau (a "private" PGR consultant). The PGR employees are James Fleishman and Bob Nguyen. On February 8, 2011, the SEC amended the Complaint to add as parties Barai Capital Management ("Barai Capital") (a New York–based hedge fund), Samir Barai (Barai Capital's founder and hedge fund portfolio manager), Jason Pflaum (an analyst at Barai Capital), and Noah Freeman and Donald Longueuil (both hedge fund portfolio managers).

2. According to the SEC Complaint, PGR is an expert network firm that purports to provide professional investment research to their clients. Many PGR consultants are corporate insiders at various high-tech companies.

3. The SEC alleged that the four PGR consultants named as defendants – Longoria, DeVore, Shimoon, and Jiau – obtained material, non-public confidential information about

sales, performance, and earnings of numerous public companies and shared that information with PGR clients who traded on that inside information.

4. The SEC alleged that the two PGR employees named as defendants – Fleishman and Nguyen – acted as conduits by receiving information from PGR consultants and passing that information directly to PGR clients.

5. The SEC alleged that the hedge fund and hedge fund portfolio managers and analyst – Barai Capital, Barai, Freeman, Longueuil, and Pflaum – were among the recipients of the material non-public information supplied by PGR consultants and employees, and traded on the information or caused hedge funds they managed to trade based on the information.

6. The SEC claims that altogether, hedge funds and other traders reaped approximately $30 million in illicit profits or losses avoided as a result of the disclosure of material non-public information by PGR consultants and employees.

7. The SEC's amended complaint charged each of the defendants with violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and charged Fleishman, Nguyen, Jiau, Barai, Pflaum, Freeman, and Longueuil with aiding and abetting others' violations of Section 10(b) and Rule 10b-5 thereunder. The amended complaint also charged Longoria, DeVore, Barai, Pflaum and Barai Capital with violations of Section 17(a) of the Securities Act of 1933. The Complaint sought permanent injunctions, disgorgement, and financial penalties. Additionally, the SEC sought a permanent officer and director bar for Longoria, Shimoon, and DeVore.

8. A final judgment on consent was entered against DeVore on July 12, 2011. In addition to a permanent injunction, DeVore was ordered to pay $145,750 plus $6,098.50 in prejudgment interest. Because of his agreement to cooperate in a SEC investigation and/or enforcement action, a civil penalty was not imposed. DeVore was also barred from acting as an officer or director of any public company.

9. On September 12, 2011, a final judgment on consent was entered against Longueuil, which included a permanent injunction and an order to pay $250,000 in disgorgement and prejudgment interest of $102,832.60. The disgorgement was credited by $1,251,685, the amount of forfeiture ordered in a

related criminal case against Longueuil. No civil penalty was assessed given the judgment in the criminal case.

10. The case is still pending as to the other defendants.

11. In a parallel action, defendants Jiau and Longueuil were indicted by a Grand Jury in the Southern District of New York. Longueuil pled guilty on April 28, 2011 to conspiracy and securities fraud charges, and was sentenced to 30 months in prison. After a jury trial, Jiau was found guilty on charges of conspiracy and securities fraud. Jiau was sentenced to four years in prison. Fleishman was also indicted by a Grand Jury in the Southern District of New York and was convicted on September 20, 2011 of conspiracy following a jury trial. Separately, Longoria, DeVore, Nguyen, Shimoon, Freeman, Barai, and Pflaum pled guilty to charges of conspiracy and securities fraud. They are awaiting sentencing.

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

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

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

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

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

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

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

C. *SEC v. Galleon Management, LP, et al.* ("Galleon"), 09-Civ-8811 (S.D.N.Y. Oct. 16, 2009)

1. In our 2009 and 2010 Outlines, we reported that the SEC charged Galleon, a hedge fund advisory firm, Raj Rajaratnam, its founder, another hedge fund (New Castle Funds LLC), and five other individuals, including executives at IBM, McKinsey, and Intel with perpetrating an insider trading scheme that involved extensive and recurring insider trading ahead of various corporate announcements. Later, the SEC amended its complaint to include new charges against nine additional individuals and four more hedge funds and trading firms.

2. The SEC alleged that the defendants were part of a widespread insider trading ring in which certain participants traded based on material, non-public information concerning corporate events, such as acquisitions and earnings announcements involving at least twelve companies (e.g., Polycom, Google, Hilton Hotels, Sun Microsystems, and Sprint Nextel).

3. Some of the defendants allegedly shared material, nonpublic information in exchange for compensation but did not trade. Other defendants allegedly traded in their own accounts, in the accounts of tippers, and/or on behalf of institutions, such as hedge funds.

4. In January 2010, the SEC again amended its complaint, this time to file additional charges of insider trading against Rajaratnam and Anil Kumar, a friend of Rajaratnam's and former Galleon investor who had been senior partner and director of the global consulting firm, McKinsey & Co. The new allegations raise the total illicit trading profits or losses avoided from the scheme from $33 million, as alleged in the initial complaint, to more than $52 million.

5. In the complaint, the SEC alleged that, between 2003 and 2009, Rajaratnam paid Kumar $1.75 million to $2 million for material, nonpublic information to generate almost $20 million in illicit profits at Galleon. The SEC also alleged that Kumar reinvested with Galleon the funds he received from Rajaratnam, which resulted in a combined total profit of $2.6 million for his participation in the scheme.

6. Also in January 2010, the SEC settled charges against defendants Ali Far and Choo-Beng Lee, who were cofounders of Spherix Capital, an unregistered hedge fund investment adviser. Far and Lee consented to permanent injunctions and to be jointly and severally liable for more than $1,335,000 in disgorgement and a civil penalty of approximately $668,000.

7. In April 2010, the SEC settled insider trading charges against another defendant, Schottenfeld Group, LLC ("Schottenfeld"), a registered broker-dealer. The SEC alleged that four Schottenfeld traders used material, nonpublic information to trade in the stocks of three public companies for Schottenfeld's accounts. Schottenfeld consented to a permanent injunction, to disgorge approximately $460,000, and to pay a civil penalty of approximately $230,000. This penalty was reduced to that amount (i.e., 50% of disgorgement) in recognition of Schottenfeld's agreement to cooperate in the SEC's investigation.

8. In May 2010, the SEC settled insider trading charges against Kumar, who consented to a permanent injunction, to disgorge $2,600,000, and to pay a civil penalty in an amount to be set by the court no later than November 2011.

9. In October and November 2010, the SEC settled insider trading charges against Roomy Khan, a former Galleon and Intel Corp. employee, and Rajiv Goel, another former Intel employee. The SEC alleged that Khan and Goel provided material, nonpublic information to Galleon on numerous occasions. Both defendants consented to permanent injunctions. Khan and Goel also consented to pay disgorgement of $1.85 million. The Court will determine at a later date whether Khan and Goel will be required to pay civil monetary penalties.

10. In February 2011, the SEC settled insider trading charges against Ali Hariri, former Vice President of Broadband Carrier Networking at Atheros Communications, Inc. The

SEC alleged that Hariri tipped co-defendant Ali Far in advance of certain of Atheros's earnings announcements, and that Far and co-defendant CB Lee traded profitably based on that information. In exchange, Far tipped Hariri with inside information on another company. Through trading based on inside information he received from Far, Hariri personally profited by $2,548.91. Hariri consented to a permanent injunction, disgorgement, and a permanent officer and director bar. In a parallel criminal action, *United States v. Hariri*, 10 CR 00173 (S.D.N.Y.), Hariri pleaded guilty and was sentenced to a term of imprisonment for 18 months, two year supervised release, and ordered to pay a criminal fine of $50,000.

11. The SEC seeks injunctions, disgorgement, civil penalties, and orders barring the remaining defendants from acting as officers or directors of any registered public company.

12. Criminal charges were also brought against Rajaratnam and others in the Southern District of New York. On May 11, 2011, a jury found Rajaratnam guilty on 14 counts of conspiracy and securities fraud. Other related defendants previously pled guilty to insider trading charges.

D. *SEC v. Robert Feinblatt, Jeffrey Yokuty, Trivium Capital Management LLC, Sunil Bhalla, and Shammara Hussain*, 11-Civ-0170 (S.D.N.Y. Jan. 10, 2011)

1. In a case related to the *Galleon* matter, the SEC filed an insider trading civil injunctive action against four individuals and a hedge fund investment advisory company relating to three quarterly earnings announcements and two corporate takeovers. The defendants are Trivium Capital Management LLC, ("Trivium") a New York-based hedge fund investment advisor with $600 million under management, Robert Feinblatt (a principal at Trivium), Jeffrey Yokuty (an analyst at Trivium), Sunil Bhalla (Senior Vice President at Polycom), and Shammara Hussain (an employee at Market Street Partners, which consulted for Google).

