



FINRA Annual Conference

Washington, DC May 23 – 25, 2011

Litigation and Enforcement Case Trends

Tuesday, May 24

2:15 – 3:30 p.m.

After attending this session, you will be able to:

- Understand FINRA Enforcement priority program areas.
- Understand the impact of enforcement investigations, settlements, Office of Hearing Officers (OHO) and National Adjudicatory Council (NAC) decisions, and enforcement policies and practices on your firm and practice.

Moderator: Brad Bennett
Executive Vice President
FINRA Enforcement

Panelists: Christian R. Bartholomew
Partner
Weil, Gotshal & Manges LLP

David M. Levine
Managing Director
Deutsche Bank AG

Michael Wolk
Partner
Bingham McCutchen LLP

Outline

FINRA Enforcement priorities

What to expect when you receive an information request from the regulator

A disciplinary action is recommended: should I settle or litigate?

- Pros and cons
- Wells Process
- How much negotiating room is there
- Appeals – National Adjudicatory Council (NAC)

Hot Topics

- Credit for cooperation, self-reporting and the impact of FINRA Rule 4530 (Reporting Requirements)
- Disciplinary actions against compliance professionals – lessons learned
- Sanction trends

Speaker Biographies

Christian R. Bartholomew is a partner in Weil, Gotshal & Manges LLP's Securities Litigation practice and leads the firm's securities litigation and enforcement efforts in the Washington, DC and Miami offices. Mr. Bartholomew focuses exclusively on representing financial institution and public company clients in securities litigation and enforcement matters. He represents clients in investigations conducted by the U.S. Department of Justice (DOJ), the U.S. Securities and Exchange Commission (SEC), FINRA and other federal and state regulators, and is currently handling several subprime-related investigations for Fortune 100 clients. Mr. Bartholomew also represents clients in connection with numerous private securities litigation matters, and has recently secured victories in matters for major financial services and accounting clients at both the trial and appellate levels. Before joining Weil, Mr. Bartholomew served for five years as the senior trial counsel for the SEC's Southeast Regional Office, where he prosecuted numerous precedent-setting cases. As senior trial counsel at the SEC, Mr. Bartholomew litigated and tried numerous precedent-setting cases, including the SEC's first "earnings management" case against W.R. Grace, first case to result in the revocation of a broker-dealer's registration based on a failure to supervise charge, first case under MSRB Rule G-17 to charge a municipal bond dealer with unfair dealings, first case involving sales of so-called "viatical settlements," and first federal court case involving a broker-dealer's refusal to turn over records to SEC examiners. Prior to joining Weil, Mr. Bartholomew was the head of Washington, DC litigation and vice chair of the Securities Litigation and Enforcement Group at a large international law firm. Mr. Bartholomew is admitted to practice in the District of Columbia and Florida.

Brad Bennett, executive vice president of Enforcement, joined FINRA in January 2011, and is responsible for overseeing FINRA's Department of Enforcement. In this capacity, Mr. Bennett directs investigating and bringing all formal FINRA disciplinary actions against firms and their associated persons for violations of FINRA rules and federal securities laws. Previously, Mr. Bennett was a partner at the law firm Baker Botts in Washington, DC, where he specialized in financial and securities law violations. Before joining Baker Botts in 2001, he was an attorney at Miller, Cassidy, Larocca & Lewin. Mr. Bennett started his career at the Securities and Exchange Commission as a senior attorney in the Division of Enforcement, with responsibility for cases covering all facets of securities law, including accounting, broker-dealer regulation, tender offers and insider trading. Mr. Bennett serves as an adjunct professor of securities regulation at Catholic University's Columbus School of Law. He received his undergraduate degree from St. Lawrence University and his J.D. from Georgetown University Law Center.

David M. Levine joined Deutsche Bank in 2001 and, in his current position as managing director, works on a variety of securities-related legal and regulatory issues. He assists the global general counsel in management of the department, including involvement in priority legal matters worldwide. In addition, he is the chief legal officer (globally) for Deutsche Bank's Research Department. Prior to joining Deutsche Bank, Mr. Levine spent eight years at the U.S. Securities and Exchange Commission. During 2001, Mr. Levine served as the agency's Chief of Staff. In this role, he coordinated SEC policy, managed the Office of the Chairman, and served as liaison to the White House and Congress. Before that, Mr. Levine spent three years as the SEC's senior adviser to the director of Enforcement. From February 1996 through May 1998, Mr. Levine served as the special assistant to the SEC's general counsel. From 1993 through February 1996, Mr. Levine was an enforcement staff attorney in the SEC's New York Regional Office. Mr. Levine was the recipient of three Chairman's Awards for Excellence for his work on Regulation FD, auditor independence and securities litigation reform. Mr. Levine currently serves on FINRA's Compliance Advisory Committee, as well as on a subcommittee of its Statutory Disqualification Committee, and is a member of SIFMA's Compliance and Legal Society Executive Committee and Legal subcommittee. Previously, he served on FINRA's Membership Committee (2003 – 2005), including as chair in 2005. In 2006, Mr. Levine was appointed by FINRA's Board of Governors to the National Adjudicatory Council and served as vice chairman (2008) and chairman (2009). The NAC serves as FINRA's appellate court hearing all appeals of enforcement actions. Mr. Levine is the author of: *Research Analyst Conflict Disclosures—Less Would Be More*, BNA's Securities Regulation & Law Report (Vol. 41, No. 6) at 217 (Feb. 9, 2009); and co-author of: "You've Got Jail:" *Current Trends in Civil and Criminal Enforcement of Internet Securities Fraud*, 38 GEORGETOWN AMERICAN CRIM. L. REV. 405 (2001); *Insider Trading Redux*, NAT'L L.J. at B6 (Oct. 18, 1999); *The Securities Litigation Uniform Standards Act of 1998: The Sun Sets on California's Blue Sky Laws*, 54 BUS. LAW. 1 (1998); *The New Securities Class Action: Federal Obstacles, State Detours*, 39 ARIZ. L. REV. 641 (1997); *The Limits of Central Bank's Textualist Approach: Attempts to Overdraw the Bank Prove Unsuccessful*, 26 HOFSTRA L. REV. (1997). Mr. Levine graduated from Hofstra University School of Law in 1993, where he was valedictorian and an associate editor of the law review.

Michael Wolk is a partner in the Broker-Dealer, Securities Enforcement and Litigation, Internal Investigations and Trading and Markets practices of Bingham McCutchen LLP. He is resident in the firm's Washington, DC office and focuses his practice on SEC, exchange and FINRA compliance and enforcement matters, with a particular focus on equity and fixed income trading, and marketplace and conduct rules and their application to broker-dealers, associated persons and investment advisers. In addition to representing firms and associated persons in regulatory investigations, Mr. Wolk counsels his clients on regulatory and compliance issues. Before private practice, he served as vice president and chief counsel of the Market Regulation Department at NASD and as a branch chief of the Division of Enforcement at the SEC.

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Presentation Notes

I. PROCEDURAL ISSUES

A. Credit for Cooperation

1. [Guidance Regarding Credit for Extraordinary Cooperation, FINRA Regulatory Notice 08-70 \(November 2008\)](#)

www.finra.org/Industry/Regulation/Notices/2008/P117453

FINRA issued the guidance to apprise firms of the circumstances in which extraordinary cooperation by a firm or individual may directly influence the outcome of an investigation. The types of extraordinary cooperation by a firm or individual that could result in credit can be categorized as follows: (1) self-reporting before regulators are aware of the issue; (2) extraordinary steps to correct deficient procedures and systems; (3) extraordinary remediation to customers; and (4) providing substantial assistance to FINRA's investigation. These steps alone or taken together can be viewed in a particular case as extraordinary cooperation and, depending on the facts and circumstances, can have an impact on FINRA's enforcement decisions.

In connection with the attorney-client privilege, the waiver or non-waiver of the privilege itself will not be considered in connection with granting credit for cooperation. Moreover, it is not the waiver of attorney-client privilege that warrants credit for cooperation but rather the extraordinary assistance to the staff in uncovering the facts in an investigation that yields the benefit.

There is significant regulatory value in crediting conduct that rises to the level of extraordinary cooperation. Such cooperation may put the regulator on notice of regulatory problems before it finds them during an examination or investigation or assist the regulator in resolving matters more quickly, thereby allowing it to deploy regulatory resources more efficiently. This enables FINRA to achieve its mission of investor protection and market integrity more effectively.

Credit for extraordinary cooperation in FINRA matters may be reflected in a variety of ways, including a reduction in the fine imposed, eliminating the need for or otherwise limiting an undertaking, and including language in the settlement document and press release that notes the cooperation and its positive effect on the final settlement by FINRA Enforcement. In an unusual case, depending on the facts and circumstances involved, the level of extraordinary cooperation could lead FINRA to determine to take no disciplinary action at all.

By publishing these standards of cooperation, FINRA seeks to increase transparency as to the basis for sanctions imposed in cases and to encourage firms to root out,

correct and remediate violative behavior. By making clear that FINRA has given credit for extraordinary cooperation in a particular case, FINRA will inform firms and associated persons of the types of conduct considered and the degree to which such actions are to the individual or firm's benefit.

It is important to note that the level of cooperation is just one factor to be considered in determining the appropriate disciplinary action and sanctions. Other factors include the nature of the conduct, the extent of customer harm, the duration of the misconduct, and the existence of prior disciplinary history, all of which impact the appropriate sanction in any particular matter.

2. Cases

UIT Sweep Cases – two of the AWCs include language recognizing the firm's self-remediation (see below)

Van Kampen (Jan. 2011)

- *“The Firm has remediated customers who paid more than the exchange discount described in the prospectus a total of about \$200,000, including interest. In addition, the Van Kampen prospectuses currently disclose the in-kind exchange discount fully and accurately.”*

Global Strategic (\$150,000) (October 2010)

- In this case FINRA found that the firm failed to design and implement an adequate AML compliance program. Global processed in excess of \$1.4 billion in wire and/or journal transfers, through approximately 7,500 transactions, into and out of their customers' accounts. Most of this money movement occurred in the accounts of foreign institutional and retail customers domiciled in Columbia, Ecuador or Mexico. Many of these customers utilized multiple brokerage accounts to move money through first and third-party disbursements out of and between the accounts, while conducting limited to no securities activities in their accounts.
- Global and Hernandez conducted an insufficient AML review of the accounts and the activity and therefore failed to either detect or investigate the numerous “red flags” and failed to file SARs as appropriate.
- Global received significant credit for cooperation because among other things, it retained the services of a consulting firm to conduct an extensive AML “look-back” of transactions that occurred in the accounts at issue to assist Global in determining whether the account warranted further investigation and, ultimately, whether a SAR-SF should have been filed. Based on this consultant's analysis, the firm conducted an extensive review of activity identified by the consultant as potentially suspicious and filed approximately 46 SAR-SFs. The sanctions contained reflect FINRA's consideration of the significant remedial efforts undertaken by the firm.

Merrill Lynch (August 2010)

- *“Following FINRA's publication of a settlement with another firm concerning UIT transactions and independent of FINRA's pending inquiry, the Firm analyzed its application of sales charge discounts to UIT transactions reaching back to January 2006. As a result of its review, Merrill Lynch identified customers that were overcharged when purchasing UITs through the Firm and, in accordance with the undertakings set forth below, will remediate those customers more than \$2 million in overcharges.”*

Citigroup Failure to Supervise Tax Related stock transactions (\$600,000 fine; October 2009) (see below)

- In determining the appropriate sanction, FINRA noted that Citigroup discovered and self-reported the violations giving rise to this matter, that the firm hired a law firm to conduct a review of these trades and to assist in remedial efforts, and that the firm and its outside counsel provided substantial assistance to FINRA staff during the investigation.

