

BEFORE THE NATIONAL ADJUDICATORY COUNCIL  
FINANCIAL INDUSTRY REGULATORY AUTHORITY

In the Matter of the Continued Membership  
of  
Firm X  
with  
FINRA

Redacted Decision

Notice Pursuant to  
Rule 19h-1  
Securities Exchange Act  
of 1934

SD13001

Date: 2013

**I. Introduction**

On February 9, 2009, Firm X (“Firm X” or “the Firm”) submitted a Membership Continuance Application (“MC-400A” or “the Application”) with FINRA’s Department of Registration and Disclosure. The Application seeks to permit the Firm, a FINRA member firm subject to a statutory disqualification, to continue its membership with FINRA. A hearing was not held in this matter. Rather, pursuant to FINRA Rule 9523, FINRA’s Department of Member Regulation (“Member Regulation”) recommended that the Chair of the Statutory Disqualification Committee, acting on behalf of the National Adjudicatory Council, approve the Firm’s continued membership with FINRA pursuant to the terms and conditions set forth below.

For the reasons explained below, we approve the Firm’s Application.

**II. The Statutorily Disqualifying Event Underlying the Application**

The Firm filed the Application in connection with a statutorily disqualifying judgment entered by a United States District Court in 2008 (the “Judgment”). The Judgment, among other things, permanently enjoined the Firm from violating Section 15(c) of the Securities Exchange Act of 1934 (“Exchange Act”) and was based on a complaint issued by the Commission alleging that the Firm, in 2007 and 2008, mislead customers regarding the nature and risks of auction rate securities (“ARS”) that the Firm underwrote, marketed, and sold.<sup>1</sup> The complaint further alleged that the Firm misrepresented to its customers that ARS were safe, highly liquid investments and comparable to money market funds. The complaint also alleged that, after the ARS market began to deteriorate, the Firm increased its support of ARS by committing its own capital to help prevent those auctions from failing and although the Firm knew that the risk of failed auctions had materially increased, it did not timely and accurately disclose this information to its

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<sup>1</sup> Exchange Act Sections 3(a)(39) and 15(b)(4)(C) provide that a member firm is subject to statutory disqualification if it is enjoined from, among other things, engaging in any conduct or practice as a broker-dealer or in connection with the purchase or sale of any security.

customers. The complaint alleged that when the Firm stopped supporting ARS auctions and the markets subsequently failed, many customers were left with illiquid, long-term maturity ARS.

The Judgment, which the Firm consented to, required the Firm to comply with certain undertakings, including making offers to repurchase at par certain ARS from customers and paying customers who sold their ARS below par the difference between par and the sale price of the ARS. In connection with the Judgment, the Firm repurchased at par ARS from customers (including individual investors), and was required to use “best efforts” to provide liquidity opportunities to its institutional customers. In 2010, the Commission determined that the Firm had complied with the terms of the Judgment and that the Commission would not seek additional penalties against the Firm.

### **III. Background Information**

Firm X has been a FINRA member for more than 70 years. The Firm has approximately X branch offices, X of which are offices of supervisory jurisdiction (“OSJs”). The Firm employs approximately X registered individuals and X non-registered individuals.

Firm X has had its share of disciplinary infractions. Member Regulation has represented that, notwithstanding the Firm’s disciplinary and regulatory history, it satisfies the standard for continued membership in FINRA. As discussed below, we agree.