2. The SEC alleged insider trading around Polycom's quarterly earnings releases for Q4 2005 and Q1 2006. The SEC alleged that Bhalla, through his position at Polycom, learned inside information and provided this information to Roomy Khan, a former Galleon employee. Khan both traded on the basis of this information and provided the information to Feinblatt, Yokuty, and others including Raj Rajaratnam, who all traded on this information.

3. The SEC also alleged that Khan obtained inside information from a Moody's rating agency analyst in advance of the July 3, 2007 announcement of the takeover of Hilton Hotels. Khan passed this information along to Feinblatt and Yokuty, who traded on behalf of Trivium for a profit of approximately $5.2 million and avoiding losses of approximately $4.9 million.

4. The SEC further alleged that Hussain tipped Khan to inside information on Google's Q2 2007 results. Hussain obtained the inside information while working for a consulting firm that performed investor relations work for Google. Khan passed this information to Feinblatt and Yokuty, who traded for profits exceeding $2.5 million.

5. Finally, the SEC alleged that Khan received inside information regarding the March 2007 acquisition of Kronos, a software company, from a private equity firm. Khan traded on this information and tipped Feinblatt and Yokuty, who made approximately $1.8 million profit for Trivium.

6. The SEC voluntarily dismissed its claims against Trivium with prejudice in June 2011. On June 15, 2011, a final judgment on consent was entered against Hussain. In addition to a permanent injunction, Hussain was ordered to pay disgorgement of $21,619.80, prejudgment interest of $4,795.47, and a civil penalty of $21,619.80.

7. A final judgment on consent was entered against Yokuty on July 11, 2011, which included a permanent injunction and ordered Yokuty to pay disgorgement of $127,595.10, $34,935.12 in prejudgment interest, and a $127,595.10 civil penalty.

8. On July 17, 2011, a final judgment on consent was entered against Feinblatt. In addition to a permanent injunction, Feinblatt was ordered to pay disgorgement in the amount of $829,765, prejudgment interest of $186,023, and a civil penalty of $1,659,530.

9. The action is ongoing as to defendant Bhalla.

E. *SEC v. Michael Cardillo*, 11-Civ-0549 (S.D.N.Y. Jan. 26, 2011)

1. In another case related to the *Galleon* matter, the SEC filed insider trading charges against Michael Cardillo, a former trader at the hedge fund investment adviser Galleon Management, LP, for allegedly trading ahead of the

September 2007 announced acquisition of 3Com Corp. ("3Com"), and the November 2007 announced acquisition of Axcan Pharma Inc. ("Axcan").

2. The SEC alleged that based on material, nonpublic information regarding the acquisitions of 3Com and Axcan, Cardillo traded in the securities of those two companies on behalf of a Galleon hedge fund, resulting in more than $730,000 in illicit profits.

3. The SEC alleged that the material, nonpublic information concerning the acquisitions of 3Com and Axcan were originally misappropriated by former attorneys at the law firm of Ropes and Grey LLP, who tipped the inside information, through another attorney, to a former proprietary trader at the broker-dealer Schottenfeld Group, who tipped the information to a trader who worked out of the offices of the Galleon Group, who then tipped the inside information to Cardillo.

4. The SEC's Complaint charged Cardillo with violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder.

5. On July 18, 2011, a final judgment on consent against Cardillo was entered. In addition to a permanent injunction, Cardillo was ordered to pay $58,520 in disgorgement, prejudgment interest of $9,523, and a civil penalty of $29,260. The disgorgement and prejudgment interest was deemed satisfied by the amount of forfeiture to be ordered in the pending criminal case against Cardillo.

6. Cardillo has pled guilty to related criminal charges and is awaiting sentencing.

F. *SEC v. Adam Smith*, 11-Civ-0535 (S.D.N.Y. Jan. 26, 2011)

1. In another case related to the *Galleon* matter, the SEC filed insider trading charges against Adam Smith, a former portfolio manager of the Galleon Emerging Technology funds (f/k/a the Galleon Communications funds) alleged to have engaged in insider trading in the securities of ATI Technologies, Inc. ("ATI").

2. The SEC alleged Smith caused the Galleon funds he advised to purchase shares of ATI based on material, non-public information concerning Advanced Micro Devices Inc.'s

$5.4 billion takeover of ATI in July, 2006. The trading generated over $1.3 million in illicit profits.

3. The SEC alleged Smith obtained material, nonpublic information concerning the AMD/ATI transaction from an investment banking source that Smith had known for years. This source, according to the SEC, provided Smith with the tip in order to win favors from Galleon such as securing investment banking work from, or obtaining future employment with Galleon.

4. The SEC's Complaint charged Smith with violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder.

5. A final judgment against Smith was entered on May 31, 2011. In addition to a permanent junction, Smith was ordered to pay $149,706.25, plus prejudgment interest. Any forfeiture awarded in the criminal case against him will be credited toward the payment. Based on Smith's agreement to cooperate with the SEC, no civil penalty was imposed.

6. Smith has pled guilty to related criminal charges and is awaiting sentencing.

G. *In the Matter of Rajat K. Gupta*, Admin. Proc. File No. 3-14279 (Mar. 1, 2011)

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

2. The SEC alleged that Rajaratnam caused the various Galleon hedge funds to trade based on material, nonpublic information provided to him by Gupta regarding Berkshire Hathaway Inc.'s $5 billion investment in Goldman Sachs, as

well as Goldman Sach's financial results from the second and fourth quarters of 2008. Because of the disclosure of this material, nonpublic information, the Galleon hedge funds are alleged to have made trades resulting in profits or loss avoidance in excess of $17 million.

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

4. The SEC alleged that Gupta willfully violated Section 17(a) of the Securities Act of 1933, and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder.

5. In its administrative cease and desist proceeding, the SEC sought disgorgement, civil penalties, and a cease and desist order.

6. In March 2011, Gupta filed a Complaint against the SEC seeking declaratory and injunctive relief to prevent the SEC from retroactively applying the Dodd-Frank Act to seek civil penalties from Gupta in an administrative proceeding rather than a federal court action. *Rajat K. Gupta v. SEC*, 11 Civ. 1900 (S.D.N.Y Mar. 18, 2011). Gupta's complaint sought to move the administrative case to federal court, and alleges that the SEC administrative proceeding denies him his constitutional right to a jury and treated him differently than the more than two dozen other *Galleon*-related defendants sued in federal court. In July 2011, the district court, sympathizing with Gupta's equal protection argument, rejected the SEC's motion to dismiss and allowed Gupta to proceed on his Complaint seeking injunctive relief. The court, however, narrowed Gupta's Complaint to the equal protection issue.

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

H. *SEC v. Thomas Hardin*, 10-Civ-8600 (S.D.N.Y. June 6, 2011)

1. As we reported in our 2010 Outline, in another case related to the *Galleon* matter, on November 12, 2010, the SEC filed

insider trading charges against Hardin, a former managing director at Lanexa Management LLC, a hedge fund investment adviser, relating to two corporate takeovers and a quarterly earnings announcement. The SEC alleged that Hardin received material, nonpublic information from *Galleon* defendant Roomy Khan. Hardin allegedly traded based on this information and passed the information to others who traded, resulting in illegal profits of at least $950,000.

2. A final judgment on consent was entered against Hardin on June 6, 2011. In addition to a permanent injunction, Hardin was ordered to pay disgorgement of $33,321.95 plus $6,749.09 in prejudgment interest. A civil penalty will be assessed at a later date. In a related administrative proceeding, Hardin consented to an entry of an order barring him from association with any investment adviser, broker-dealer, municipal securities dealer, or transfer agent.

3. Hardin previously pled guilty to related criminal charges and is awaiting sentencing.

I. *SEC v. Lanexa Management LLC* ("Lanexa") *and Thomas C. Hardin*, 10-Civ-8599 (S.D.N.Y. Apr. 25, 2011)

1. As we reported in our 2010 Outline, in November 2010, the SEC filed a second insider trading action against Hardin and also sued Lanexa, his former employer, in connection with another insider trading ring involving two former corporate attorneys.