MLPFS & UBS Closed- End Fund Cases (July 2009) (see below)

- In determining the appropriate sanctions against the firms, FINRA considered the firms' remediation efforts, which included payments to customers in excess of \$3 million by Merrill Lynch and more than \$2 million by UBS. Also, FINRA considered the firms' self-reviews and prompt remedial measures to correct systems and procedures to prevent future violations.

Merrill Lynch Government Securities, Inc. (\$140,000) (May 2008)

- MLGS failed to reconcile principle and interest payments relating to mortgage backed securities and US Treasuries, primarily in connection with repurchase agreements and reverse repurchase agreements. The firm also had an inadequate system of supervision and control with respect to this activity.
- In the AWC from May 2008 (there was no press release), FINRA noted that: *“MLGSI undertook extensive measures to cooperate with FINRA staff and address the accounting problems discussed herein. In particular, MLGSI promptly conducted a thorough internal review of the subject matter described in this AWC and presented its findings to FINRA staff. MLGSI also arranged for FINRA staff to meet with its outside auditors to discuss their testing and sampling methodology and review their workpapers. Consistent with Principal Consideration twelve of the Sanction Guidelines, the mitigated sanction in this matter reflects the Firm's extraordinary cooperation.”*

B. FINRA Regulatory Notice 11-06 – Reporting the Results of Internal Investigations

New FINRA Rule 4530(b), which becomes effective in July 2011, requires a member firm to report to FINRA within 30 calendar days after the firm has concluded, or reasonably should have concluded, on its own that the firm or an associated person of the firm has violated any securities, insurance, commodities, financial or investment-related laws, rules, regulations or standards of conduct of any domestic or foreign regulatory body or self-regulatory organization (SRO). This requirement is generally modeled after a requirement in the NYSE rule.

The new rule does not require firms to report every instance of noncompliant conduct. With respect to violative conduct by a firm, this provision requires the firm 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. Regarding violative conduct by an associated person, the provision requires a firm to report only conduct that has widespread or potential widespread impact to the firm, its customers or the markets; conduct that has a significant monetary result on a member firm(s), customer(s) or market(s); or multiple instances of any violative conduct.

For purposes of compliance with the “reasonably should have concluded” standard, FINRA will rely on a firm's good faith reasonable determination. If a reasonable person would have concluded that a violation occurred, then the matter is reportable; if a reasonable person would not have concluded that a violation occurred, then the matter is not reportable.

Additionally, a firm determines the person(s) within the firm responsible for reaching such conclusions, including the person's required level of seniority. However, stating that a violation was of a nature that did not merit consideration by a person of such seniority is not a

defense to a failure to report such conduct. Further, it may be possible that a department within a firm reaches a conclusion of violation, but on review senior management reaches a different conclusion. Nothing in the rule prohibits a firm from relying on senior management's determination, provided such determination is reasonable as described above. Moreover, the reporting obligation under FINRA Rule 4530 and the internal review processes set forth under other rules (e.g., FINRA Rule 3130) are mutually exclusive. While internal review processes may inform a firm's determination that a specific violation occurred, they do not by themselves lead to the conclusion that the matter is reportable.

For example, FINRA would not view a discussion in an internal audit report regarding the need for enhanced controls in a particular area, standing alone, as determinative of a reportable violation. It should also be noted that an internal audit finding would serve only as one factor, among others, that a firm should consider in determining whether a reportable violation occurred.

Lastly, the new rule provides that certain disciplinary actions taken by a firm against an associated person must be reported under a separate provision rather than under the internal conclusion provision.

II. POLICY ISSUES

A. Fixed Income

Municipal Securities

Its annual Examination Letter, FINRA reminded municipal securities dealers that they must understand the municipal securities they sell to meet their disclosure, suitability and pricing obligations, and obligation to deal fairly with customers under the rules of the Municipal Securities Rulemaking Board (MSRB) and federal securities laws. Firms must review their procedures for compliance with MSRB Rule G-32, which requires the delivery of an official statement, or a notice of its availability on the MSRB's Electronic Municipal Market Access (EMMA) system, to any customer purchasing a municipal security during the primary offering disclosure period.

FINRA reminded firms that material information must be disclosed to customers at or before the time of trade to enable them to evaluate these investments. Continuing disclosures made by issuers to the MSRB via EMMA are part of the information that dealers must obtain, disclose and consider in meeting their regulatory obligations. The SEC recently amended SEA Rule 15c2-12, which governs continuing disclosures. In any transaction in a municipal security, firms also must have reasonable grounds for determining that a recommendation is suitable for a customer based on information available from the issuer or otherwise, and must use information that is available to determine the prevailing market price of a security as the basis for establishing a fair price in a transaction with a customer. To meet these regulatory requirements, among other things, firms must perform an independent analysis of the municipal securities they sell and may not rely solely on a security's credit rating. Accordingly, any firm that sells municipal securities must review and, as necessary, update their procedures to ensure compliance with MSRB rules and the federal securities laws, including the recent amendments to SEA Rule 15c2-12. See FINRA *Regulatory Notice 10-41*.

Cal PSA

- As has been reported in the press, FINRA is collecting information from certain FINRA firms relating to their membership in, contributions to, and activities in connection with the California Public Securities Association ("Cal PSA"), a municipal securities industry association that appears to control at least two political action committees. Among other things, FINRA is examining whether the firms complied with applicable securities laws, and FINRA and MSRB rules, including MSRB rules which require disclosure of certain political contributions and which prohibit indirect violations.

Municipal Gas Bond and Retail Municipal Sweep

Gas Bond Sweep

The Gas Bond Sweep involves an examination of nine member firms that conducted retail business in Main Street Natural Gas, Inc. Gas Project Revenue Bonds ("Gas Bonds"). The nine firms selected conducted the most business in the Gas Bonds from March to December 2008. In total the firms examined participated in 2,684 transactions involving the Gas Bonds. The exams were opened in May 2009.

The focus of the sweep includes:

- Sales practice issues as well as firm controls
- Providing of Official Statements during new issue periods
- MSRB Rule G-17 – Material Facts
- SEC Rule 15c2-12 – Issuer Material Events
- Advertising and Sales Literature

Retail Municipal Sweep

The Retail Municipal Securities Sweep involved some of the largest municipal securities dealers that were not previously reviewed by Enforcement or as part of the Gas Bond Sweep. The sweep focused on the same regulatory concerns as the Gas Bond sweep, but did not focus on the sale of a specific bond issue. In total, nine firms were examined and the exams were opened in June 2009.

The focus of the sweep includes:

- Sales practice issues as well as firm controls
- Providing of Official Statements during new issue periods
- MSRB Rule G-17 – Material Facts
- SEC Rule 15c2-12 – Issuer Material Events
- Advertising and Sales Literature

Material Findings from these two sweeps have been referred to Enforcement. Anticipated formal actions primarily concern two issues, along with related supervisory procedure and control failures: firms failing to provide official statements to customers, either because they had deficient procedures, or had adequate procedures that they did not follow; and firms failing to receive notice of material events and provide notice to customers (15c2-12/G-17), again because they either had weak procedures, or failed to follow their adequate procedures.

III. SUBSTANTIVE AREAS OF INTEREST

A. Specific Unconventional Instruments

1. Principal Protected Notes

Principal Protection Notes are a variation of a structured product, which is a pre-packaged investment strategy, based on derivatives, such as a single security, a basket of securities, options, indices, commodities, debt issuances and/or foreign currencies and, to a lesser extent, swaps. A feature of some structured products is a "principal guarantee" function, which offers protection of principal if held to maturity, provided the issuer remains solvent and does not default on the note. They have a fixed maturity, and have two components: a note and a derivative. The derivative component is often an option. The note provides for periodic interest payments to the

investor at a predetermined rate, and the derivative component provides for the payment at maturity.

Pros and Cons

Benefits of structured products may include:

- principal protection (depending on the type of structured product)
- tax-efficient access to fully taxable investments
- enhanced returns within an investment (depending on the type of structured product)
- reduced volatility (or risk) within an investment (depending on the type of structured product).

Disadvantages of structured products may include:

- credit risk - structured products are unsecured debt of the issuer;
- lack of liquidity - structured products rarely trade after issuance and anyone looking to sell a structured product before maturity should expect to sell it at a significant discount;
- no daily pricing - structured products are priced on a matrix, not net-asset-value. Matrix pricing is essentially a best-guess approach ;
- highly complex - the complexity of the return calculations means few truly understand how the structured product will perform relative to simply owning the underlying asset.

(Investopedia, Understanding Structured Products)

Possible Violative Conduct

Principal Protection Notes were sold by a number of issuers and their customers included retail investors. The issues raised by the sale of PPNs both at the registered representative and firm level are the suitability of the investment, and the propriety of disclosures at the point of sale relating to the riskiness of the investments. Further, with respect to the firm, whether the 100% Principal Protection Notes' name and description misled investors into thinking they were not subject to issuer credit risk, and overall failure to supervise relating to the training, marketing and sales of the PPNs. The Rules include FINRA Advertising Rules under NASD Rule 2210(d) (1) (A) and 2211, as well as FINRA Rule 2110 (standards of commercial honor), NASD Rule 3010 (supervision) and NASD Rule 22310 (suitability).

UBS Financial Services, Inc. (\$2.5 million fine and restitution of \$8.25 million) (April 2011)

- FINRA fined UBS and ordered restitution for omissions and statements made that effectively misled some investors regarding the "principal protection" feature of 100% Principal-Protection Notes (PPN's) Lehman Brothers Holdings Inc. issued prior to its September 2008 bankruptcy filing.
- FINRA found that UBS:
 - failed to emphasize adequately to some investors that the principal protection feature of the Lehman-issued PPN's was subject to issuer credit risk;
 - did not properly advise UBS financial advisors of the potential effect of the widening of credit default swap spreads on Lehman's financial strength or provide them with proper guidance on the use of that information with clients;

- failed to establish an adequate supervisory system for the sale of the Lehman-issued PPNs and failed to provide sufficient training and written supervisory policies and procedures;
 - did not adequately analyze the suitability of sales of the Lehman-issued PPNs to certain UBS customers;
 - created and used advertising materials that had the effect of misleading some customers about specific characteristics of PPNs.
- FINRA found that some of the UBS' financial advisors did not understand the product, including the limitations of the "protection" feature. Consequently, certain financial advisors communicated incorrect information to their customers.
 - Certain advertising materials suggested that a return of principal was guaranteed if customers held the product to maturity; however, UBS did not adequately address the importance that credit risk could result in loss of principal.
 - Suitability procedures were also lacking. UBS did not have risk profile requirements for certain PPN's; therefore the PPNs were sold to some investors for whom the product was not suitable, including investors with "moderate" and "conservative" risk profiles. Moreover, these particular investors were more likely to rely on UBS' representations about the "100% principal protection" feature because of their risk adverse investment objectives.

2. CMOs/Subprime

A CMO is a security that pools together mortgages and issues shares - called "tranches" - with various characteristics and risks. The underlying mortgages serve as the collateral for the CMO and provide principal and interest payments to shareholders.

One of the most volatile and risky CMO tranches is the "inverse floater CMO," a thinly traded mortgage-backed security which is typically highly leveraged and vulnerable to a high degree of price volatility. Rising interest rates reduce the interest earned and also may decrease the principal payments to the investor. The reduction in the repayment of principal extends the maturity date, potentially for as much as 30 years. Furthermore, since each inverse floater is uniquely structured and thinly traded, prices used for valuation purposes are determined using theoretical pricing models. These prices are strictly best estimates of value and can vary substantially from prices obtained through actual bidding or market offerings. As a result, buying inverse floaters on margin further heightens the risk of investing in the product.

Since 1993, FINRA (formerly NASD) has published warnings that inverse floaters are suitable only for sophisticated investors willing to take on high levels of risk. FINRA has brought several actions dealing with CMOs and inverse floaters.