#### **A. Routine Examinations**

The Firm’s most recent Cycle Examination was conducted in 2011.<sup>2</sup> This examination resulted in FINRA issuing the Firm a Cautionary Action in 2012. The Cautionary Action cited the Firm for violations of the following securities rules and regulations: NYSE Rule 401A (Customer Complaints); NYSE Rule 35.80 (Notifications to Security Office and Return of Exchange-Issued Identification Cards); Exchange Act Rule 15c3-3(b)(2)/03 (Deliveries); Article V, Section 2 of FINRA’s By-Laws (Application for Registration); Article V, Section 3 of FINRA’s By-Laws (Notification by Member of Termination); NYSE Rule 351(d) (Reporting Requirements) and NASD Rule 3010 (Supervision); 31 CFR 103.122 (Customer Identification Programs for Broker-Dealers) and NASD Rules 3010 (Supervision) and 3110(c) (Customer Account Information); and Exchange Act Rules 15c3-1(c)(2)(iv)/04 (Assets Not Readily Convertible to Cash-Cash Surrender Value) and 15c3-1(c)(2)(vi) (Securities Haircuts) and FINRA Rule 4511 (Books and Records Requirements). The Firm stated that it corrected all deficiencies cited in the 2012 Cautionary Action.

In 2011, FINRA issued the Firm a Cautionary Action, which cited the Firm for violations of the following securities rules and regulations: Exchange Act Rule 15c3-1(c)(2)(iv)(C)/072

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<sup>2</sup> FINRA has not yet completed the Firm’s 2012 cycle examination. In addition, Member Regulation referred the Firm to the Department of Enforcement for exceptions related to MSRB Rule G-32, net capital, books and records, supervision, and controls. This remains pending.

(Intercompany Accounts with a Parent Bank) and NYSE Rules 342 (Offices-Approval, Supervision and Control) and 440 (Books and Records); Exchange Act Rules 15c3-1(c)(2)(iv)(E) (Other Deductions) and 15c3-3 (Exhibit A-General)/08 (Other Credits or Values Includible-Regardless of Allocation); Exchange Act Rules 15c3-3(b)(2)/021 (Turnarounds-Non Availability) and 15c3-3(d)(1)/101 (Securities Loans Recalls-Elective Procedure); Exchange Act Rule 15c3-3 (Exhibit A-Item 8/01) (Suspense Accounts); Exchange Act Rule 10b-10(a) (Disclosure Requirement); NYSE Rules 351(d) (Reporting Requirements) and 401A (Customer Complaints); Article V, Section 2 of FINRA's By-Laws (Application for Registration); Exchange Act Rule 17a-4(f)(2) (Records to Be Preserved by Certain Members, Brokers & Dealers); NYSE Rule 35.80 (Notifications to Security Office and Return of Exchange-Issued Identification Cards); and Exchange Act Rule 17a-5(a) (Filing of Monthly and Quarterly Reports). The Firm stated that it corrected all deficiencies cited in the 2011 Cautionary Action.

In 2010, Member Regulation issued the Firm a Cautionary Action.<sup>3</sup> The Cautionary Action cited the Firm for violations of the following securities rules and regulations: Rule 200(g) of Regulation SHO (Order Marking Requirements); Exchange Act Rules 15c3-3 (Exhibit A-Item 1)/02 (Non-Regulated Commodity Accounts) and Exhibit A-Item 2/032 (Commingled Collateral as Options Clearing Corporation Margin Deposit); Exchange Act Rules 17a-3 (Records to be Made by Certain Exchange Members, Brokers and Dealers) and 17a-5 (Reports to be Made by Certain Brokers and Dealers), NYSE Rule 342 (Offices-Approval, Supervision and Control) and NYSE Rule 440 (Books and Records), and NASD Rule 3010 (Supervision); Article V, Section 2 of FINRA's By-Laws (Application for Registration); Exchange Act Rule 17a-3 (Records to be Made by Certain Exchange Members, Brokers & Dealers); NYSE Rule 342.16 (Supervision of Registered Representatives) and NASD Rule 3010(d)(2) (Review of Correspondence); NASD Rule 3070(c) (Reporting Requirements) and NYSE Rule 351(d) (Reporting Requirements) and NYSE Rule 401A (Customer Complaints). The Firm stated that it corrected all deficiencies cited in the 2010 Cautionary Action.