2. The SEC alleged that the two former attorneys provided the fraudulent tips concerning corporate takeovers to Zvi Goffer, a former trader at Schottenfeld Group LLC ("Schottenfeld"), in exchange for kickbacks. Goffer allegedly passed the material, nonpublic information to another Schottenfeld trader, who tipped Hardin. Hardin then placed trades related to one of those takeovers on behalf of Lanexa, a hedge fund.

3. A final judgment on consent was entered against Hardin on April 25, 2011. In addition to a permanent injunction, Hardin was ordered to pay disgorgement of $19,310 plus $2,426 in prejudgment interest. A civil penalty will be assessed at a later date. As noted above, in a related administrative proceeding, Hardin consented to an entry of an order barring him from association with any investment adviser, broker-dealer, municipal securities dealer, or transfer agent. The case is ongoing as to Lanexa.

4. The SEC seeks disgorgement and other relief against Lanexa.

5. Separately, several of the individuals involved in these matters have been criminally charged; some of the defendants have pled guilty, while others contested the charges. Specifically, on June 13, 2011, a jury found Goffer and two co-defendants guilty on charges of securities fraud and conspiracy. Goffer was sentenced on September 21, 2011 to 10 years in prison.

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.

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

1. The SEC commenced an administrative proceeding against Wells Fargo Securities LLC (f/k/a Wachovia Capital Market LLC) ("Wachovia") which alleged that Wachovia violated the antifraud provisions of the Securities Act in connection with its offering of two collateralized debt obligations ("CDOs") tied to the performance of residential mortgage-backed securities ("RMBS").

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

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

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

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

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

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

2. The SEC alleged that J.P. Morgan Securities structured and marketed a synthetic CDO, Squared CDO 2007-1 ("Squared"), which was tied to the performance of residential mortgages and was structured and marketed in early 2007 when the United States housing market was beginning to show signs of distress. Specifically, the SEC alleged the investment portfolio for Squared consisted primarily of credit default swaps referencing other CDO securities whose value was tied to the U.S. residential housing market.

3. The SEC alleged that the marketing materials for Squared represented that its investment portfolio was selected by GSC, a registered investment adviser with experience analyzing credit risk in CDOs. However, not disclosed in the marketing material and unknown to investors was that the Magnetar Capital LLC ("Magnetar") hedge fund, which was poised to benefit if the CDOs defaulted, played a significant role in selecting which CDOs should make up the portfolio.

4. The SEC also alleged that while participating in the selection of the investment portfolio, Magnetar shorted a substantial portion of the assets it helped to select by entering into credit default swaps to buy protection on them. The CDO securities Magnetar shorted had a notional value of approximately $600 million, representing over half of Squared's investment portfolio.

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

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

distribution, and $27,730,279 will be paid to the U.S. Treasury.

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

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

Misappropriation of Fund Assets

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

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

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

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

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

5. There is also a pending investigation by the U.S. Attorney's Office.

Mortgage-Backed Securities

The Commission remains keenly focused on cases involving mortgage-backed securities. Below is an example of that trend, as well as the SEC's pursuit of cases against individuals.

A. *SEC v. Charles Schwab Investment Management, Charles Schwab & Co., Inc., and Schwab Investments*, CV-11-0136 (N.D. Cal. Jan. 11, 2011); *In the Matter of Charles Schwab Investment Management, Charles Schwab & Co., Inc., and Schwab Investments*, Admin. Proc. File No. 3-314184 (Jan. 11, 2011)

1. The SEC filed a settled action against Charles Schwab Investment Management ("CSIM") and Charles Schwab & Co., Inc. ("CS&Co.") charging the companies with making misleading statements regarding the Schwab YieldPlus Fund and failing to establish, maintain and enforce policies and procedures to prevent the misuse of material, nonpublic information. The SEC also charged CSIM and Schwab Investments with deviating from the YieldPlus Fund's concentration policy.

2. Specifically, the SEC alleged that CSIM and CS&Co. failed to adequately inform investors about the risks of investing in the YieldPlus Fund, including misleading investors about the maturity and credit quality of the YieldPlus Fund's securities as compared to a money market fund.

3. The SEC also alleged that the YieldPlus Fund deviated from its concentration-policy when it invested approximately 50% of the fund's assets in private issuer-mortgage backed securities, well over the fund's stated policy of not concentrating more than 25% of assets in any one industry.

4. CSIM and CS&Co. agreed to pay a total of $118,944,996, including $52,327,149 in disgorgement of fees by CSIM, a $52,327,149 penalty against CSIM, a $5,000,000 penalty against CS&Co., and pre-judgment interest of $9,290,698.

5. In a separate administrative proceeding, the SEC instituted settled cease-and-desist proceedings against CSIM, CS&Co, and Schwab Investments for the same conduct. CSIM, CS&Co., and Schwab Investments consented to a cease-and-desist order which requires, among other things, that they correct all disclosures regarding the fund's concentration policy and retain an independent consultant to review and make recommendations about their policies and

procedures to prevent misuse of material, nonpublic information.

6. On the same day the SEC brought its actions, FINRA also settled a case with a Schwab entity. That case is summarized in the FINRA section below.

B. *SEC v. Kimon P. Daifotis and Randall Merk*, CV-11-0137 (N.D. Cal. Jan. 11, 2011)

1. The SEC filed a civil action against Kimon Daifotis and Randall Merk charging them with securities fraud and other securities law violations in connection with Charles Schwab's YieldPlus Fund (see above).

2. The SEC alleged that Daifotis, former lead portfolio manager for the Schwab YieldPlus Fund, and Merk, formerly President of Charles Schwab Investment Management (CSIM) and a trustee of the YieldPlus Fund, misled investors about the risks of investing in the YieldPlus Fund, which experienced a significant decline in assets from $13.5 billion to $1.8 billion during an eight-month period during the credit crisis of 2007-08.

3. Specifically, the SEC alleged that during this period, Daifotis and Merk allegedly made false and misleading statements about the rate at which the fund was experiencing investor redemptions.

4. The SEC also charged Daifotis with aiding and abetting the YieldPlus Fund's deviation from its concentration policy by directing the investment of more than 25% of the Fund's assets in private-issuer mortgage-backed securities. Merk is alleged to have aided and abetted violations of anti-fraud provisions by approving other Schwab funds' redemptions of their investments in YieldPlus by a portfolio manager who allegedly was in possession of material, nonpublic information about the YieldPlus fund.

5. The complaint seeks permanent injunctive relief, civil penalties, and disgorgement against both Daifotis and Merk. The case is ongoing.

Municipal Bond Actions

The Commission has called for greater scrutiny of the municipal securities market. The below case involves alleged bid rigging in this market. The SEC brought a similar case last year.

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

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

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

3. The complaint alleged that between 2000 and 2004, UBS FS facilitated improper payments to other bidding agents and improperly steered business to favored providers of reinvestment products. In some cases, UBS FS is alleged to have given favored providers information on competing bids in a practice known as "last looks." In other instances, UBS FS allegedly obtained off-market "courtesy" bids or pre-arranged "set-ups" by purposefully obtaining non-competitive bids from others so that the favored provider would win the business.

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

5. UBS FS consented to pay $47.2 million in penalties, disgorgement, and prejudgment interest, which will be returned to the affected municipalities. UBS FS and its

affiliates have also agreed to pay $113 million to settle parallel charges brought by other federal and state authorities.

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

Mutual Fund Pricing

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

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

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

3. The SEC alleged that Morgan Keegan and Weller failed to price the funds in accordance with the funds' policies and procedures. For example, Fund Accounting often sought broker-dealer price confirmations for certain securities. Kelsoe reviewed the price confirmations and convinced one broker-dealer to change the price confirmations obtained by Fund Accounting and the independent auditor, who were unaware of this practice. Kelsoe also allegedly did not inform Fund Accounting or the funds' boards of directors when he received price-changing information regarding the funds' securities.

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

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

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

7. Morgan Keegan agreed to pay restitution of $200 million to settle all of the foregoing actions. Specifically, $20.5 in disgorgement, $4.5 million in prejudgment interest, and $75 million in civil penalties will be paid to the SEC, to be distributed to harmed customers through a Fair Fund. The firm will pay $100 million into a state fund for customers. Additionally, as part of the settlement with the SEC, Morgan Keegan and Morgan Asset are barred from being involved in the pricing of securities for investment companies for three years. Kelsoe consented to pay a civil penalty of $250,000 and to an industry bar and a bar from participating in any penny stock offering. Weller agreed to a penalty of $50,000 and a 12-month suspension from acting in a supervisory capacity and participating in the offering of a penny stock. He was also prohibited from appearing or practicing before the Commission as an accountant.