Brookstreet Securities Corporation (various settlements) (September 2010)

- Six brokers formerly associated with Brookstreet Securities Corporation, a now-defunct nationwide brokerage firm based in Irvine, CA, settled a disciplinary action that included, among other charges, fraudulent and/or negligent misrepresentations and omissions and unsuitable recommendations to retail customers in the sale of collateralized mortgage obligations (CMOs). The brokers were suspended in all capacities for periods ranging from six to 18 months. Five of the brokers demonstrated an inability or reduced ability to pay any monetary sanctions. Two brokers also were required to pay restitution of over \$60,000, and one broker was also required to pay a \$10,000 fine.
- The findings included that during the period June 2004 through May 2007, the brokers sold CMOs to retail customers when the brokers lacked a basic understanding of these complex and illiquid securities. The brokers failed to adequately investigate and understand the CMO products, and did not have reasonable grounds to believe the individual CMO purchases were suitable for

each customer. The brokers led the customers to believe that the CMOs were safe, government-backed securities. Customers were also told that they could consistently achieve annual returns of 10 to 15 percent, regardless of market conditions. In fact, the particular CMOs were generally not government guaranteed, and were subject to price volatility and to uncertain cash flows and maturities based on changes in interest rates.

- In connection with the misrepresentations and omissions, three of the brokers were found to have acted fraudulently and three brokers were found to have acted negligently. The brokers were also found to have engaged in discretionary authority in customer accounts without obtaining prior written authorization and failing to adhere to high standards of commercial honor and just and equitable principles of trade.

Deutsche Bank Securities, Inc. (\$7.5 Million; July 2010)

- FINRA fined Deutsche Bank Securities, Inc. \$7.5 million for negligently misrepresenting delinquency data in prospectus supplements, for misrepresenting delinquency data on its Reg AB website and for related supervisory failings in connection with the issuance of subprime securities.
- Delinquency rates constitute material information for residential mortgage backed securities (MBS) investments because that data affects the investor's ability to evaluate the fair market value, the yields on the certificates and the anticipated holding periods of each of these securitizations. Investors may consider this information in assessing the profitability of these securitizations and in determining whether future returns would be disrupted by mortgage holders who fail to make loan payments.
- During 2006 and 2007, Deutsche Bank Securities underwrote subprime MBS and sold them to institutional investors. FINRA found that in the prospectus supplements of six subprime securitizations worth approximately \$2.2 billion offered in March 2006, the firm described a method of calculating delinquencies that was in fact different from the method it actually used. As a result, delinquencies were underreported. Accordingly, DBSI violated NASD Rule 2110.
- FINRA also found that Deutsche Bank Securities negligently underreported historical delinquency rates on a website maintained by the firm that was referenced in prospectus materials in connection with the sale of 16 MBS.
- Issuers of subprime MBS are required to disclose historical performance information for prior securitizations that contain similar mortgage loans as collateral. That information, which includes historical delinquency rates, is called "static pool" information – and it is one of the disclosure requirements for asset-backed securities under Securities and Exchange Commission (SEC) Regulation AB. After Regulation AB became effective in December 2005, Deutsche Bank Securities prospectus supplements for new subprime MBS offerings informed investors they could view static pool information on the firm's Regulation AB website.
- In January 2007, Deutsche Bank Securities learned that the outside vendor it retained to populate its Regulation AB website was underreporting delinquencies as a result of errors made by the servicers responsible for tracking delinquencies. Deutsche Bank Securities was able to determine that these errors affected 16 securitizations and was able to provide corrected delinquency data for 13 of them to the vendor to use going forward. But the vendor failed to use the corrected data. The firm never ensured that the vendor posted the corrected static pool information and continued to refer investors to the inaccurate information about these 13 securitizations on the Regulation AB website. While Deutsche Bank Securities was not able to determine the extent to which delinquency rates were underreported in the remaining three affected securitizations, the firm continued to use this data without indicating on its Regulation AB website that the information was inaccurate. As a result, DBSI violated NASD Rule 2110.

- DBSI also failed to have adequate supervisory systems in place to ensure that its Reg AB website contained accurate static pool information. In particular, DBSI did not have a system in place to identify, correct or prevent the use of inaccuracies in the static pool information in subsequent offerings. As a result, DBSI violated NASD Rules 3010 and 2110.

HSBC Securities (USA) (\$375,000 and \$320,000 restitution) (August 2010)

- FINRA found that the firm recommended sales of unsuitable Collateralized Mortgage Obligations (“CMOs”) to retail customers without adequately explaining the risks of the product.
- Six HSBC brokers made 43 unsuitable recommendations of inverse floater CMOs to retail customers who did not have a high-risk profile and 25 of the sales were in excess of \$100,000.
- The firm did not provide its brokers who sold CMOs with sufficient training on the product in particular to inform them that the investment was suitable for sophisticated investors with high risk tolerance or of the risk associated with the specific inverse floater CMOs that were offered.
- FINRA also found that the firm failed to maintain and establish a supervisory system and written procedures regarding the sale of CMOs that was reasonably designed to supervise whether the sales were suitable and the attendant risks of the product were fully explained.

3. ARS

The Security

ARS are typically debt instruments (corporate or municipal bonds) with a long-term maturity for which the interest rate is regularly reset through a Dutch auction. ARS can also refer to a preferred stock for which the dividend is reset through the same process. In the Dutch auction, broker-dealers submit bids on behalf of potential buyers and sellers of the bond. Based on the submitted bids, the auction agent will set the next interest rate as the lowest rate to match supply and demand. Auctions are typically held every 7, 28, or 35 days. Since ARS holders do not have the right to put their securities back to the issuer, a failed auction means that the investors cannot access their investment until the next successful auction or until the security matures, which may not occur for many years.

Earlier in 2008, FINRA released guidance for investors caught in the auction failures in the Investor Alert *Auction Rate Securities: What Happens When Auctions Fail*.

The Investigation

FINRA commenced its increased scrutiny of the auction rate market in March 2008, when required regulatory filings showed an increase in the number of investor complaints against broker-dealers regarding ARS. Sixty investigations were opened.

FINRA's investigation found that many firms sold ARS using advertising, marketing materials or communications that were not fair and balanced, or that failed to contain adequate disclosure of the risks of ARS, and therefore did not provide a sound basis for investors to evaluate the benefits and risks of purchasing ARS. FINRA's investigation also found evidence that many firms failed to establish and maintain a supervisory system reasonably designed to achieve compliance with the securities laws and FINRA rules with respect to the marketing and sale of ARS.

Settlements

To date, FINRA has settled with 16 firms resulting in a total of \$6,540,000 in fines, with offers to initiate or complete repurchase offers of more than \$2 billion in ARS.

Complaints Filed

In May 2010, FINRA announced that Thomas Weisel Partners LLC and Stephen Henry Brinck Jr. were named as respondents in a FINRA complaint alleging that the firm and Brinck, the then head of the fixed income desk, sold approximately \$15.7 million of ARS from the firm's parent company account to customers' accounts to obtain cash to pay corporate bonuses. The case went to hearing early this year.

4. Reverse Convertibles (FINRA Investor Alert 2/16/10)

Structured products are securities derived from or based on a single security, a basket of securities, an index, a commodity, a debt issuance and/or foreign currency. Structured products generally consist of two parts, a note and a derivative whose value is typically realized when the product matures.

One type of structured product is a reverse convertible, which is a relatively short-term investment typically linked to an underlying asset, such as a single stock, basket of stocks or an index. A reverse convertible is a combination of an interest bearing note, typically at an above-market rate, and a put option. The interest rate is paid regardless of the performance of the underlying assets. When the product matures, the investor receives his or her original principal back if the underlying asset is trading at or above its price at issuance, or if it has never traded below a certain percentage of the original price, or the "knock-in level," which is set at issuance. If the underlying asset has traded below the knock-in, and on the valuation date closes below the issuance price, the investor typically gets the underlying asset put to him or her at the issuance price, even though that asset is now worth less.

For example, a customer invests \$10,000 in a reverse convertible, in which the underlying asset is a stock, with an initial price of \$10 and a "knock-in level" of 70%. If the value of the stock falls below \$7.00 (knock-in level) at any point during the life of the product, and on the valuation date the stock closes at \$9.00, then the customer will be put the stock at \$10.00. The overall value of the stock position has decreased in value by \$1,000. On the other hand, if the value of the stock never fell below \$7.00 then the customer will receive the full \$10,000 at maturity, regardless of the current price. In either scenario, the customer receives the coupon payment.

Another type of structured product is a principal protected note (PPN). Typically, PPNs guarantee 100% of the invested principal, as long as the note is held to maturity. Regardless of the performance of the linked index (or other underlying investment), the investor receives back all the capital invested. At maturity, the note will be worth the principal amount plus any appreciation from the linked investment. In many PPNs, the upside on growth is capped and income is variable. In some products, if the performance of the linked investment drops below a certain level, income ceases completely.

Structured products such as reverse convertibles and principal protected notes have soared in popularity in the past few years. These products are increasingly being sold to retail investors, who may, or may not understand the product and the nature of the risk to their principal.

Some of the concerns regarding the sale of reverse convertibles to retail investors are that they might appear to the untrained eye to be a traditional bond because of the coupon payment; the credit qualification is attached to the issuer and not the security; and studies have shown that investors mistakenly value reverse convertibles more like bonds, not options.

Some of the additional regulatory concerns regarding the sale of structured products to retail investors, including reverse convertibles and principal protected notes, are whether firms are using fair and balanced oral presentations and promotional material, whether firms have appropriate supervisory and compliance structures around the sale these products to retail customers, including account eligibility determinations, what suitability determinations were made by the RRs at the point of sale, and what type of product training was offered to RRs and supervisors.

Cases

Santander Securities of Puerto Rico (\$2 million and over \$7 million reimbursement to customers for losses) (April 2011)

- FINRA found significant deficiencies in Santander Securities' structured products business, including unsuitable sales of reverse convertible securities to retail customers, inadequate supervision of sales of structures products, inadequate supervision of accounts funded with loans from its affiliated bank and other violations related to the offering and sale of structured products.
- Santander Securities brokers bore the responsibility of evaluating structured products without sufficient suitability guidance or required training on structures products. The firm also had no process in place for reviewing or approving any particular structured product prior to offering the product to a customer.
- Moreover, the firm did not have effective procedures in place to monitor customer accounts for potentially unsuitable purchases of structured products and had no suitability policies governing product concentration. As a result, the firm failed to detect certain accounts with concentrated positions in certain risky structured products, specifically reverse convertibles.
- Some Santander Securities brokers recommended that customers use funds borrowed from the firm's banking affiliate to purchase reverse convertibles, claiming that it would enable the customers to capture the spread between the interest they paid to the bank and the higher coupon rate they received from the reverse convertible. However, these recommendations substantially increased the clients' exposures to risk. Many customers lost money and owed additional money to the bank when the value of the reverse convertible declined and the sold the product at a loss.

Ferris, Baker, Watts Inc., N/K/A/ RBC Capital Markets (\$500,000 and restitution of \$190,000) (October 2010)

- FINRA found that the firm made unsuitable recommendations of reverse convertible notes to 57 customers, had inadequate supervisory procedures governing the sale of RCNs, and failed reasonably to supervise accounts that purchased RCNs.
- During the relevant period, the firm sold approximately 961 issues of RCNs to over 2,000 accounts without having appropriate guidelines in place for registered representatives.
- FBS sold RCNs to customers who were 85 years or older or who had stated net worths of less than \$50,000. The firm did not have reasonable grounds to believe that the RCNs were suitable for 57 accounts in light of their investment objectives, risk tolerance, age, net worth and investment experience and because some of the accounts were over-concentrated in RCNs.
- Although branch managers reviewed accounts that purchased RCNs by conducting spot checks of daily blotters, the firm failed to provide branch managers with guidance or tools to determine suitability or over-concentration.