## B. Regulatory Actions

Since 2008, Firm X has had more than 80 disclosable regulatory events, the majority of which relate to the failure of the Firm's ARS market. With the exception of one matter described below, FINRA's Central Registration Depository ("CRD"®) indicates that these matters have been resolved by the Firm. We discuss below the more recent regulatory actions involving the Firm.

In 2012, Firm X entered into a Letter of Acceptance, Waiver and Consent ("AWC") with FINRA for violations of FINRA Rules 2010 and 6730, NASD Rules 2110, 2320, 2440, 3110, and 6230 and IM-2440, MSRB Rules G-14, G-17, and G-30, and Exchange Act Rule 17a-3.

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<sup>3</sup> The Firm also received a letter of admonition, which concerned a violation of NYSE Rule 132 (Comparison and Settlement of Transactions Through a Fully-Interfaced or Qualified Clearing Agency) based on a review of the NYSE Audit Trail report that disclosed improperly coded trades.

Without admitting or denying the allegations set forth in the complaint, the Firm consented to findings that it: failed to comply with rules and regulations regarding reporting to FINRA's Trade Reporting and Compliance Engine ("TRACE") and the Real-Time Transaction Reporting System; failed to use reasonable diligence to ascertain the best inter-dealer market and failed to buy or sell in such market so that the resulting price to its customers was as favorable as possible; purchased municipal securities for its own account from a customer or sold such securities for its own account to a customer at a price that was not fair and reasonable; and sold or purchased corporate bonds to or from customers at prices that were not fair. As a result, FINRA censured the Firm, fined it \$900,000, and ordered that it pay restitution of \$32,356.

In 2012, Firm X entered into an AWC with FINRA for violations of FINRA Rule 2010, NASD Rules 2110, 3010, and 3110, and Exchange Act Rules 17a-3 and 17a-4. Without admitting or denying the allegations set forth in the complaint, the Firm consented to findings that it, among other things, failed to maintain accurate performance data and static pool information in connection with certain mortgage securitizations and failed to establish and maintain effective supervisory and operational policies and procedures regarding these and other matters. As a result, FINRA censured the Firm and fined it \$3.5 million.

In 2012, Firm X entered into another AWC with FINRA for violations of FINRA Rule 2010 and NASD Rules 2110, 2310, and 3010. Without admitting or denying the allegations set forth in the complaint, the Firm consented to findings that it failed to establish and maintain a supervisory system reasonably designed to comply with securities rules in connection with the sale of non-traditional exchange-traded funds and failed to provide adequate training to its registered representatives regarding these products. The AWC also found that certain Firm representatives made unsuitable recommendations. As a result of these findings, FINRA censured the Firm, fined it \$2 million, and ordered that it pay restitution of \$146,431.

In 2012, the Firm, without admitting or denying any allegations, consented to a cease and desist order with State 1 for allegations relating to the failure of the Firm's ARS market. State 1 fined the Firm \$134,075 and ordered it to comply with various undertakings.

In 2012, the Firm entered into an AWC with NASDAQ for violations of NASDAQ Rules 4755 and 6955. Without admitting or denying the allegations of the complaint, the Firm consented to findings that it failed to transmit certain reports to the Order Audit Trail System ("OATS"), reported inaccurate information on OATS reports, and entered orders into the NASDAQ Market Center that failed to indicate whether the orders were a buy, short sale, or long sale. As a result, NASDAQ censured the Firm and fined it \$20,000.

In 2012, the Firm entered into an AWC with FINRA for violations of FINRA Rule 2010 and NASD Rules 2110, 2711, and 3010. Without admitting or denying the allegations of the complaint, the Firm consented to findings that certain research reports failed to contain required disclosures and that the Firm failed to have adequate supervisory procedures in connection therewith. As a result, FINRA censured the Firm and fined it \$725,000.