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

Privacy and Confidentiality of Client Information

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

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

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

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

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

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

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

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

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

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

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

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

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

Record Keeping

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

1. In an enforcement action arising out of the production of documents and information during an examination, the SEC

charged a broker-dealer and its chief compliance officer with providing false documents to the examination staff.

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

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

Securities Offerings

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

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

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

3. Clifton supervised MPG's sales representatives and sales practices. The SEC alleged he held weekly meetings in

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

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

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

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

7. A public hearing before an Administrative Law Judge is pending, and an initial decision is expected in 2012.

Supervision

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

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

2. According to the SEC, the desk manager failed to meet his duty of best execution to the Plan Customers. This failure

occurred because the order desk manager directed the traders to execute the trades for the Plan Customers through cross trades with favored accounts of hedge funds and individuals at prices that favored the hedge funds.

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

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

5. The SEC alleged that BNY failed to supervise the desk in two respects. First, BNY failed to establish reasonable procedures for following up on red flags raised in best execution exception reports. Second, BNY did not have procedures in order to determine whether the order desk manager was fulfilling his responsibility to conduct a daily best execution review of executions on regional exchanges

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

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

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

1. This case concerns Ameritrade's alleged supervisory failures with respect to the offer and sale of shares of a short-term bond fund, the Reserve Yield Plus Fund (the "Fund"), that

"broke the buck" when Lehman Brothers, Inc. failed in September 2008 and the value of Lehman's commercial paper owned by the Fund dropped significantly.

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

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

4. Ameritrade settled the matter by agreeing to a censure. In light of the fact that Ameritrade undertook voluntarily to pay $10 million to customers who owned the Fund, the SEC did not seek to impose a civil penalty on Ameritrade.

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

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

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

3. Torrey Pines settled the matter by agreeing to a censure and to an undertaking to retain an independent consultant to review its policies, procedures, and systems concerning

supervision of registered representatives and the outside business activities of associated persons. A civil money penalty was not imposed based upon Torrey Pines' representations of its inability to pay.

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

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

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

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

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

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

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

3. The SEC further alleged that Pagliarini should have determined that certain trades and wire transfers executed

by HWM were potentially fraudulent and accordingly filed SARs for those transactions.

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

Swaps Trading

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

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

2. The SEC alleged that by October 2009, Morgan Stanley's net risk position in one of the securities exceeded the $50 million limit the firm placed on any single emerging market security. As such, Morgan Stanley notified Feinblum that he needed to reduce the net risk position to bring it within the firm's limit. Despite this warning, on at least 32 separate occasions between October and December 2009 Feinblum entered swap orders into Morgan Stanley's risk management system, and then almost immediately cancelled the orders. The effect of this strategy was to temporarily and artificially reduce the net risk positions in the securities. During this time, Feinblum allegedly represented to the firm that he continued to reduce the desk's net risk position to bring it within the firm's limit, when, in fact, he continued to increase the net risk position.

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

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

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

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

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

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

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

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

Unregistered Offerings

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

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

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

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

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

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

Personnel Changes

Late last year, FINRA announced that it had appointed J. Bradley Bennett as the new Head of Enforcement, effective January 1, 2011. Mr. Bennett joined FINRA from Baker Botts in Washington, D.C.

In May 2011, two senior Enforcement officials left FINRA. Chief Counsels Linda Riefberg and Suzanne Elovic, who each led an enforcement unit in New York, departed from FINRA after serving with the organization and its predecessor (NYSE Regulation, Inc.) for many years. Richard Best, a Director of Enforcement, was elevated to Acting Chief Counsel.[17] In August, the media reported that Daniel Nathan, Director of FINRA's Regional Enforcement program, planned to leave the organization.[18]

Enforcement Statistics

Through June 2011, FINRA appears to be off to a fast start in bringing cases with large fines. Specifically, as shown in the following table, in the first half of this year, FINRA imposed fines of more than $100,000 in a greater number of cases than it had during the same period in 2010. This is particularly true with respect to fines over $1.5 million.[19]

Fine Range	2010 (Jan. – June)	2011 (Jan. – June)
$100,001 to $250,000	14	10
$250,001 to $500,000	7	10
$500,001 to $750,000	4	5
$750,001 to $1,000,000	0	3
$1,000,001 to $1,500,000	1	1
$1,500,001 or more	1	5
Total	27	34

17 Compliance Reporter, May 2011.

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

19 The information in the table was collected based on our review of FINRA's monthly "Disciplinary and Other FINRA Actions" publications and FINRA news releases issued between January and June 2010 and 2011.

For context, in 2010, FINRA filed 1,310 new disciplinary actions – an increase of 13% from the 1,158 in the prior year. FINRA also resolved 1,178 formal actions last year; in 2009, it had concluded 1,090 such cases. Last year, FINRA expelled 14 firms from its membership (compared to 20 in the prior year), barred 288 people (versus 383 in 2009) and suspended 428 individuals (an increase over the 363 such actions in the prior year).[20]

Last year, FINRA reported that it had levied fines of almost $42.2 million. That figure represents a decline from the $47.6 million in fine revenue in 2009, a decrease of $5.4 million or 11.3%. According to FINRA, the number of fines it levied in 2010 remained flat compared with the prior year (643 fines imposed in 2010 versus 644 in 2009). The average fine, however, decreased from about $73,900 in 2009 to approximately $65,600 in 2010. In 2010, FINRA ordered firms and individuals to provide nearly $6.2 million in restitution to customers.[21]

Enforcement Policy Developments

Although Mr. Bennett has only been in place since January, there have been several interesting enforcement developments in that short time.

In one of his earliest press interviews, Mr. Bennett provided three insights to his enforcement approach. Mr. Bennett indicated that he expected his team to be "tough but fair," that he was going to attempt to "streamline the processes that may be bogging down important matters," and warned that although he had recently switched sides from defending the industry to being its chief prosecutor, "he will not go easy" on financial services firms.[22] In a subsequent interview, Richard G. Ketchum, FINRA's Chairman and CEO, commented that Mr. Bennett had "brought a renewed passion" to the Department of Enforcement and predicted that the industry will see both more cases and cases brought more quickly.[23]

At a spring ABA SRO Sub-Committee of the Securities Litigation Committee panel session, Mr. Bennett described his views regarding sanctions. He emphasized that fines should be proportional to the case under review and the violations being alleged. Mr. Bennett further indicated that fines will have a logic

20 *See* FINRA Statistics page available at: http://www.finra.org/Newsroom/Statistics/.

21 *See* FINRA 2010 Year in Review and Annual Financial Report, available at: http://www.finra.org/.

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

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

and framework that should provide guidance to firms reviewing such actions. This approach is intended to provide clarity and guidance to the industry.[24]

In further comments at the ABA SRO Sub-Committee meeting, Mr. Bennett offered some thoughts concerning the enforcement process. He noted that although he would be generally accessible to defense counsel, he cautioned firms about requesting meetings to discuss "administrative" issues like document production. Rather, Mr. Bennett suggested saving such requests for meetings to discuss important policy and legal issues, after the record in the investigation has been sufficiently developed.[25] Additional issues addressed by Mr. Bennett are described in the following sections.

New Self-Reporting Requirements

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

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

In a major change for both legacy NYSE and NASD firms, with respect to violations by a member firm, broker-dealers are expected to report "only conduct that has widespread or potential widespread impact to the [firm], its customers or the markets, or conduct that arises from a material failure of the [firm's] systems, policies or practices involving numerous customers, multiple errors or significant dollar amounts."

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

Senior officials at FINRA have tried to allay industry concerns regarding the new provision by indicating that the Department of Enforcement will not be looking to initiate stand-alone cases under the new Rule and that, when such actions are

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

25 *Id*.

brought, it will be clear that a pattern of serious misconduct had occurred but was not reported to FINRA.[26]

Commenting on the new Rule, Mr. Bennett indicated that credit for extraordinary cooperation will continue to be available to firms in instances where such efforts save FINRA significant time and effort and/or those where firms provide the Staff with information that it would otherwise not be able to obtain on its own.[27]

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

Current FINRA Enforcement Priorities

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

- **Anti-money laundering**: FINRA continues to review anti-money laundering issues, including examining master/sub accounts.
- **Regulation D offerings**: FINRA is concerned about suitability, supervision, advertising, and potential fraud in these kinds of offerings. FINRA is reportedly looking closely at the potential liability of individual registered representatives who may have engaged in inadequate due diligence and the suitability of recommendations made by brokers.
- **Structured products**: Continuing its emphasis on the sales practices and supervision regarding structured product offerings to retail investors, FINRA remains focused on reverse convertibles, principal protected notes and other structured products.
- **Regulation S-P**: These matters involve protecting the confidentiality of customer information.
- **Non-traditional ETFs**: FINRA is reportedly probing advertisements relating to these products and sales practices regarding leveraged, inverse or leveraged inverse ETFs.
- **Routine fees**: Senior FINRA officials have indicated that there may be cases involving excessive charges for routine fees (e.g., postage and handling fees in connection with transactions) in its enforcement pipeline.
- **Municipal securities**: FINRA's activities appear to be honing in on sales practices, disclosures, suitability, and pricing. Moreover, FINRA has

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

27 *See* Knoll and Ryfa Memorandum.

indicated interest in the delivery of official statements and firms' procedures for disclosing material information to investors.