- The firm's written procedures and supervision were inadequate because the firm failed to insure that the RCNs were sold to customers for whom they were suitable.

H&R Block (\$200,000 fine and \$75,000 restitution) (February 2010)

- FINRA found that H&R Block failed to establish adequate supervisory systems and procedures for supervising sales of RCNs to retail customers.
- FINRA also fined and suspended a broker for making unsuitable sales of RCNs to a retired couple.
- Firm used an automated surveillance system to facilitate its suitability review of securities transactions and to monitor customer accounts for potentially unsuitable positions and activity. The system would flag for review any transaction or account meeting certain parameters. The system was not configured or designed to monitor RCN transactions or positions and the firm did not establish an effective alternative means to do so. As a result, the firm failed to detect and respond to indications of potentially unsuitable RCN concentration levels in numerous customer accounts. The firm also failed to provide sufficient guidance to its supervising managers on how to assess suitability in connection with their brokers' recommendation of RCNs.

Joey W. Dean (Feb. 1, 2011 Default Decision, barring Dean in all capacities)

- Dean made material misrepresentations to eight customers in the sale of structured products issued by Morgan Stanley in the form of notes that offered protection of principal if held to maturity, and variable monthly income that was determined by a formula linked to the Russell 2000 or the S&P 500.
- Dean told the customers that their principal was protected, which was accurate only if they held the notes to maturity, which was five years. He told the customers there was a guaranteed rate of return of 10% (in two cases 8%). This was a misrepresentation, because there was no guaranteed rate of return.
- In January 2008, the notes ceased paying monthly income. Dean did not inform three of the customers, knowing that they expected regular monthly income. Instead, he began selling shares of their investments in the structured products to generate funds for the accustomed withdrawals. The sales were unauthorized and masked Dean's misrepresentations regarding the guaranteed income.
- The eight customers were all recent retirees, most from a local paper factory. Dean concentrated 73% to 93% of the liquid net worth of the customers in the structured products. The Office of Hearing Officers stated that concentration in the unsecured products of a single issuer was inherently risky and unsuitable.

5. Life Settlements

A life settlement is the sale of an existing life insurance policy to a third party. The transaction typically occurs when an individual, often a senior citizen, no longer needs the policy or cannot afford to keep paying the policy premiums. A policy holder can sell the policy to a third party for a lump sum amount that is less than the net benefit, but more than the cash surrender value. The institution purchasing the policy becomes the owner/beneficiary of the policy and responsible for all future premiums. Ultimately, the institution receives the death benefit at maturity. Life settlement transactions involve materially different factors and issues than transactions in conventional securities. Marketing and other sales efforts related to Life Settlements are directed almost exclusively toward senior investors who, concerned about economic conditions and retirement, may consider selling their variable life insurance policies without fully appreciating the risks and costs of the transactions. For this reason, FINRA expects firms who engage in life settlements to use appropriate and even heightened supervision to regulate the transactions.

We will continue to closely scrutinize this area to ensure that commissions charged in life settlements are reasonable, can be justified, and are disclosed properly. We will also continue to review the transactions to ensure suitability, best execution, and the use of fair and balanced advertising.

Case

USAA Advanced Planners, Inc., Michael Rodman and Dennis Tubbergen (November 2010)

- First action involving excessive commission charges in life settlement transactions. The firm and its two principals were ordered to pay a total of \$351,000 in partial restitution to customers who were charged excessive commissions in connection with the sales of five customers' variable life insurance policies. Rodman was also suspended in all capacities for ten business days. The firm and its principals charged commissions ranging between 17% and 36% of the gross offer in five life settlement transactions (the gross offer being the amount the third party was willing to pay to purchase the policy). These commissions were excessive, unreasonable and unfair, taking into consideration all relevant factors, including market conditions, expenses, and the value of the firm's services. Moreover, the firm never disclosed its commissions to the policy owners. We also found that USA Advanced Planners failed to establish written procedures describing how the firm would determine compensation in life settlement transactions.

6. Non-Traded REITs

Non-traded Real Estate Investment Trusts (REITs) are public companies that mainly own, and in most cases, operate income-producing real estate such as apartments, shopping centers, offices, hotels, warehouses and other properties. Non-traded REITs raise money for two years before they start buying assets. After that, they can, and often do, register to raise more money. As public companies they are required to report earnings and other events to the SEC, however, their shares are not listed on any stock exchange and they are generally illiquid. There is no active market for non-traded REITs, however, some liquidity is provided through redemption programs or other means. Generally a year after a REIT purchase is made and upon an investor's request, the REIT will redeem shares up to an amount that equals 3% to 5% (depending on the REIT) of the shares outstanding in the prior year. If 3% to 5% of the outstanding shares are redeemed before the year end, then the redemption program is suspended, which has been happening more frequently in the past few years. Redemptions are usually at a discount of approximately 10%. In addition to the redemption program, there is a limited secondary market for Non-Traded REITs and sometimes REIT shares are the subject of mini-tender offers in which the shares are purchased (often at a substantial discount).

Non-traded REITs pay dividends (also called disbursements) typically of 6 - 8%. These dividends can be comprised of earnings, return of principal or borrowings or any combination of the three. The dividends are a major selling point for Non-traded REITs. Non-traded REITs have a limited life of usually seven to ten years after which the REIT must list its shares, sell itself to another company or liquidate its portfolio.

Since June 2010, Enforcement, Member Regulation, and OFDMI have coordinated closely on examinations and investigations in this area.

We are looking at the marketing and sale of Non-Traded REITs at a number of firms. These matters involve approximately a dozen different REIT sponsors. Significant investigations involve Non-Traded REITs that collapsed, had accounting problems, valuation issue, and conflicts of interests or advertising issues.

- One significant investigation involves the sales practices of an individual representative, while many small investigations involve single representative -

single customer matters. We expect to file a number of cases this year alleging some combination of the following violations:

- Advertising issues including minimizing the risk associated with a particular REIT and/or misleading statements or claims.
- Misrepresentations or omissions to investors about the offerings
- Account statement related issues, including failure to provide account statements or using stale or inaccurate pricing information.
- Excessive underwriting compensation and/or failure to file material information with FINRA regarding underwriting compensation
- Suitability

B. AML

1. Master/Sub Accounts

FINRA Regulatory Notice 10-18

- FINRA issued *Regulatory Notice 10-18* dealing with other issues that arise from master/sub accounts. The application of many FINRA rules, federal securities laws and other applicable federal laws depends on the nature of the account and the identity of its beneficial owners. At times, an account may take the form of a master/sub-account arrangement where the beneficial ownership interests in the various sub-accounts may or may not be identified to the firm. Certain master/sub-account arrangements raise questions regarding whether the master account and all sub-accounts have the same beneficial owner and, therefore, whether they can legitimately be viewed as one customer account for purposes of FINRA rules, the federal securities laws and other applicable federal laws.
- If a firm has actual notice that the sub-accounts of a master account have different beneficial ownership (but does not know the identities of the beneficial owners) or the firm is privy to facts and/or circumstances that would reasonably raise the issue as to whether the sub-accounts, in fact, may have separate beneficial owners (and therefore is on “inquiry notice”), then the firm must inquire further and satisfy itself as to the beneficial ownership of each such sub-account. This list is not exhaustive and is only included to reflect some types of “red flags” that would put a firm on inquiry notice that the sub-accounts may have separate beneficial owners, including but not limited to for example:
 - the sub-accounts are separately documented and/or receive separate reports from the firm;
 - the firm addresses the sub-accounts separately in terms of transaction, tax or other reporting;
 - the sub-accounts incur charges for commissions, clearance and similar expenses, separately, based upon the activity only of that subject sub-account;
 - the firm is aware of or has access to a master account or like agreement that evidences that the sub-accounts have different beneficial owners;
- When a firm becomes aware of the identities of the beneficial owners of the subaccounts pursuant to its duties arising from actual notice or inquiry notice outlined above, the firm will be required to recognize the sub-accounts as separate customer accounts for purposes of applying FINRA rules, the federal securities laws and other applicable federal laws.

Cases

FINRA has been focusing on whether or not firms have an adequate anti-money laundering program given the firm's business model and in particular, whether or not the firm has an adequate system for detecting and reporting suspicious activity. Those firms with customers using certain master/sub account relationships can present particular issues for AML compliance. The general structure is one master account with various sub accounts. The arrangement is particularly attractive to day-traders because they may not be required to maintain a minimum account equity balance and their buying power may exceed the individual 4:1 margin-to-equity ratio required of accounts held directly at a broker-dealer.

These types of accounts can create several issues.

- First, for AML purposes, sub-accounts, depending on how they are set up, may trigger CIP and customer due diligence obligations for the underlying accountholders (See Treasury/SEC Q&A on Omnibus Accounts and CIP obligations 10/1/03). But whether or not a firm has CIP obligations with subaccounts, it still has an obligation to monitor the accounts for suspicious activity.
- Second, the firm may be at risk for aiding and abetting an unregistered broker-dealer. (See SEC Release No. 60764 In the matter of GLB Trading and Robert Lechman). FINRA has made referrals to the SEC where we see a master account operating as an unregistered broker-dealer.

Pinnacle Financial Services (February 2010)

- FINRA fined Pinnacle \$300,000 for failing to have an adequate AML program tailored to the risk of its business. Pinnacle business involved opening up master accounts for foreign financial institutions located in high risk jurisdictions all over the world. Some of these master accounts were traditional omnibus accounts. Others were multi-tiered arrangements where the beneficial sub-account owners independently directed and controlled account activity via on-line access without any participation by the master.
- The firm's procedures were "cookie-cutter" procedures that didn't fit the firm's business. As a result, the firm failed to properly verify the identity both the master accounts and failed to identify and verify the identity of those subaccounts with direct trading access to the firm. The procedures called for the firm to obtain documentation that doesn't typically exist for foreign customers, such as US driver's license and US tax identification numbers and used a vendor service with virtually no information on foreign customers.
- In addition, the firm failed to adopt effective procedures for reviewing accounts for suspicious activity. The procedures included a list of red flags but no guidance on how to identify and examine for suspicious activity and failed to address the master/sub structures at all. For example, it did not review journal and wire transactions between subaccounts.
- As a result, the firm failed to identify and report suspicious activity in several accounts, such as a possible manipulation and irregular large money movements in excess of a customer's reported liquid and total net worth. In fact, the defective AML program permitted accounts to be used to facilitate an international fraud scheme involving a Latvian bank.

There are several pending matters involving master/sub account relationships and Direct Market access arrangements of various types, including one case involving a clearing firm.

DMA Sweep

FINRA's Enforcement Department is conducting a review of broker/dealers that provide Direct Market Access, Naked Access, Electronic Access or Sponsored Access ("DMA") to their customers. The sweep is reviewing the firm's AML policies particularly as they related to master/sub account relationships and transaction monitoring for suspicious activity reporting.

2. Additional AML Cases

Suspicious Activity Monitoring

First Clearing Corporation (\$400,000 fine) (January 2011)

- From at least January 1, 2007 through September 30, 2008, FCLLC failed to establish and implement an adequate AML compliance program for detecting, reviewing and reporting suspicious activity in certain fully disclosed accounts. FCLLC did not review or monitor the suspicious activity in most of the exception reports that it prepared for, and distributed to, introducing broker-dealers or otherwise conduct sufficient risk-based monitoring of activity in accounts introduced by its unaffiliated introducing broker-dealers. Instead, FCLLC reviewed a limited amount of potentially suspicious money movements and penny stock activity beginning in 2007. As a result, FCLLC failed to establish and implement a transaction monitoring program reasonably designed to achieve compliance with the SAR reporting provisions of 31 U.S.C. 5318(g) and the implementing regulations as required by NASD Rule 3011(a).