In 2011, the Firm entered into an AWC with FINRA for violations of Exchange Act Rule 17a-4, FINRA Rule 2010, and NASD Rules 2110, 3010, and 3110. Without admitting or

denying the allegations of the complaint, the Firm consented to findings that it failed to retain emails for a 14-month period and failed to establish and maintain appropriate systems and procedures to comply with recordkeeping rules. The AWC further found that the Firm failed to detect and remedy defects in its email retention system. As a result, FINRA censured the Firm and fined it \$750,000.

In 2011, the Firm entered into a Stipulation and Consent with the New York Stock Exchange for violations of Rule 203(b)(1) of Reg SHO by accepting a short sale order in an equity security from another person, or effecting a short sale in an equity security for its own account, without locating a sufficient number of shares. The Firm neither admitted nor denied the allegations of such findings, and NYSE censured the Firm and fined it \$7,500.

In 2011, the Firm entered into an AWC with FINRA for violations of MSRB Rule G-27. Without admitting or denying the allegations of the complaint, the Firm consented to findings that it failed to establish and maintain a supervisory system and written supervisory procedures (“WSPs”) reasonably designed to achieve compliance with disclosure requirements for municipal securities transactions. As a result, FINRA censured the Firm, fined it \$75,000, and ordered that the Firm review its supervisory procedures.

In 2011, the Firm entered into a consent order and agreed to a final judgment in connection with a complaint filed against it by the Commission. The complaint alleged that certain of the Firm’s marketing materials for residential mortgage-backed securities were materially misleading. Specifically, the complaint alleged that when the U.S. housing market was showing signs of distress, the Firm structured and marketed an approximately \$1 billion collateralized debt obligation (“CDO”) and exercised significant influence over the selection of half of the assets included in the CDO. The complaint further alleged that the Firm then took a proprietary short position with respect to those assets and did not disclose to investors the role it played in the asset selection process and its short position. This matter is not yet final and remains pending.

In 2011, the Firm entered into an AWC with FINRA for violations of Exchange Act Section 17(a), Exchange Act Rule 17a-3, and NASD Rules 3010, 3012, and 3110. Without admitting or denying the allegations of the complaint, the Firm consented to findings that it failed to detect or respond adequately to a series of red flags that a registered representative was improperly using customer funds. As a result, FINRA censured the Firm and fined it \$500,000.

In 2011, the Firm, without admitting or denying any allegations, consented to a cease and desist order with State 2 for allegations relating to the failure of the Firm’s ARS market. State 2 fined the Firm \$1,048,229 and ordered it to comply with various undertakings.

In 2011, the Firm consented to an order to settle allegations by State 3 that the Firm allowed a representative to establish an account for one of his customers without verifying certain information with the customer. Without admitting or denying the allegations, the Firm consented to an order to cease from future violations and paid costs and fees totaling \$26,000.

In 2011, the Firm entered into an AWC with FINRA for violations of FINRA Rule 2010 and NASD Rules 2830 and 2110. Without admitting or denying the allegations of the complaint, the Firm consented to findings that it failed to include a required legend on certain customers' unit investment trust purchase confirmations disclosing deferred sales charges. As a result, FINRA censured the Firm, fined it \$25,000, and required the Firm to amend its confirmations to include specific disclosures concerning deferred sales charges.

In 2011, the Firm consented to a cease and desist order with the State of Ohio for allegations relating to the failure of the Firm's ARS market. The Firm was fined \$919,280 and agreed to various undertakings.

In 2010, the Firm entered into a stipulation and consent agreement with the State 4 Insurance Department. The Firm admitted that it did not, in certain instances, present complete, accurate, or timely disclosure statements to customers in variable annuity transactions, did not adequately process and resolve customer complaints regarding the sale of life insurance policies and annuity contracts, and made unsuitable recommendations of such products. The Firm was fined \$2 million and agreed to various undertakings.

In 2010, the Firm consented to a cease and desist order with the State of Illinois for allegations relating to the failure of the Firm's ARS market. The Firm was fined \$4.525 million and agreed to various undertakings.