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

- **Auction rate securities**: Recent comments from senior staff suggest that these cases may be coming to an end.

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

- **Prospectus delivery**: This issue has been raised in a recent case and is the subject of a new FINRA sweep.

Key topics for FINRA's Enforcement, Member Regulation and Market Regulation Departments are also set forth in detail in the lengthy 2011 Annual Regulatory and Examination Priorities Letter.[28]

Revisions to FINRA's Sanction Guidelines

In March 2011, FINRA announced four revisions to its Sanction Guidelines. First, the Sanction Guidelines now make clear that "proximate causation" is the required standard for restitution orders in FINRA disciplinary actions. Second, the Sanction Guidelines have been revised to recognize that, where appropriate, adjudicators may order the use of disgorged funds to remedy customer harms, rather than adding those moneys as a fine payable to FINRA. Third, the Sanction Guidelines now reflect that not every factor in the Principal Considerations in Determining Sanctions section have the potential to be aggravating and mitigating considerations. Rather, the use of a factor is dependent upon the facts and circumstances of the particular case and the type of violation under consideration. Finally, the Sanction Guidelines have been amended to instruct adjudicators to also consider sanctions imposed by other regulators for the same misconduct and to determine whether that sanction was sufficiently remedial in nature.[29]

Revolving Door Restrictions Proposal

Recently, FINRA submitted a proposed rule change to the SEC that would impose certain restrictions on former officers. The proposed rule change would amend Rule 9141 to prohibit a former senior FINRA officer from appearing on

[28] *See* 2011 Annual Regulatory and Examination Priorities Letter (Feb. 8, 2011).

[29] *See* Sanction Guidelines – FINRA Revises Sanction Guidelines, Regulatory Notice 11-13 (Mar. 2011).

behalf of clients before certain adjudicators (i.e., Hearing Officers, Hearing Panels, the National Adjudicatory Council, and the Board of Governors) for a period of one year after leaving the organization. The proposal would also modify Rule 9242 to bar a former officer, for a period of one year after termination, from providing expert testimony for a respondent in a litigated matter. For purposes of both amendments, FINRA officers include Vice Presidents, Senior Vice Presidents, and higher ranking executives.[30]

Targeted Examination Letters

In 2010, FINRA appeared to have significantly slowed its use of this examination/investigative technique, as only four letters were posted to the Targeted Examination Letters page on its website versus eight in the prior year.

Continuing this trend, in the first six months of 2011, only one such letter was published by FINRA. In March 2011, FINRA posted a letter indicating that it was engaging in a review of reverse convertible advertising and sales literature. This is not surprising in light of the enforcement activity surrounding this product.

In a panel discussion earlier this year, Mr. Bennett commented that FINRA would consider increasing the number of Targeted Examination Letters to provide firms with more information about such reviews, which in turn could help firms in examining their own protocols relating to the product or issue that is the subject of the sweep letter.[31]

Disciplinary Actions Database

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

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

Taken together, these steps significantly promote transparency and make it easier for counsel to both search for and obtain copies of relevant precedent

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

31 Knoll and Ryfa Memorandum.

when engaged in discussions with the staff about the potential sanctions to be imposed in a matter under investigation.

Enforcement Actions[32]

529 Plans

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

A. *Merrill Lynch, Pierce, Fenner & Smith Incorporated* ("Merrill Lynch") (Mar. 2011)[33]

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

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

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

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

5. Merrill Lynch also consented to an undertaking that required it to distribute a stand-alone letter to each current customer who resided in a state that offered 529-related state tax benefits when the customer opened an affected account at Merrill Lynch at any time during the period from June 2002 through February 2007. If requested by the customer within

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

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

180 days of mailing the letter, Merrill Lynch must assist in transferring or rolling over the customer's account into a 529 plan of the customer's choice within the customer's home state, waiving any fees in connection with the sale, transfer, rollover, and initial purchase. Merrill Lynch must also provide semi-annual reports to the Enforcement staff describing customer inquiries, concerns, or complaints relating to the letter.

Anti-Money Laundering

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

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

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

2. According to FINRA, First Clearing's compliance program was inadequate because the firm reviewed only a limited number of transactions covering potentially suspicious activity.

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

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

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

Auction Rate Securities

Since the summer of 2008, regulators have brought numerous cases against broker-dealers arising out of the auction rate securities freeze that occurred earlier that year. FINRA has initiated more than a dozen such actions. As noted above, these investigations seem to be coming to an end.

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

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

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

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

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

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

and maintain an adequate supervisory system, including written supervisory materials, for its ARS activities.

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

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

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

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

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

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

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

4. FINRA also found that Nuveen failed to revise the disclosures in its brochures after a lead auction manager responsible for approximately $2.5 billion of ARPS notified the firm in early January 2008 that it intended to stop

managing Nuveen auctions and thereafter did not submit supporting bids in a January 22, 2008 auction that failed. According to FINRA, the auction failure and the firm's inability to find a replacement manager raised serious questions about whether investors could obtain liquidity in future auctions, and the firm's negligence in failing to revise the marketing brochures to reflect this risk made the brochures materially misleading.

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

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

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

Customer Confidential Information

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

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

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

2. According to FINRA, the firms failed adequately to protect customer records and information in their electronic portfolio management system, OmniSource, and specifically allowed certain employees to share computer sign-on credentials to access OmniSource files for the purpose of conducting business on behalf of the firms. OmniSource contained customer account records consisting of confidential

information including names, addresses, Social Security numbers, account numbers, account registrations, transaction details, account balances, birth dates, and email addresses. OmniSource contained approximately 513,559 LFS customer account records and 1,148,874 LFA customer account records as of August 20, 2009.

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

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

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

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

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

Directed Brokerage

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

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

1. The SEC set aside a FINRA National Adjudicatory Council ("NAC") decision affirming that AFD violated FINRA's Anti-Reciprocal Rule intended to prevent "conflicts of interest that might cause retail firms to recommend investment company shares based upon the receipt of commissions from that investment company." Commissioners Casey and Paredes issued the opinion, Commissioner Aguilar dissented, and Chairman Schapiro and Commissioner Walter (both of whom were senior executives at the NASD when the case was originally brought) did not participate.

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

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

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

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

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

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

Mortgage-Backed Securities

The credit crisis has led to several enforcement actions regarding the marketing and sales of mortgaged-backed securities. Below are four cases brought by FINRA to date this year.

A. *Charles Schwab & Company, Inc.* ("Schwab") (Jan. 11, 2011)

1. FINRA settled a matter with Schwab in which FINRA alleged that from September 1, 2006 to February 28, 2008, the firm violated advertising and supervision rules in connection with its marketing and sale of YieldPlus, an ultra-short-term bond fund managed by a Schwab affiliate.

2. In August 2006, Schwab's affiliate reclassified certain mortgage-backed securities ("MBS") for purposes of the YieldPlus fund's concentration policies, thereby allowing it to increase its MBS holdings. As a result, the percentage of MBS assets in YieldPlus increased from less than 25% in August 2006 to more than 50% by the end of February 2008.

This caused YieldPlus to be disproportionately impacted by the downturn in the MBS market that began in the summer of 2007. The fund's NAV dropped 9.3% in 2007–2008.

3. According to FINRA, Schwab was or should have been aware of the fund's significant exposure to MBS in light of the increasingly unfavorable financial markets. However, Schwab did not change the way it marketed YieldPlus or the internal guidance it provided to its registered representatives.

4. FINRA alleged that in written and oral communications, Schwab portrayed YieldPlus as a stable, low-risk alternative to cash investments; claimed that YieldPlus was widely diversified when approximately 82% of its investments were in mortgage-related and financial services securities; discussed YieldPlus' historical record of share price stability or safety when its holdings created risk and potential volatility; and omitted material information regarding the fund's holdings and the risks involved in investing in the fund. According to FINRA, certain changes in Schwab's compensation practices may have created an incentive for registered representatives to recommend YieldPlus over other products.