Penny Stocks

Penny stock transactions can be of higher risk as they are frequently used for unregistered distributions, market manipulations and securities fraud. Some firms essentially ignore the red flags because they are making money from the transactions and other firms don't seem to understand the risk of this business, particularly if it is new to them.

AIS Financial, Inc. (Expulsion) (April 2011)

- A hearing panel expelled AIS Financial for failing to implement and enforce an AML program. The panel found that AIS disregarded its AML responsibilities by ignoring prominent red flags and blatant suspicious activity for an extended period of time for financial gain.
- Motivated by commissions, the firm received from allowing its customers to liquidate billions of shares of penny stocks from numerous accounts, AIS turned a blind eye to the suspicious activity and concealed the activity from regulatory authorities.
- In one instance, the hearing panel found that AIS failed to report suspicious activity that occurred in two corporate accounts controlled by a money management firm based in Costa Rica, whose owner had been the subject of significant regulatory actions by the SEC for securities fraud for engaging in an Internet manipulative scheme.
- AIS permitted five accounts, controlled by a customer and his nephew, both of whom had disciplinary histories and criminal indictments for engaging in organized criminal activity and money laundering prior to opening accounts at AIS, to deposit and liquidate penny stocks in their accounts just two months after the SEC had charged them with securities fraud.
- In addition, the hearing panel found that AIS permitted approximately 20 customers to deposit and liquidate approximately 65 million shares of low-priced

and thinly traded Asia Global Holdings Corp stock. The liquidations generated sales proceeds of approximately \$5.1 million for the customers and commissions of \$243,304 for the firm.

Newbridge Securities Corp (\$600,000) (August 2010)

- During the period 2003 to 2008, the firm committed numerous violations including market manipulation, improper sales of unregistered offerings, and failure to develop and implement an adequate AML program. Separate action against the AMLCO. Fine: \$600,000. Action against the AMLCO: Suspended for one year as a principal, fined \$10,000 and ordered to complete 16 hours of AML training.

New Castle Financial Services LLC (May 2010)

- New Castle settled a disciplinary action for violations resulting from its failures to act on suspicious penny stock transactions by their customers, one of whom had been convicted of securities fraud. The firm was also charged with violations relating to failures in their Anti-Money Laundering Programs and other areas. New Castle was fined \$200,000, and undertook the retention of an independent consultant. The AWC also requires the Firm to have each of its associated persons (excluding persons having solely ministerial responsibilities) complete 16 hours of AML continuing education training. FINRA also sanctioned the firm's president, Anthony Lodati. Lodati has agreed to an AWC that fines him \$30,000 and suspends him for two months from associating with any FINRA member firm in any principal capacity. Lodati also agreed to complete 16 hours of AML continuing education training.
- FINRA's investigation found that customers extensively traded low-priced securities, or penny stocks. New Castle participated in an unlawful distribution of penny stocks by selling approximately 20 million unregistered shares of stock into the public markets through four issuers. From September 2007 through March 2008, the customers selling these shares were associated with a felon convicted for securities fraud who had controlling or other financial interests in the issuers.
- These customers deposited physical certificates or electronically delivered shares into their accounts and, within a few days, sold the shares and wired out the cash proceeds. Additionally, the firm failed to implement policies, procedures and internal controls reasonably designed to detect, investigate and timely report suspicious transactions during the time period May 21, 2007 through August 21, 2008. For example, beginning in May 2007, approximately 10 individuals associated with the convicted felon engaged in a pattern of depositing large blocks of unregistered, thinly traded penny stocks and then selling those securities out of the Firm within a few days, with proceeds amounting to approximately \$10,000,000 wired out of the accounts. These wires represented approximately 80% of all outgoing wire activity at the Firm during January through March 2008.
- The Firm also facilitated the distribution of unregistered shares and sold securities to public investors using a private placement memorandum that failed to disclose a felon's association with the issuer.

A.B. Watley Direct, Inc. (\$125,000) (March 2010)

- FINRA required the firm to retain an Independent Consultant to conduct a review of the adequacy of its policies, systems and procedures, and training relating to its anti-money laundering (AML) compliance program. The firm failed to establish and enforce an adequate and reasonable AML program, in that it failed to detect and investigate red flags of possible suspicious activity in customer accounts involving the sale of hundreds of thousands of shares of various penny stocks and failed to timely report such activity on a SAR-SF.

Pond Equities (\$100,000) (April 2010)

- FINRA found that the firm had failed to timely detect, investigate, and report suspicious activity occurring at the firm in at least 40 accounts, including multiple accounts maintained for no apparent legitimate reason, numerous transactions involving large blocks of low-priced securities of companies with problematic and high risk financial histories, and customers who have regulatory histories of securities-related violations such as stock fraud and manipulation.
- FINRA further found that Pond failed to implement reasonable procedures to detect, investigate and report instances of suspicious trading, failed to investigate any of the suspicious transactions and failed to file Suspicious Activity Reports

C. Section 5

FINRA Regulatory Notice 09-05

FINRA issued *Regulatory Notice 09-05, Unregistered Resales of Restricted Securities*, to remind firms and brokers of their obligations to determine whether securities are eligible for public sale before participating in what may be illegal distributions. It also discusses the importance of recognizing "red flags" of possible illegal, unregistered distributions and reiterates firms' obligations to conduct searching inquiries in certain circumstances to avoid participating in illegal distributions and to file suspicious activity reports where appropriate.

Seaboard Securities Inc. (\$100,000)

- Seaboard participated in the distribution of approximately one billion shares of various unregistered securities in violation of Section 5. Firm failed to review for suspicious activity and make any appropriate filings.

DOE v. Padilla

- FINRA alleged that Respondent Padilla, while associated with Empire Financial Group and later with Cambria Capital Advisors, routinely assisted customers in liquidating large blocks of unregistered OTC shares that the customers had received as compensation for "stock promotion" services. Padilla did little or nothing to ascertain whether the unregistered shares could be sold subject to a valid exemption from registration. He required only that the issuer or the selling customer provide a written certification that the shares were "free trading." A certification that Padilla accepted without question despite the presence of myriad red flags indicating that the selling customers were in fact statutory underwriters and, in some instances, might be engaged in market manipulation. A Hearing Panel found that Padilla participated in an illegal distribution of unregistered securities in violation of Section 5 of the Securities Act of 1933. The findings stated that Padilla impermissibly relied upon others, including his firms' compliance departments, transfer agents and clearing firms, to prevent any sales that might be unlawful. Padilla was suspended from association with any FINRA member in any capacity for six months. Padilla was fined \$132,701 which includes disgorgement of commissions and an additional \$10,000 fine.
- This decision has been appealed to the NAC and the sanctions are not in effect pending consideration of the appeal.

D. Regulation D

We are looking at private placements in a variety of types of companies that ultimately failed. Principally Medical Capital Holdings, Inc. or Provident Royalties, Inc.

- These offerings were made pursuant to exemptions from registration provided by Regulation D.

- Typically these issuers made a series of offerings, and part of the appeal of the later offerings was the success to date of the earlier ones
- Some of the offerings were sold by affiliated broker-dealers, as well as a group of other firms that sometimes sold more than one of the offerings that we are investigating

Cases to Date

- FINRA Sanctions Two Firms and Seven Individuals for Selling Private Placements Without Conducting a Reasonable Investigation
 - FINRA sanctioned two firms and seven individuals for selling interests in private placements without conducting a reasonable investigation. The companies whose securities were sold in these private placements were unrelated to the firms and individuals FINRA sanctioned. The companies ultimately failed, resulting in significant investor losses.
 - FINRA imposed sanctions against the following firms and individuals for failing to conduct a reasonable investigation of the sale of private placements offered by Medical Capital Holdings, Inc. (MedCap) and/or Provident Royalties, LLC.
 - Workman Securities Corp., of MN, was ordered to pay \$700,000 in restitution to affected customers. Robert Vollbrecht, Workman's former President, was barred in any principal capacity, and fined \$10,000.
 - Timothy Cullum, former Chief Executive Officer, and Steven Burks, former President, of Cullum & Burks Securities, Inc., of Dallas, TX, a now-defunct firm, were each suspended in any principal capacity for six months and fined \$10,000.
 - Jeffrey Lindsey and Bradley Wells, two former executives with Capital Financial Services, Inc., of ND, were each suspended for six months in any principal capacity and fined \$10,000.
 - Jay Lynn Thacker, former Chief Compliance Officer for Meadowbrook Securities, LLC (fka Investlinc Securities, LLC), of MS, was suspended for six months in any principal capacity and fined \$10,000.
 - David William Dube, former Owner, President, Chief Compliance Officer and Anti-Money Laundering (AML) Compliance Officer of (now-defunct) Peak Securities Corporation, of FL, was barred for failing to conduct adequate due diligence, as well as a failure as AML Compliance Officer to detect, investigate and report numerous suspicious transactions in 10 customer accounts where "red flags" existed.
 - In addition, FINRA fined Askar Corporation, of MN, \$45,000 for its failure to conduct due diligence on a private placement from DBSI, Inc., another company that defaulted on its obligations. FINRA found that Askar only reviewed the offering documents and sales materials provided by DBSI before approving the product for sale, without independently verifying DBSI's representations in the offering documents.
 - FINRA found that broker-dealers who sold the MedCap, Provident and DBSI private placement offerings did not have reasonable grounds to believe that the private placements were suitable for any of their customers. Also, they failed to engage in an adequate investigation of the private placements and failed to establish, maintain and enforce a supervisory system reasonably designed to achieve compliance with applicable securities laws and regulations. Without performing proper due diligence, the firms could not identify and understand the inherent risks of these offerings. The sanctioned principals did not have reasonable grounds to allow the firms' registered representatives to continue selling the offerings despite the red flags that existed regarding the private placements.
 - From 2001 through 2009, MedCap, a medical receivables financing company based in Anaheim, CA, raised approximately \$2.2 billion from over 20,000 investors through nine MedCap private placement offerings of promissory notes.

MedCap made interest and principal payments on its promissory notes until July 2008, when it began experiencing liquidity problems and stopped making payments on notes sold in two of its earlier offerings. Nevertheless, MedCap proceeded with its last offering, MedCap VI, which it offered through an August 2008 private placement memorandum.

- In July 2009, the SEC filed a civil injunctive action in federal district court in which it sought, and was granted, a preliminary injunction to stop all MedCap sales. The SEC alleged that MedCap and its executives defrauded investors in MedCap VI by misappropriating approximately \$18.5 million of investor funds. The SEC also alleged that MedCap misrepresented that it had never defaulted on or had been late in making interest or principal payments, when in fact, MedCap had defaulted on or was late in paying nearly \$1 billion in principal and interest on the notes from its previous Regulation D offerings. The court appointed a receiver to gather and conduct an inventory of MedCap's remaining assets. The SEC action is pending.
- From September 2006 through January 2009, Provident Asset Management, LLC marketed and sold preferred stock and limited partnership interests in a series of 23 private placements offered by an affiliated issuer, Provident Royalties. The Provident offerings were sold to customers through more than 50 retail broker-dealers nationwide and raised approximately \$485 million from over 7,700 investors. Provident Royalties' business plan included the acquisition of a combination of producing and non-producing sub-surface mineral interests, working interests and production payments in real property located within the United States. Although a portion of the proceeds of Provident Royalties' offerings was used for the acquisition and development of oil and gas exploration and development activities, millions of dollars of investors' funds were transferred from the later offerings' bank accounts to the Provident operating account in the form of undisclosed and undocumented loans, and were used to pay dividends and returns of capital to investors in the earlier offerings, without informing investors of that fact.

Additionally, FINRA has brought ten cases, including several complaints, and AWCs naming firms and individuals – mainly principals and chief compliance officers, with at least as many more to come.