In 2010, the Firm, without admitting or denying any allegations, consented to a cease and desist order with State 5 for allegations relating to the failure of the Firm's ARS market and the Firm's failure to maintain tape recordings from its auction desk. State 5 fined the Firm \$150,507, and the Firm agreed to comply with certain undertakings.

In 2010, the Firm consented to a censure and \$300,000 fine imposed by the New York Stock Exchange. Without admitting or denying any allegations, the Firm consented to findings that it failed to supervise the activities of a trader at the Firm, in violation of NYSE Rule 342.

In 2010, the Firm entered into an AWC with FINRA for violations of Exchange Act Rule 17a-3, SEC Rule 604 of Regulation NMS, NASD Rules 2110, 2111, 2320, 3110, 3220, 4632A, 4632, 6130, 6230, and 6955, and MSRB Rules G-17 and G-30. Without admitting or denying the allegations of the complaint, the Firm consented to findings that it, among other things: failed to timely and correctly report transactions to TRACE; failed to execute orders fully and promptly; failed to use reasonable diligence to ascertain the best inter-dealer market and failed to buy or sell in such market so that the price to its customer was as favorable as possible under prevailing market conditions; purchased municipal securities for its own account from a customer or sold securities for its own account to a customer at an aggregate price that was not fair and reasonable; failed to transmit certain reportable order events to OATS and transmitted inaccurate reports to OATS; and failed to accurately report transactions to the NASDAQ Market Center or the FINRA/NASDAQ Trade Reporting Facility. As a result, FINRA censured the Firm, fined it \$400,000, and ordered that it pay \$10,100 in restitution.

In 2010, the Firm consented to an order with State 6 requiring the Firm to pay a \$400,000

fine, pay \$142,000 in restitution, and pay investigation costs of \$175,000. The Firm settled allegations that it failed to adequately supervise a registered representative.

In 2010, the Firm, without admitting or denying any allegations, entered into a consent order with State 7 to settle allegations that the Firm failed to properly supervise its representatives and their handling of certain brokerage accounts. Firm X was assessed the costs of the investigation, which amounted to \$125,000, and agreed to refrain from future violations of the State 7 Uniform Securities Act.

In 2010, Firm X, without admitting or denying any allegations, agreed to a consent order with State 8 in which it consented to a finding that it failed to supervise one of its registered representatives. State 8 censured the Firm, ordered that it pay \$195,000 in restitution, \$75,000 to the State's Investor Education and Protection fund, and \$3,750 in costs.<sup>4</sup>

#### **IV. The Firm's Proposed Continued Membership with FINRA and Proposed Supervisory Plan**

Firm X seeks to continue its membership with FINRA notwithstanding the Judgment. The Firm included a "supervisory plan" with the Application to address deficiencies relating to the underlying cause of the statutory disqualification. The plan discusses a number of measures that Firm X represents it has undertaken in connection with the events underlying the statutory disqualification.

Specifically, the Firm represents that, in 2009, it created a firm-wide organization in its Risk Management division called the Investment Products Risk organization which, in turn, drafted the Retail Distribution of Investment Products and Services ("RDIP") Policy and Standards. As stated in the plan, the RDIP Policy and Standards (which were adopted by the Firm in 2011) establish consistent requirements for investment and product ratings and an investment decision framework to assist the Firm's financial advisors and other client relationship professionals in assessing the suitability and appropriateness of investments. The RDIP Policy and Standards also specify minimum training that must be completed by financial advisors and other client relationship professionals in order to sell complex investment products to retail investors. Further, as part of the RDIP project, the Firm created two sub-organizations that set standards concerning the creation and distribution of retail investment products. Specifically, the Manufacturing Product Approval Committee determines whether a product