5. FINRA also alleged that Schwab failed to establish and maintain a supervisory system that was reasonably designed to achieve compliance with applicable securities laws and regulations regarding the promotion and sale of the fund. Specifically, FINRA alleged that Schwab provided its registered representatives with information and sales materials that were not fair and balanced and failed to provide customers with a sound basis for evaluating YieldPlus.

6. During the relevant period, Schwab sold over $13.75 billion in YieldPlus shares to customers. Of that amount, $3.6 billion were solicited; approximately 40% of the solicited sales were to customers age 65 and older. Schwab collected approximately $17.5 million in fees from sales of the fund.

7. Schwab consented to a censure and payment of $18,000,000, consisting of a fine of $500,000 and disgorgement of $17,500,000, both of which went into a restitution fund for investors.

8. The SEC's action against Schwab is described above.

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

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

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

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

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

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

6. FINRA further alleged that Credit Suisse failed to establish a reasonable system to supervise the maintenance and

updating of its Reg AB website and failed to pursue its own review of the accuracy of posted information for RMBS deals that Credit Suisse should have known were likely to contain erroneous calculations.

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

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

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

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

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

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

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

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

D. *In the Matter of Northern Trust Securities, Inc.* ("Northern Trust") (June 2, 2011)

1. FINRA alleged that during the period October 2006 through October 2009, Northern Trust failed to establish and implement an adequate supervisory system with respect to sales of certain collateral mortgage obligations ("CMOs") to retail customers and for monitoring certain high volume securities trades.

2. According to FINRA, Northern Trust utilized an exception reporting system provided by Northern Trust's clearing firm that would flag transactions or accounts that triggered pre-determined parameters established by Northern Trust. The transactions that were flagged were to be reviewed by the compliance department for suitability. However, Northern Trust was unaware that the system was not capturing 43.5% of the firm's business during the relevant period because certain trades were done on a separate system that was not fed into the exception reporting system. As a result, Northern Trust failed to monitor and review potentially unsuitable CMO concentration levels in customer accounts.

3. FINRA found that between January 2007 and June 2008, 26 customer accounts held by customers over the age of 70 held cumulative CMO positions in excess of 50% of the value of their accounts.

4. FINRA alleged that Northern Trust did not become aware of this issue until a 92-year-old widowed customer filed an arbitration proceeding regarding concentration levels of a Countrywide CMO in her account totaling nearly 47.6% of her total liquid net worth. The Countrywide CMO had a maturity date of 2037 and a high risk of default due to the location of many of the underlying mortgages, thus exposing this customer to high risk and causing an unrealized loss of about $183,000.

5. Northern Trust consented to a censure and fine of $600,000.

Municipal Securities

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

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

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

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

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

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

5. According to FINRA, between October 2006 and February 2009, Southwest failed to adopt, maintain, and enforce procedures designed to ensure compliance with various MSRB rules. In particular, Southwest failed to amend its procedures to address changes to MSRB rules and failed to enforce certain procedures. The firm’s procedures required that all municipal finance professionals pre-clear their political contributions through the Compliance Department; however, no such preapproval process was ever

implemented. FINRA alleged that Southwest's inadequate supervisory systems and procedures failed to detect that one of its municipal professionals had made a political contribution, leading to the firm engaging in prohibited municipal securities business, for which the SEC brought a regulatory action in March 2010.

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

Private Placements

Consistent with highlighting private placements as an area of regulatory concern, FINRA initiated the following actions this year.

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

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

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

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

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

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

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

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

Prospectus Delivery

Since at least 2004, regulators have been focused on firms' deficiencies regarding delivery of prospectuses. This is another case in this area.

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

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

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

3. FINRA noted that WFA used a third-party service provider to deliver prospectuses. The service provider had a "print on demand" service whereby it would print an electronic copy of a fund's prospectus when paper copies were unavailable, but WFA did not use the service extensively. FINRA further alleged that WFA was aware of the deficiencies because the

service provider sent daily exception reports to WFA and met quarterly with WFA to review delivery statistics and WFA conducted monthly reviews, all of which showed that prospectuses were not timely sent.

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

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

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

Real Estate Investment Trusts ("REITs")

Below is a description of a matter involving REITs that is currently being litigated.

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

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

2. According to FINRA, since 2004 DLA had valued the shares in certain REITs consistently and falsely at $11 per share, despite a fluctuating market. DLA also consistently charged a 10% fee on all REIT shares sold.

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

responsibility, making it inappropriate to rely on outside sources for due diligence.

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

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

Short Sales/Regulation SHO

Short sales actions, including those under Regulation SHO, have been a steady part of FINRA's (and its predecessors') enforcement program. Here are two cases brought earlier this year.

A. *In the Matter of Robert W. Baird & Co. Inc.* ("Baird") (Apr. 2011)

1. FINRA settled a matter with Baird in which FINRA alleged that between January 2005 and March 2010, Baird failed to comply with the locate requirements of Regulation SHO ("Reg SHO"), engaged in related supervisory violations, and failed to disclose its market maker status in certain equity research reports. Interestingly, several months later FINRA initiated an action against Baird's compliance officer. That case is described immediately below.

2. According to FINRA, Baird released significant numbers of proprietary, institutional, retail and employee short sale orders for execution without valid locates. In samples selected over a three-month period, FINRA found that 592 of 713 proprietary short sale orders, nine of 753 institutional short sale orders, and 114 of 1,403 retail and employee short sale orders did not have properly documented locates. FINRA also alleged that the firm's traders entered an indeterminable number of short sale orders for which locates were not obtained or documented.

3. The firm used multiple order entry systems, none of which prevented the release of short sale orders for execution without valid locates, and one of which did not require the entry of any locate information. According to FINRA, the

noncompliance with locate requirements was not corrected in a timely manner because the firm's post-trade review for locates was not reasonable. FINRA also noted that Baird failed to allocate sufficient resources to the locate process.

4. FINRA further alleged that Baird misapplied the bona fide market maker exception as a result of the firm's traders' mistaken belief that the firm's status as a market maker in a security exempted all firm short sales in that security from the locate requirement.

5. According to FINRA, the firm experienced systemic operational and supervisory deficiencies that persisted, in some instances, for five years. FINRA noted, among other things, that the firm's Compliance Department failed to establish a reasonable supervisory system for Reg SHO, the firm failed properly to train and supervise stock loan personnel, the firm lacked reasonable written policies and procedures for Reg SHO compliance, and the firm's limited reviews of Reg SHO compliance were ineffective. FINRA further alleged that even after being alerted to Reg SHO deficiencies by NYSE examiners in June 2007, Baird failed to take reasonable remedial action.

6. FINRA also alleged that Baird failed to disclose its market maker status in 693 equity research reports concerning 360 securities.

7. Baird consented to a censure and fine of $900,000.

B. *In the Matter of Susan Margaret Labant* (Aug. 19, 2011)

1. This is a companion case to the *Baird* matter. Here, FINRA brought a case against Susan Labant, a former Assistant Compliance Director at Baird. According to FINRA, Labant "was the person responsible for, among other things, the firm's Capital Markets' Regulation SHO compliance." In this role, her responsibilities included establishing policies and procedures designed to achieve compliance with Reg SHO. FINRA charged, however, that Labant failed to implement a "comprehensive and effective framework" for compliance with Reg SHO. FINRA criticized Labant in the following respects:

(a) First, FINRA alleged that the policies and procedures drafted and/or reviewed by Labant and subsequently put in place by the firm were not reasonably designed to comply with certain requirements of Reg SHO.

(b) Second, Labant failed to review and/or coordinate the firm's Reg SHO-related policies and procedures established for various areas of the firm.

(c) Third, the written policies and procedures she created or reviewed were unreasonable and in some instances incorrect.

(d) Fourth, Labant did not coordinate the firm's stock loan desk's role and responsibility regarding Reg SHO.

2. According to FINRA, as a result of these deficiencies, "among other reasons," the firm experienced systemic Reg SHO-related operational and supervisory problems.

3. FINRA also charged that Labant failed to take reasonable steps to remedy the firm's violations even after being informed of various deficiencies by NYSE examiners.

4. Labant's conduct allegedly violated NASD Rules 3010, 2110 and 2010.

5. Labant consented to a nine-month suspension as a principal, a $10,000 fine, and the requirement that she re-qualify as a principal for resuming such activities.