Findings: Each AWC finds some combination of the following violations:

- Failure to conduct adequate due diligence, in violation of well-established standards and/or the firm's own internal procedures
- False and misleading misrepresentations or omissions to investors about the offerings, including inflated expectations of returns, the risk of the investments, and the past performance of other similar offerings by the same issuer
- Reasonable Basis Suitability
- Customer-specific Suitability
- Unregistered offerings in violation of Section 5 as a result of the failure to satisfy the conditions of Reg D, such as engaging in a widespread solicitation.

Pacific Cornerstone Capital (\$750,000) (January 2010)

- FINRA fined Pacific Cornerstone Capital and its former CEO, Terry Roussel, a total of \$750,000 for failing to include full and complete information in private placement offering documents and marketing material. FINRA also charged advertising violations and supervisory failures.
- From January 2004 to May 2009, Pacific Cornerstone sold private placements in two affiliated companies using offering documents and accompanying sales literature that contained targets as to when investors would receive the return of their principal investment and the yield on their investment. The offering documents included statements that the affiliated entities targeted returns of principal in two to four years and

targeted a yield on a \$100,000 investment in excess of 18 percent. FINRA found no reasonable basis for those statements.

- The firm continued to use a similar targeted time period for return of capital and rate of return in successive offering documents, although those targets were not supported by prior performance. FINRA also found that the offering documents failed to disclose the complete financial condition of one or both of the companies.

E. Bank Broker-Dealer

In 2009, the Fordham Law Securities Arbitration Clinic noted that there was an up-tick in arbitration claims involving Bank Broker-Dealers. Specifically attorneys were seeing a pattern of cases where investors were coming into the bank to renew their CDs and were being directed to the brokerage representative. In these cases the RR recommended non-bank securities products without FDIC guarantees in order to obtain a higher yield allegedly misrepresenting the safety of the investment. Because of market fluctuation some of these products declined in value and the customer lost money.

In light of this information, and other information regarding customer complaints at bank broker-dealers involving sales of CDs and UITs that suggested there may be sales practice problems in Bank BDs, FINRA staff began analyzing additional data on Bank Broker-Dealers where similar concerns were raised, and also noted potential issues involving supervision, training, cash-compensation, and complaint reporting. Late last year, Enforcement sent requests to twelve Bank BDs that appeared to have the largest concentration of complaints.

F. Regulation S-P

SEC and FINRA rules require every broker-dealer to adopt written policies and procedures that address safeguards for the protection of customer records and information. We are looking at firms that do not have adequate Reg S-P policies or have had breaches in security and have not responded appropriately to the breach. Regulation S-P requires that financial institutions provide customers with a notice of their privacy policies. Further the Regulation prohibits these financial institutions from disclosing nonpublic personal information about a customer to nonaffiliated third parties unless, among other things, the firm gives the consumer certain required notices and a reasonable opportunity, before the firm discloses the information, to opt out of the disclosure. 17 C.F.R. § 248.10.

Lincoln Financial Securities, Inc./Lincoln Financial Advisors Corp. (February 2011)

FINRA assessed total fines of \$600,000 – a record for Reg SP -- against Lincoln Financial Services, Inc. (LFS) of Concord, New Hampshire (\$450,000), and an affiliated firm, Lincoln Financial Advisors Corporation (LFA) of Fort Wayne, Indiana, (\$150,000), for their failures to adequately protect non-public customer information.

Both firms maintained a web-based system that combined non-public customer account information from various sources and allowed employees to view the customer account information within a single site. Home office personnel from both firms could access the system either by clicking on a link on the firm's website or by using an Internet browser to go directly to the system's website and log in with one of the shared user names and passwords. For extended periods of time – seven years for LFS and approximately two years for LFA – certain current and former employees were able to access customer account records through an Internet browser, using shared log-on credentials. Between the two firms, over one million customer account records were accessed through the use of shared user names and passwords. Since neither firm had policies or procedures to monitor the distribution of the shared user names and passwords, they were not able to track how many or which employees gained access to the site during this period of time. As a result of allowing uncontrolled access to the system, confidential customer records including names, addresses, social security numbers, account numbers, account balances, birth dates, email addresses and transaction details were at risk.

In addition, LFS and LFA did not have procedures to disable or change the shared user names and passwords on a recurring basis even after a home office employee had been terminated. Many individuals left the two firms during the relevant time period, yet the shared user names and passwords were never changed, and the firms had no way of determining whether former employees continued to access confidential customer information using those same user names and passwords. FINRA also found that LFS representatives in the field used their own computers to conduct securities business, and were not required to install or utilize security applications such as antivirus, encryption or firewall software. As a result, brokers' log-in credentials were at risk of being obtained by an unauthorized party, potentially exposing customer information that might have been downloaded to the broker-owned computer.

D.A. Davidson & Co. (\$375,000) (April 2010)

FINRA found that the firm failed to employ adequate safeguards to protect confidential customer information against hackers. The database was not encrypted and the firm never changed the default password for the database. The firm also failed to review the web server logs which showed evidence of the system breach. The firm learned of the breach when it received an email from the hacker threatening to blackmail the firm. Upon receipt of the threat, the firm took remedial measures, among others, by disabling the website, reporting the incident to law enforcement officials and assisting them in identifying the hackers.

G. Advertising

National Foundation of America (August 2009 – January 2011)

FINRA's investigated numerous registered representatives employed by various broker dealers who sold to elderly investors installment plan contracts offered by National Foundation of America ("NFOA") between 2006 and 2007. NFOA was a Tennessee non-profit corporation that misrepresented itself to the public as an approved charitable organization. In June 2007, amidst allegations that NFOA directors had used investor funds to pay personal expenses and purchase automobiles and property, the State of Tennessee placed NFOA in receivership and, later, into liquidation.

The registered representatives failed to provide written notice to and receive approval from their broker-dealer employers prior to soliciting and selling the NFOA product which was a security. These registered representatives also failed to conduct adequate due diligence of NFOA and sold the NFOA product by providing customers with misleading and unapproved sales materials and negligently misrepresenting that a tax deduction was available in connection with their investments in the NFOA product.

Actions to date - Seven AWCs, with suspensions ranging from four months to a bar, and fines from \$30,000 to \$94,000 with several restitution awards; one Complaint.

More settlements and complaints are expected.

UBS Securities, LLC (\$600,000) (February 2011)

FINRA fined UBS Securities a total of \$600,000 for failing to adequately supervise a trader who concealed more than \$28 million in trading losses by making fictitious and inaccurate entries into the firm's trading systems of non-deliverable forward ("NDF") and Brazil 40 Bond transactions. The firm also failed to provide its supervisors with the information necessary to adequately supervise the trader, and failed to establish and maintain adequate written procedures for the trading of NDFs and for the creation and maintenance of certain required NDF related books and records.

FINRA found that the firm's failures resulted from multiple causes, including among other things, its failure to closely monitor the trader's use of the NDF dual entry systems, obtain and make available to supervisors NDF-related reports prepared and maintained by UBS AG (the firm's parent company), closely monitor the process for amending, confirming and

settling NDF transactions which were handled by UBS AG and capture NDF and Brazil 40 bond transactions on its electronic supervisory system.

H. Systems and Procedures to Identify and Prevent Losses from Trading and Back Office Operations

FINRA continues to examine for and bring enforcement proceedings relating to firms' systems and procedures to identify and prevent losses to the firm, the firm's customers, and other parties from trading done by the firm or from a firm's back office operations. Such systems and procedures are an essential part of a firm's supervision of these two areas.

BNP Paribas Securities (\$650,000) (February 2011)

The firm failed to have adequate systems and procedures, such as independent price verification, to identify the risk of loss to the Firm that might arise when it allowed traders on its Listed Options Desk 1 to manually value their positions (rather than use the firm's automated systems) and the risk of loss from arbitrage trades entered by its Stock Loan and Borrow (SLAB) Desks. As a result, BNP Paribas Securities was unaware of multi-million dollar losses incurred on both Desks. The firm was also sanctioned for filing an inaccurate Form U-5 for one trader on the Listed Options Desk. In settling the matter, FINRA took into consideration the firm's self report and its extraordinary cooperation during FINRA's investigation.

UBS (\$600,000 fine) (February 2011)

The firm was sanctioned for failing to supervise the activities of a trader on its Fixed Income Emerging Markets Latin American Desk who, from January 2006 through May 2006, concealed more than \$28 million in trading losses on non-deliverable forward (NDF) and Brazil 40 Bond transactions. Non-deliverable forward transactions were processed through two separate systems, each owned and maintained by UBS's parent company, UBS AG in Zurich. The trader was able to make fictitious and inaccurate entries by exploiting shortcomings in these two systems. For example, he delayed entering actual trade data into one of the firm's systems when the data concerned unprofitable transactions. In each instance, the result was to conceal an unrealized loss associated with an actual transaction and/or to create the appearance of a fictitious profit in connection with both actual and fictitious transactions.

I. Hedge Funds

Fraud – MICG/Martinovich (February 2011)

FINRA expelled MICG Investment Management, LLC of Newport News, VA and barred Jeffrey A. Martinovich, the firm's CEO and majority owner, for securities fraud, misusing investors' funds and causing false account statements to be issued to investors in connection with their management of a proprietary hedge fund named MICG Venture Strategies, LLC (Venture Strategies). MICG and Martinovich organized, controlled and managed the hedge fund.

FINRA found that the Respondents improperly assigned excessive asset values to two non-public securities owned by the hedge fund, and used the excessive asset values as the basis for paying unjustified management and incentive performance fees.

FINRA found that, in order to inflate their management and incentive fees – which were dependent on the value of the hedge fund's assets, MICG and Martinovich assigned unjustifiably high values to the assets, rather than relying on independent or legitimate valuations or valuation methods. For example, at various times, the Respondents valued an equity interest at more than triple the price at which it was contemporaneously being offered to them for sale. One of the assets was an interest in a company that acquired about a 93

percent ownership interest in the Derby Rams Football Club (a British professional soccer team), the team's stadium and other related assets.

FINRA also found that Martinovich also fraudulently induced an elderly, non-accredited MICG customer to invest \$75,000 in the hedge fund. Martinovich did not have reasonable grounds for believing the investment was suitable, and failed to disclose to the customer that Venture Strategies needed the funds to pay incentive and/or management fees from which MICG and Martinovich would derive financial benefit.

J. Social Networking – FINRA Regulatory Notice 10-06

- In 2010, FINRA issued *Regulatory Notice 10-06, Social Media Websites; Guidance on Blogs and Social Media Web Sites*. The Regulatory Notice provided guidance to firms on applying the communications rules to social media sites, such as blogs and social networking sites. The goal of this *Notice* is to ensure that—as the use of social media sites increases over time—investors are protected from false or misleading claims and representations, and firms are able to effectively and appropriately supervise their associated persons' participation in these sites. The Notice emphasized the need for each firm, when establishing its policies and procedures in this area, to develop policies and procedures that are best designed to ensure that the firm and its personnel comply with all applicable requirements. The Notice also emphasized that it was addressing the use by a firm or its personnel of social media sites for business purposes and did not purport to address the use by individuals of social media sites for purely personal reasons.
- **Recordkeeping:** Every firm that intends to communicate, or permit its associated persons to communicate, through social media sites must first ensure that it can retain records of those communications as required by Exchange Act Rules 17a-3 and 17a-4 and NASD Rule 3110. SEC and FINRA rules require that for record retention purposes, the content of the communication is determinative and a broker-dealer must retain those electronic communications that relate to its “business as such.”
- **Suitability:** If a firm or its personnel recommends a security through a social media site suitability requirements of NASD Rule 2310 apply. Whether a particular communication constitutes a “recommendation” for purposes of Rule 2310 will depend on the facts and circumstances of the communication. (See *Notice to Members (NTM) 01-23 (Online Suitability)* for additional guidance concerning when an online communication falls within the definition of “recommendation” under Rule 2310.)
- **Supervision:** The content provisions of FINRA's communications rules apply to interactive electronic communications that the firm or its personnel send through a social media site. While prior principal approval is not required under Rule 2210 for interactive electronic forums, firms must supervise these interactive electronic communications under NASD Rule 3010 in a manner reasonably designed to ensure that they do not violate the content requirements of FINRA's communications rules. Firms may adopt supervisory procedures similar to those outlined for electronic correspondence in *FINRA Regulatory Notice 07-59 (FINRA Guidance Regarding Review and Supervision of Electronic Communications)*. As set forth in that notice, firms may employ risk-based principles to determine the extent to which the review of incoming, outgoing and internal electronic communications is necessary for the proper supervision of their business.
- **Third Party Posts:** The Notice also addresses the issue of third party posts and whether such posts become communications of the firm under Rule 2210. As a general matter, FINRA does not treat posts by customers or other third parties as the firm's communication with the public subject to Rule 2210. Thus, the prior principal approval, content and filing requirements of Rule 2210 do not apply to these posts. Under certain circumstances, however, third-party posts may become attributable to the firm. Whether third-party content is attributable to a firm depends on whether the firm has (1) involved itself in the preparation of the content (“entanglement” theory) or (2) explicitly or implicitly endorsed or approved the content (“adoption” theory).