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

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

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

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

4. In investigating the short sales, FINRA alleged several deficiencies in the overall practices of Southwest in establishing and maintaining correspondent relationships like that with Cutler, including, among other things, that Southwest lacked operational and escalation policies and procedures, lacked due diligence in clearing services, and failed properly to identify and conduct risk assessments of correspondents.

5. Southwest consented to a censure, a fine of $650,000, and an undertaking requiring it to designate a risk management officer to identify and manage the risks associated with its correspondent clearing services business.

6. In determining the appropriate sanctions, FINRA took into account that Southwest performed an internal audit immediately after it had learned of the trading by Cutler on August 6, 2009 and shared the results of that audit with FINRA staff. Southwest also updated its automated risk management limits to lower thresholds for which NASDAQ alerts would be triggered, as well increased the number of employees who would receive such alerts. In addition, Southwest implemented mandatory NASDAQ training regarding the ACT system. FINRA also noted Southwest's substantial assistance to FINRA staff during the investigation.

7. FINRA also expelled Cutler for improper short selling, net capital, and other violations. Cutler's president, Glenn Cutler, consented to a bar from association in any supervisory or principal capacity, a two-year suspension, and a fine of $100,000.

Structured Products

While the SEC has seemingly targeted alleged misconduct regarding the marketing and sale of structured products to institutional investors, FINRA has focused its efforts on the sale of these investments to retail customers. Two cases brought earlier this year are summarized below.

A. *Santander Securities Corporation* (“Santander”) (Apr. 12, 2011)

1. FINRA settled a matter with Santander in which it alleged unsuitable sales of reverse convertible securities to retail customers, inadequate supervision of sales of structured products, inadequate supervision of accounts funded with loans from its affiliated bank, and other violations related to the offering and sale of structured products.

2. According to FINRA, for most of the period from September 2007 to September 2008, the firm had no formal procedures for reviewing or approving structured products before offering them to customers. Instead, individual brokers evaluated the products, but received limited and inadequate training, guidance, and supervision related to structured products, including their risks and their suitability for individual clients. During the relevant period, Santander customers invested $130 million in reverse convertibles and the firm earned more than $1.7 million in commissions.

3. According to FINRA, the firm also failed adequately to follow up on compliance reports of accounts over-concentrated with positions in reverse convertibles, including identification of 108 accounts holding more than 20% of the accounts’ value in a single reverse convertible product, accounting for approximately $17.8 million in reverse convertibles.

4. FINRA also found that the firm actively solicited account holders to borrow money from its banking affiliate using securities pledged in their brokerage accounts as collateral, and some brokers then assisted clients in using the borrowed funds to buy reverse convertibles, even though the clients did not understand the products or risks. When the stock market declined precipitously in 2008, some clients were left with large debts to the bank.

5. FINRA alleged other violations by Santander, including (i) failing to comply with certain public offering and corporate financing requirements, (ii) inserting confidentiality provisions inconsistent with FINRA guidance in five customer settlement agreements, and (iii) filing six Forms U4 or U5 for brokers that inaccurately reported broker contributions to reverse convertibles settlements when no such contributions were made.

6. Santander consented to a censure, a fine of $2 million and an undertaking to (i) review its written policies and procedures, training and available tools in the areas of

product suitability, sales supervision, and intrastate offerings; (ii) establish written policies and procedures for the development and vetting of new products; and (iii) train personnel with responsibility for FINRA regulatory filings.

7. In setting the sanction, FINRA noted that Santander had provided over $7 million in restitution to customers.

B. *In the Matter of UBS Financial Services, Inc.* ("UBSFS") (Apr. 11, 2011)

1. FINRA alleged that between March 2008 and June 2008, UBSFS made statements and omissions that effectively misled some investors regarding the "principal protection" feature of "100% Principal Protection Notes" ("PPNs") that Lehman Brothers Holdings Inc. issued prior to its September 2008 bankruptcy.

2. According to FINRA, some UBSFS financial advisors described the structured notes as principal-protected investments and failed to emphasize that the investments were unsecured obligations of Lehman Brothers subject to issuer credit risk.

3. FINRA alleged that UBSFS failed to establish an adequate supervisory system for the sale of these notes and failed to provide sufficient training and written supervisory policies and procedures, noting that some of the financial advisors did not understand the product.

4. FINRA also alleged that the firm did not adequately analyze the suitability of the sales of Lehman-issued PPNs to certain customers and created and used advertising about the PPNs that was effectively misleading to customers, particularly in light of the changes in the market after the takeover of Bear Stearns in early 2008.

5. UBSFS consented to a censure, a fine in the amount of $2.5 million, and customer restitution of $8.25 million.

Supervision

Year in and year out, FINRA brings a number of supervisory cases. Below are five such actions initiated in the first six months of 2011.

A. *In the Matter of BNP Paribas Securities Corp.* (Feb. 2011)

1. FINRA alleged that BNP Paribas Securities Corp. ("BNPP") failed to establish and maintain adequate systems and

procedures regarding its Listed Option Desk ("LO Desk") and Stock Loan and Borrow ("SLAB") desks, maintained certain inaccurate books and records, and filed an inaccurate Form U5 during 2007.

2. According to FINRA, the LO Desk was one of only a few desks at BNPP that was allowed to mark positions manually throughout the trading day on a case-by-case basis by individual traders. However, no supervisor on the LO Desk or in the larger department housing the LO Desk reviewed the manual valuations and, although there was a procedure in place to create a report of such valuations, none was ever generated.

3. Because of this deficiency, BNPP was unaware of losses, caused by one trader, of more than $18 million incurred over an 11-week period in 2007 on the LO Desk. When another trader was promoted to supervisor of the desk in late 2007, he undertook a review of the manual positions and discovered the issues with this trader. Following this discovery, BNPP sought the trader's resignation, in lieu of termination. At that time, BNPP filed a U5 for the trader.

4. FINRA alleged that failures stemming from the LO Desk caused certain of BNPP's books and records to be inaccurate prior to November 2007. In addition, FINRA alleged that, when BNPP filed its U5 form for the trader responsible for the inaccurate marks on the LO Desk, it incorrectly indicated that the trader's termination was "voluntary" when in fact the trader was "permitted to resign." That trader was also under internal review at the time of his termination, but BNPP further incorrectly indicated that he was not. In May 2008, when BNPP's internal investigation was completed, the Firm filed an amended U5 and self-reported the LO Desk incident to FINRA.

5. In addition, in February 2007, BNPP's SLAB desk pursued an arbitrage opportunity in which it borrowed shares of a stock from a custodial bank and loaned them to a BNPP affiliate. However, the arbitrage opportunity was lost when there was an over-subscription of the cash option of the tender offer of the stock, and BNPP lost approximately €3.4 million. FINRA alleged that BNPP failed to have a system or procedure in place to track and assess the risk of loss for such arbitrage trades.

6. BNPP consented to a censure and fine in the amount of $650,000.

7. In determining the appropriate sanctions, FINRA considered the fact that BNPP self-reported the inaccurate U5 filing prior to filing an amended U5, and also provided substantial assistance to the staff's investigation of the circumstances that led to the mismarking and improper filing. BNPP was specifically recognized for its efforts in providing witnesses for on-site for interviews and for creating and providing to the Staff a compendium of highly relevant documents.

B. *UBS Securities LLC* ("UBS Securities") (Feb. 2011)

1. FINRA settled a matter with UBS Securities in which FINRA alleged that from January to May 2006 UBS Securities failed to (i) monitor adequately the trading activity of a junior trader on its Fixed Income Emerging Markets Latin American Desk ("LatAm Desk"), (ii) provide the trader's supervisors with reports and information necessary to supervise the trader's activity, (iii) establish and maintain adequate written procedures, and (iv) maintain accurate books and records.

2. FINRA alleged that the trader made false and inaccurate entries into the firm's trading systems for transactions in Brazil 40 bonds and nondeliverable forward ("NDF") contracts involving Brazilian Reals and U.S. Dollars, causing the trader's risk positions to be incorrectly calculated and his profits to be overstated and losses to be understated. The trader lost more than $28.7 million during the period.

3. While most traders on the LatAm Desk used NDFs for hedging, the trader in question was permitted to trade NDFs as a primary product on a proprietary basis for the firm. UBS Securities authorized the trader to enter his own NDF transactions into two trading systems, although other traders on the desk were permitted to use only one. These trading systems belonged to and were maintained on the servers of UBS AG in Zurich, Switzerland.