Investigations and Formal Disciplinary Actions

FINRA Provides Guidance on Its Enforcement Process

Executive Summary

FINRA is providing this guidance to provide transparency into its enforcement process, and to assist firms and their associated persons with their understanding of how the investigative process works and to highlight procedural safeguards in this process, including:

- Enforcement Procedures and Managerial Oversight
- Conducting Investigations
- Sufficiency of Evidence Reviews
- Wells Process
- Disciplinary Advisory Committee Review
- Litigation Group Consultation Process
- Independent Office of Disciplinary Affairs
- Independent Office of Hearing Officers

Questions regarding this *Notice* should be directed to Susan Merrill, Executive Vice President, Enforcement, at (646) 315-7300.

March 2009

Notice Type

- Guidance

Suggested Routing

- Compliance
- Legal
- Senior Management

Key Topic(s)

- Enforcement Process
- Investigations
- Formal Disciplinary Actions
- Wells Process

Referenced Rules & Notices

- FINRA Rule 8210

Background & Discussion

One of FINRA's most important functions is the fair and effective enforcement of rules contained within the FINRA Rulebook, the rules of the Municipal Securities Rulemaking Board and the federal securities laws and rules. FINRA's Enforcement and Market Regulation Departments are responsible for investigating and bringing all FINRA formal disciplinary actions against firms and their associated persons. The Enforcement Department handles a broad range of investigations and cases, while the legal section of the Market Regulation Department focuses on trading and quality of market cases. The staff of these departments (also collectively referred to as Enforcement) work closely with other FINRA offices such as Advertising Regulation and Corporate Financing. Similarly, the Enforcement Department works closely with FINRA's Member Regulation Department, which requests information and takes testimony in the course of its examinations of firms and reviews of customer complaints. If another department believes, in consultation with Enforcement staff, that a formal disciplinary action is warranted, the matter will be referred for formal action.

FINRA investigations may be opened from various sources, including but not limited to, automated surveillance reports, examination findings, filings made with FINRA, customer complaints, anonymous tips, referrals from other regulators or other FINRA departments, and press reports.

Enforcement Procedures and Managerial Oversight

The staff investigates and litigates cases pursuant to comprehensive internal procedures that set forth uniform policies and procedures that govern the investigative and enforcement process.¹ In addition, all cases are also subject to a multilayered managerial review that focuses on, among other things, the substantive evidence developed during the investigation and an analysis of applicable rules and case precedent. Investigations are assessed at various points to ensure that Enforcement resources are being deployed appropriately.

Conducting Investigations

All FINRA investigations are non-public and confidential, and firms and individuals are entitled to be represented by counsel. The staff engages in an objective fact-finding process when conducting an investigation, without bias for or against the parties involved. To conduct its investigations, the staff requests documents and takes sworn testimony from firms and associated persons pursuant to FINRA Rule 8210, which requires firms and associated persons to respond to requests for information; failure to respond may result in a fine, suspension or bar from the industry. The staff may also contact customers and other individuals who are not within FINRA's jurisdiction and who provide information voluntarily.

Rule 8210 requests inform the recipient that FINRA investigations are non-public and confidential. Information acquired during an investigation may be disclosed in connection with an investigation or disciplinary proceeding, in response to requests from the Securities and Exchange Commission or other governmental agencies and pursuant to a lawfully issued subpoena and/or information-sharing agreements entered into between FINRA and other regulators. Rule 8210 requests for testimony also inform the witness that he or she has the right to have an attorney present, the right to review a copy of his or her transcript, and may request, in writing, a copy of the transcript, which shall be released unless the staff has good cause to withhold it.

Sufficiency of Evidence Review

At the conclusion of the investigation, the staff analyzes the evidence and applicable law and makes a preliminary determination of whether or not a violation appears to have occurred. This process is called a Sufficiency of Evidence review and is conducted under the supervision of the senior manager responsible for the investigation. If it appears that rules have been violated, the senior manager will determine whether the conduct merits a recommendation of formal disciplinary action. If the violation is of a minor nature and there is an absence of customer harm or detrimental market impact, the matter may be resolved with an informal disciplinary action, such as the issuance of a Cautionary Action. While Cautionary Actions are considered by the staff in any future disciplinary matter, these actions do not constitute formal discipline and are not reportable on FINRA's Central Registration Depository (CRD) system or Form BD.

Wells Process

If a preliminary determination to proceed with a recommendation of formal discipline is made, the staff will call the potential respondent or counsel and inform the individual or firm that FINRA intends to recommend formal disciplinary action. This is generally referred to as a Wells Call.² During the Wells Call the staff informs the potential respondent of the proposed charges and the primary evidence supporting the charges. The purpose of a Wells Call is to give the potential respondent an opportunity to submit a writing, called a Wells Submission, which discusses the facts and applicable law and explains why formal charges are not appropriate. The Wells Call is followed with a letter confirming that the Wells Call has been made (Wells Notice). An associated person who receives a written Wells Notice is required to report that event on his or her Form U4. Firms also may have disclosure obligations depending upon, for example, whether the firm is a publicly traded company. While the Wells process is used in virtually every case, the process is discretionary and there may be instances where senior Enforcement staff determines that it must move forward without providing this opportunity, such as when customer funds are at risk.

The Enforcement staff, including senior managers, carefully review the Wells Submission in assessing the case and may ask for additional information or obtain additional evidence in the matter. In many cases, after reviewing the charges that the staff is considering, the potential respondent initiates settlement discussions instead of making a Wells Submission. FINRA's independent Office of Disciplinary Affairs, discussed below, also reviews each Wells Submission before approving a settlement or authorizing the staff to issue a formal complaint. All cases where Wells Notices have been issued, particularly those involving individual prospective respondents, are reviewed regularly to ensure timely disposition of those matters. Finally, a closing letter is sent to each individual who has received a Wells Notice if the matter is closed without formal disciplinary action.

Disciplinary Advisory Committee

The Disciplinary Advisory Committee (DAC) reviews all significant cases and those matters where novel legal or factual issues exist. The DAC consists of senior managers from the Enforcement and Market Regulation Departments. The DAC considers the evidence supporting each recommended charge and vets charging decisions and sanction recommendations to ensure consistency and proportionality. The DAC recommends the charges and sanction ranges for each case for purposes of settlement discussions. In addition, the DAC considers the issue of whether credit for extraordinary cooperation is appropriate. As discussed below, however, no settlement may be finalized nor may any complaint be filed prior to review and approval by the independent Office of Disciplinary Affairs.

Litigation Group Consultation Process

While most cases settle prior to litigation through the issuance of a settlement document called a Letter of Acceptance Waiver and Consent, a Litigation Group consultation takes place for any case in which a complaint will be filed. During this process, experienced FINRA trial lawyers and a litigation manager review the matter to ensure, among other things, that there exists sufficient evidence to support the proposed charges.

Independent Office of Disciplinary Affairs

FINRA's Office of Disciplinary Affairs (ODA) is independent of Enforcement and is not involved in the investigation or litigation of cases. ODA is charged with reviewing each proposed settlement or complaint, including any Wells Submissions, to provide an independent review of the legal and evidentiary sufficiency of the charges proposed by the staff. ODA also reviews settlements for consistency with the Sanction Guidelines as well as applicable precedent. ODA approval is required before the issuance of a settlement or complaint.

Independent Office of Hearing Officers

FINRA's Code of Procedure governs the hearing process. FINRA hearings are administered by a Hearing Officer who is employed by FINRA in the Office of Hearing Officers (OHO). OHO is independent of Enforcement and, like ODA, is not involved in the investigative process. Employment protections exist for Hearing Officers to further ensure their independence; they may not be terminated except by the FINRA Chief Executive Officer, with a right to appeal to the Audit Committee of FINRA's Board of Governors.

Hearings are held before a Hearing Officer and two industry panelists. Panelists are drawn from a pool of current and former securities industry members of FINRA's District Committees, as well as its Market Regulation Committee, former members of FINRA's National Adjudicatory Council (NAC) and former FINRA Governors. Appeals from hearing decisions are made to the NAC, and respondents may further appeal an adverse decision of the NAC to the Securities and Exchange Commission, and further to a United States Court of Appeals.

Endnotes

- 1 All employees are also subject to FINRA's Code of Conduct and FINRA policies which ensure appropriate handling of potential and actual conflicts of interest, among other things.
- 2 The term Wells Notice originated in 1972 from a committee (chaired by former Senator John Wells and commonly referred to as the Wells Committee) appointed to review and evaluate the SEC's enforcement policies and practices. The Committee recommended providing notice to prospective respondents of charges that the SEC staff was considering. This notice has subsequently been referred to by securities regulators as a Wells Notice, and is used by FINRA in its disciplinary process.

FINRA Investigations

FINRA Provides Guidance Regarding Credit for Extraordinary Cooperation

Executive Summary

FINRA is issuing this guidance to apprise firms of the circumstances in which extraordinary cooperation by a firm or individual may directly influence the outcome of an investigation. The types of extraordinary cooperation by a firm or individual that could result in credit can be categorized as follows: (1) self-reporting before regulators are aware of the issue; (2) extraordinary steps to correct deficient procedures and systems; (3) extraordinary remediation to customers; and (4) providing substantial assistance to FINRA's investigation. These steps alone or taken together can be viewed in a particular case as extraordinary cooperation and, depending on the facts and circumstances, can have an impact on FINRA's enforcement decisions.¹

Questions regarding this *Notice*, should be directed to Susan Merrill, Executive Vice President, Enforcement, at (646) 315-7300.

Background & Discussion

The cornerstone of the investigative and enforcement authority of self-regulatory organizations in the securities industry is the requirement that firms and individuals employed in the industry comply with regulatory requests for information or testimony.² Notwithstanding this obligation, in certain situations, actions taken by firms or individuals go far beyond such compliance and rise to the level of extraordinary cooperation. Depending on the facts and circumstances, there are instances where cooperation by a firm or individual is so extraordinary that it should be taken into consideration in determining the appropriate regulatory response.

November 2008

Notice Type

- Guidance

Suggested Routing

- Compliance
- Internal Audit
- Legal

Key Topics

- Investigations
- Self-reporting

Referenced Rules and Notices

- NASD Rule 3070(a)
- NASD Rule 8210
- NYSE Rule 351(a)
- NYSE Information Memorandum 05-65

There is significant regulatory value in crediting conduct that rises to the level of extraordinary cooperation.³ Such cooperation may put the regulator on notice of regulatory problems before it finds them during an examination or investigation or assist the regulator in resolving matters more quickly, thereby allowing it to deploy regulatory resources more efficiently. This enables FINRA to achieve its mission of investor protection and market integrity more effectively.