4. While UBS Securities did provide the trader's supervisor with daily supervisory reports, these reports did not capture NDF trade data, and UBS Securities did not advise the supervisor of the lack of such detail. UBS AG personnel created daily NDF-related profit and loss reports and exception reports, but the majority of the reports were not provided to the firm or the supervisor. In other instances, UBS Securities provided reports to the trader himself detailing his own activity, but not to his supervisor.

5. According to FINRA, the firm failed to make and keep a memorandum of each NDF transaction; instead, such records were created and maintained by UBS AG. In addition, UBS Securities' books and records contained false, delayed, and fictitious entries made by the trader.

6. FINRA also alleged that UBS Securities failed to have adequate written supervisory procedures for supervising the trader and the transactions and for maintaining required books and records for the LatAm Desk.

7. UBS Securities consented to a censure and a fine of $600,000.

8. In setting the sanction, FINRA noted that UBS Securities conducted an internal investigation after the trader's activity came to light and that the Firm subsequently instituted remedial measures to prevent the same activity from recurring.

9. In separate actions, the NYSE barred the trader from the securities industry and the Board of Governors of the Federal Reserve barred him from the banking industry.

C. *NEXT Financial Group, Inc.* ("NEXT") (Jan. 2011)

1. FINRA settled a matter with NEXT in which it alleged that during the period from February 2008 to March 2009, NEXT failed to detect excessive trading of certain customer accounts and engaged in other supervisory and reporting violations.

2. According to FINRA, the most significant violation concerned the firm's failure to detect excessive trading by one of its registered representatives in five customer accounts, resulting in unnecessary sales charges totaling approximately $102,376. FINRA further alleged that 13 other registered representatives engaged in transactions in 38 customer accounts that, based on turnover to cost-to-equity ratios, raised the possibility that they were improperly excessive, but the firm failed to detect or inquire about the transactions. FINRA noted that the firm relied on OSJ branch managers and home office compliance personnel to review weekly blotters of registered representatives' transactions, but did not utilize exception reports or any other reasonable system for detecting improper and excessive trading. As such, FINRA found NEXT failed to properly supervise its trading.

3. With respect to the other supervisory and reporting violations, FINRA alleged the following:

   (a) NEXT failed reasonably to supervise variable annuity transactions in that the firm was unable to provide evidence of principal approval of 27 of 115 transactions reviewed by FINRA.

   (b) NEXT failed reasonably to supervise municipal bond markups and markdowns with respect to 19 riskless municipal bond transactions in which the markups or markdowns ranged from 3.01% to 4.58%.

   (c) NEXT failed to establish a reasonable branch audit program. FINRA reviewed 60 branch audits and found that in certain instances, firm auditors left audit questions unanswered, there was no home office follow-up on potentially problematic activity, the branch's response to deficiencies was not obtained or maintained, and the audit did not include a review of the branch's checking account.

   (d) The firm failed to put two registered representatives on heightened supervision in accordance with its procedures and failed to follow the heightened supervision plan for two other registered representatives.

   (e) The firm also failed to perform adequate Rule 3012 tests or submit an adequate Rule 3012 report, reasonably supervise private securities transactions in 36 registered representatives' accounts, make certain Rule 3070 and Form U4 and U5 filings in a timely and accurate manner, and properly follow up on certain AML exception reports.

4. NEXT consented to a censure, a fine of $400,000, and restitution to customers in the amount of $103,179.84.

D. *Morgan Stanley & Co. Incorporated* ("Morgan Stanley") (Jun. 2011)

   1. FINRA settled a matter with Morgan Stanley in which it alleged that from August 1999 to December 2008, a firm employee responsible for processing corporate actions misappropriated $2.5 million from the firm, its institutional customers, and a firm counterparty, and that the firm failed to have adequate systems and procedures to prevent such conduct.

2. According to FINRA, the employee, who was terminated, made numerous false journal entries into the firm's electronic system to transfer and credit money associated with corporate actions and caused 50 checks to be issued to a shell company created by the employee. The employee entered check requests himself, which were approved by persons who reported to him. The employee also caused other employees to enter check requests or used another employee's identification to do so, and then approved the requests.

3. FINRA alleged that Morgan Stanley did not have a system for reviewing journal entries prior to April 2003. Thereafter, the firm established certain processes and systems, but the employee continued to review and approve his own entries. According to FINRA, from June 2007 to December 2008, the employee made at least 450 journal entries, at least 168 of which were flagged high priority; the employee approved 57 of them and 111 were not reviewed.

4. FINRA also found that the firm did not require persons approving check requests to be supervisors and did not confirm that a check request was associated with a corporate action.

5. Morgan Stanley consented to a censure and a fine of $375,000.

6. In determining the appropriate sanctions, FINRA noted that Morgan Stanley discovered and self-reported the employee's misconduct, investigated and corrected its systems and procedures, made remediation to its customers, and provided substantial assistance to FINRA's investigation.

E. *KeyBanc Capital Markets Inc.* ("KeyBanc") (Jan. 31, 2011)

1. FINRA, on behalf of NYSE Regulation, settled a matter with KeyBanc in which FINRA alleged that the firm failed to: (i) establish adequate controls and a reasonable supervisory system with respect to its Control Room procedures, Watch and Restricted Lists, and related trading activities from January 2007 to December 2009; (ii) disclose that it had completed an internal investigation into potentially violative insider trading; and (iii) obtain, review, and monitor certain employee trade confirmations and account statements.

2. FINRA alleged that KeyBanc had in place written policies and procedures pertaining to its Control Room, Watch and

Restricted Lists, and related trading activities which required, among other things, employees to report material nonpublic information to the Control Room for inclusion on the Watch and Restricted Lists; however, KeyBanc failed to establish adequate controls to ensure that its employees were adhering to such policies and procedures. As a result, KeyBanc failed to report a significant number of companies, issuers and event updates to its Watch and Restricted Lists.

3. FINRA also alleged that KeyBanc failed to disclose to the NYSE in its July 2008 Quarterly Insider Trading Attestation that, in the second quarter of 2008, it conducted and completed an internal investigation into potentially violative insider trading activity. The internal investigation concluded that there was insufficient evidence of violative insider trading.

4. According to FINRA, KeyBanc also failed to obtain, review, and monitor trade confirmations for certain employee and employee-related accounts from January 2007 to June 2008 in a manner reasonably designed to ensure compliance with prohibitions against insider trading and manipulative activity.

5. KeyBanc consented to a censure and a fine of $350,000.

6. In setting the sanction, FINRA noted that KeyBanc undertook a comprehensive review and overhaul of its Control Room compliance procedures and increased its compliance resources, and that there was a lack of evidence related to the misuse of material nonpublic information in connection with securities on KeyBanc's Watch and Restricted Lists.

Variable Life Settlements

Last year, the SEC published a staff report regarding, among other things, the risks of investments in life settlements. Similarly, FINRA appeared focused on this issue from an enforcement perspective. Earlier this year, FINRA resolved a case in this area.

A. *USA Advanced Planners, Inc., et al.* ("USAAP") (Jan. 2011)

1. FINRA settled a matter with USAAP in which it alleged that between September 2005 and April 2007, USAAP, acting through its registered principals Michael Rodman and Dennis Tubbergen, effected five variable life settlement

transactions[34] in which it charged customers, who ranged in age from 69 to 81 years old, excessive commissions.

2. FINRA alleged that USAAP failed to disclose the source and amount of remuneration it received in connection with the life settlement transactions. USAAP received commissions for each of the transactions that ranged from 17% to 36% of the highest gross offer for the variable life policy, and in turn paid approximately 90% of that amount to the registered principals.

3. FINRA also alleged that USAAP did not provide the customers with a confirmation of each transaction.

4. FINRA further alleged that USAAP's supervisory systems, including its written supervisory procedures, were not reasonably designed to achieve compliance with FINRA rules related to the firm's variable life settlement business.

5. USAAP and Tubbergen consented to a censure, Rodman consented to a 10-day suspension, and USAAP and Rodman were ordered to pay, jointly and severally, partial restitution to customers of $351,995 plus interest. Of that amount, $52,647 was imposed jointly and severally against all three respondents for the transaction that involved the 36% commission. USAAP is also paying all of its outstanding shareholder equity to the five customers as partial restitution, and consequently will have no remaining assets to distribute to its stockholders at its pending dissolution.

[34] A life settlement involves the sale of an existing life insurance policy to a third party for more than the policy's cash surrender value but less than the net death benefit.