Credit for extraordinary cooperation in FINRA matters may be reflected in a variety of ways, including a reduction in the fine imposed, eliminating the need for or otherwise limiting an undertaking, and including language in the settlement document and press release that notes the cooperation and its positive effect on the final settlement by FINRA Enforcement. In an unusual case, depending on the facts and circumstances involved, the level of extraordinary cooperation could lead FINRA to determine to take no disciplinary action at all.

By publishing these standards of cooperation, FINRA seeks to increase transparency as to the basis for sanctions imposed in cases and to encourage firms to root out, correct and remediate violative behavior. By making clear that FINRA has given credit for extraordinary cooperation in a particular case, FINRA will inform firms and associated persons of the types of conduct considered and the degree to which such actions are to the individual or firm's benefit.

It is important to note that the level of cooperation is just one factor to be considered in determining the appropriate disciplinary action and sanctions. Other factors include the nature of the conduct, the extent of customer harm, the duration of the misconduct, and the existence of prior disciplinary history, all of which impact the appropriate sanction in any particular matter.

FINRA will consider the following factors in assessing cooperation:

1. Self-Reporting of Violations

FINRA will consider credit for self-reporting of violations before any regulatory inquiry into the conduct at issue has begun and before the violation otherwise comes to the regulator's attention. The self-reporting must be prompt, detailed, complete and straightforward in order to warrant special consideration. The type of reporting that is contemplated here is beyond that which is otherwise required to be reported pursuant to regulatory reporting requirements.⁴

2. Extraordinary Steps to Correct Deficient Procedures and Systems

FINRA may credit correction of procedures that occurs prior to detection by FINRA and, in appropriate circumstances, even after detection by FINRA. In order to encourage firms to take immediate, proactive steps to correct systems, procedures and controls that may have contributed to problems that occurred at the firm, FINRA considers it appropriate to credit such steps in reaching its decision regarding the appropriate regulatory response.

Credit for correction of procedures prior to regulatory detection is consistent with the FINRA Sanction Guidelines and cases that FINRA has recently brought. Firms that have found a problem and fully corrected related procedures before the examination or investigation began have received credit in the form of a reduction of the sanction imposed in the disciplinary action.

Credit for remediation of procedures post-detection by FINRA would be appropriately limited to those situations where, notwithstanding the fact that the firm did not discover the problem on its own, the firm nevertheless promptly and completely remediated the deficient procedures as soon as it became aware of the problem without prompting by FINRA or another regulator or law enforcement agency.⁵ To qualify for credit for extraordinary cooperation, the post-detection remediation must be taken early on, well before completion of FINRA's investigation. Steps taken later in the investigation to correct procedures will not be considered extraordinary steps and would not yield credit in the sanction determination, because a firm has a duty to correct deficient procedures.⁶

3. Extraordinary Remediation to Customers

FINRA recognizes that credit should be given for extraordinary steps taken to remediate customers, including promptly and immediately identifying injured customers and making such investors whole.⁷ FINRA also will consider the extent to which a firm proactively identifies and provides restitution to injured customers that goes beyond the universe of customers and transactions covered by the staff's investigation.⁸

4. Providing Substantial Assistance to FINRA Investigations

FINRA recognizes that receiving substantial assistance from firms during an investigation can assist FINRA in efficiently resolving investigations into violative conduct. Such assistance can have far-reaching benefits, including, among other things, shortening investigations and enhancing FINRA's ability to effectively and efficiently investigate large scale and complicated systemic failures, thereby reducing the regulatory burden on firms and FINRA resources. Examples of the types of substantial assistance that may, depending on the circumstances, warrant credit include:

- Providing access to individuals or documents outside FINRA's jurisdiction that are critical to a full investigation of violative conduct.
- Providing extraordinary assistance with the investigation. Upon learning of a problem, firms often undertake comprehensive internal investigations, and then brief FINRA staff on their findings. FINRA has credited these proactive undertakings by firms that greatly assisted the staff's investigations.⁹

- Cooperation with FINRA to uncover substantial industry wrongdoing. When on-going violative conduct has numerous participants yet is difficult to uncover, collaboration with the regulator can have a dramatic impact on regulatory consequences. This can include apprising FINRA of wrongdoing beyond the scope of the original investigation and alerting staff to industry-wide, systemic problems. When a firm or individual brings to the regulator's attention a pattern or practice of which the regulator was unaware, or is the first to come forward to cooperate in a widespread, industry-wide investigation and thereby assists the regulator in understanding, scoping and resolving the investigation, this assistance should be credited. Conditions for such credit include: (i) cooperation with the regulator to uncover related industry wrongdoing; (ii) providing substantial assistance in furtherance of the resulting investigation; and (iii) cooperating in all relevant respects.

Conclusion

Crediting extraordinary cooperation by firms and individuals in appropriate situations advances important regulatory goals. Among other things, it can shorten investigations, thereby reducing regulatory burdens on firms and FINRA resources, as well as apprise FINRA staff of wrongdoing beyond the scope of the original investigation and alerting staff to industry-wide, systemic problems. Encouraging firms and individuals to take immediate, proactive and meaningful steps and appropriately acknowledging the cooperative conduct in settlement documents may encourage others to take similar steps and will provide transparency into sanction terms and how the conduct was actually credited.

While FINRA staff will continue to assess the particular facts and circumstances in each case, including the nature of the conduct, the extent of customer harm, the duration of the misconduct and the existence of disciplinary history, the extent of a firm's extraordinary cooperation will be an important factor in determining the appropriate disciplinary action and the sanctions that will be sought by FINRA Enforcement.

Endnotes

- 1 This *Regulatory Notice* is intended to provide member firms and their associated persons with guidance concerning the factors that FINRA Enforcement considers when assessing the sanctions it will seek in the context of settlement discussions that precede the filing of a formal disciplinary action. Nothing herein is intended to alter the guidance for adjudicators set forth in the *Principal Considerations in Determining Sanctions* contained in FINRA's Sanction Guidelines.
- 2 NASD Rule 8210.
- 3 The FINRA Sanction Guidelines recognize that certain proactive, corrective measures taken by firms and individuals involved in the disciplinary process may have an impact on sanction determinations. Specifically, the *Principal Considerations* under the Guidelines provide for consideration in determining sanctions of, among other factors, self-reporting, corrective measures, and restitution prior to detection by the firm (in the case of an individual) or by a regulator (in the case of a firm), as well as substantial assistance to FINRA in its examination and/or investigation of the conduct. These Guidelines and *Principal Considerations* provide a foundation for much of what we say here, although it is important to note that they apply, strictly speaking, to adjudicators in contested matters.

The relevant *Principal Considerations* that apply to adjudicators in determining sanctions in contested matters are:
 2. Whether an individual or member firm respondent accepted responsibility for and acknowledged the misconduct to his or her employer (in the case of an individual) or a regulator prior to detection and intervention by the firm (in the case of an individual) or a regulator.
 3. Whether an individual or member firm respondent voluntarily employed subsequent corrective measures, prior to detection or intervention by the firm (in the case of an individual) or by a regulator, to revise general and/or specific procedures to avoid recurrence of misconduct.
 4. Whether the respondent voluntarily and reasonably attempted, prior to detection and intervention, to pay restitution or otherwise remedy the misconduct.
 12. Whether the respondent provided substantial assistance to FINRA in its examination and/or investigation of the underlying misconduct, or whether the respondent attempted to delay FINRA's investigation, to conceal information from FINRA, or to provide inaccurate or misleading testimony or documentary information to FINRA.
- 4 NYSE Rule 351(a) and NASD Rule 3070(a) both require firms to report certain violations to FINRA but at different times. These rules will be harmonized in the rulebook consolidation project. The type of self-reporting contemplated as extraordinary and deserving of credit would go significantly beyond these regulatory requirements. For example, a firm may satisfy its reporting requirement under Rule 351(a) by filing a brief RE-3 with FINRA. Self-reporting deserving of credit for cooperation would, at a minimum, have to include a detailed account of the discovered conduct and an offer to explain in complete detail all aspects of the conduct and provide relevant documents. See, NYSE Information Memorandum 05-65.

Endnotes (cont'd)

- 5 See, e.g., *DOE v. Morgan Stanley DW, Inc.*, AWC Action No. EAF0301160001 (Aug. 1, 2005) (The press release states: "In sanctioning Morgan Stanley, NASD took into account the firm's demonstrable steps, undertaken shortly after NASD's inquiry began, to enhance its system and procedures and which led to the firm's identification and removal of large numbers of accounts for which the Choice program was not appropriate."); *DOE v. CIBC World Markets Corp.*, AWC Action No. 2006004464101 (Jan. 8, 2008) (The press release states: "The fine for CIBC was reduced in recognition of the firm's actions in reporting the problem to FINRA and taking prompt remedial actions to correct the problem.")
- 6 This is not meant to suggest that a firm or individual cannot defend an Enforcement investigation into deficient policies and procedures. A firm that believes its procedures are adequate and does not change them promptly or until the very end of an investigation should not expect to receive a sanction reflecting credit for extraordinary cooperation in any settlement.
- 7 See, e.g., *DOE v. Northwestern Mutual Investment Services, LLC*, AWC Action No. 2006005084401 (June 28, 2007) (The press release states: "NASD imposed a reduced fine in recognition of the firm's prompt remedial steps after an NASD examination to assess client harm and provide remediation to eligible clients.")
- 8 See, e.g., *DOE v. AXA Advisors, LLC* AWC Action No. 2005002269401 (Sept. 5, 2007) (The press release states: "FINRA ordered AXA Advisors to return \$1.4 million in fees to approximately 1800 customers. AXA Advisors voluntarily refunded an additional \$1.2 million to customers... AXA Advisors also unilaterally took steps to enhance its systems and procedures and to close accounts that were not appropriate for the fee based program.
- FINRA considered these steps in determining the sanctions in this case."); *DOE v. Banc of America Investment Services, Inc.*, AWC Action No. EAF0401010002 (Nov. 21, 2006) (The press release states: "In connection with the sanctions imposed in this AWC, NASD has taken into account certain demonstrable steps undertaken by BAIS, shortly after NASD issued Notice to Members 03-68, to update and enhance its systems and procedures relating to fee-based accounts. NASD also considered BAIS's self-reporting of certain conduct... [O]n its own initiative, BAIS identified the customers affected by this conduct and has reimbursed the customers the amounts they were charged for the transactions at issue.")
- 9 See, e.g., *DOE v. Instinet/Island*, AWC Action No. 2004200002601 (Oct. 3, 2005) and *DOE v. Piper Jaffrey*, AWC Action No. 2006006755701 (Dec 18, 2007). Firms often assert attorney-client privilege in connection with a firm's internal investigation. Such a firm could still receive credit for extraordinary cooperation if it found other ways to inform FINRA staff of pertinent facts without waiving the privilege. Indeed, consistent with FINRA's duty "to provide a fair procedure for the disciplining of members and persons associated with members," FINRA as a general matter recognizes the attorney-client privilege in its adjudicatory forum. Securities Exchange Act of 1934, 15 U.S.C. § 78(o)-3. Therefore, the waiver or non-waiver of the privilege itself will not be considered in connection with granting credit for cooperation. Moreover, it is not the waiver of attorney-client privilege that warrants credit for cooperation but rather the extraordinary assistance to the staff in uncovering the facts in an investigation that yields the benefit.

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FINRA Annual Conference

Washington, DC May 23 – 25, 2011

Litigation and Enforcement Case Trends

Tuesday, May 24

2:15 – 3:30 p.m.

Resources

- FINRA *Regulatory Notice 11-13, FINRA Revises Sanction Guidelines* (March 2011)
www.finra.org/Industry/Regulation/Notices/2011/P123374
- FINRA *Regulatory Notice 11-07, FINRA Revises Sanction Guidelines* (February 2011)
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