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<sup>4</sup> Additionally, pursuant to an order in 2006, the Commission found that Firm X and other broker-dealers willfully violated Section 17(a)(2) of the Securities Act of 1933 (the "Securities Act"). The Commission found that from at least 2003, through 2004, Firm X engaged in misconduct related to ARS auctions that violated Securities Act Section 17(a). The Commission censured the Firm, ordered that it cease and desist from committing or causing any violations of Securities Act Section 17(a)(2), and fined it \$1.5 million. This 2006 Order rendered Firm X statutorily disqualified pursuant to Exchange Act Sections 3(a)(39)(F) and 15(b)(4)(D), although no notice proposing that the Firm continue to be associated with FINRA notwithstanding its disqualification was required to be filed with the Commission because the sanction related to that order was no longer in effect. *See* Exchange Act Rule 19h-1(a)(3)(iii)(B).

created by a “Firm X manufacturing business” may be offered to individual investors, and the Distribution Product Approval Committee must review and approve any new product or service before it is offered to retail investors. The Distribution Product Approval Committee may also promulgate additional required training for new products.

Similarly, the Firm’s Institutional Client Group implemented new policies and procedures and revised existing policies and procedures relating to institutional clients. According to the plan, the Firm implemented a system enhancement in 2010 to enable financial advisors and sales teams to more efficiently identify material events filed with the MSRB’s EMMA system that may be necessary to communicate to investors.

Additionally, the plan describes the manner in which the Firm enhanced its disclosures and oversight concerning municipal securities (including ARS) and the changes to its ARS-related practices and procedures. The plan also provides an overview of the changes in Firm personnel with ARS-related responsibilities since 2008, as well as an overview of the Firm’s current ARS-related staffing and organizational structure. The Firm represents that “[t]hose who had primary responsibility for ARS trading before [failures of the Firm’s ARS auctions in 2008] have either left the firm or no longer have ARS responsibility.”

Member Regulation has represented that subsequent to any approval of the Firm’s continued membership in FINRA notwithstanding its statutory disqualification, FINRA staff’s first examination of the Firm will evaluate whether it has complied with the proposed plan as described herein. After the Firm’s initial examination, FINRA will determine whether to subject the plan to further review, considering (among other things) FINRA’s overall risk-based assessment of the Firm.

## **V. Discussion**

Member Regulation recommends approval of the Firm’s request to continue its membership in FINRA. After carefully reviewing the entire record in this matter, we approve the Firm’s Application.

In evaluating an application like this, we assess whether the statutorily disqualified firm seeking to continue its membership in FINRA has demonstrated that its continued membership is consistent with the public interest and does not create an unreasonable risk of harm to the market or investors. *See* FINRA By-Laws, Art. III, Sec. (3)(d); *cf. Frank Kufrovich*, 55 S.E.C. 616, 624 (2002) (holding that FINRA “may deny an application by a firm for association with a statutorily-disqualified individual if it determines that employment under the proposed plan would not be consistent with the public interest and the protection of investors”). Factors that bear on our assessment include the nature and gravity of the statutorily disqualifying misconduct, the time elapsed since its occurrence, the restrictions imposed, and whether there has been any intervening misconduct.

We recognize that the Judgment involved serious violations of securities rules and regulations. The Commission found, however, that the Firm has fully complied with all of the



terms of the Judgment, including the various undertakings required of it.<sup>5</sup> The Firm also represents that Firm X personnel having primary responsibility for ARS prior to the events underlying the statutory disqualification are either no longer with the Firm or are no longer responsible for ARS at the Firm. The Firm further represents that it has enhanced and updated its policies and procedures concerning ARS. The plan sets forth extensive provisions regarding, among other things, future sales of products such as ARS to retail customers and additional training for firm personnel concerning complex products such as ARS. Moreover, Firm X has established organizations and procedures within the Firm to assess and evaluate the appropriateness of investment products and whether certain products may be offered to individual investors.

We further find that although the Firm has disciplinary history, the record shows that it has taken corrective actions to address noted deficiencies. Further, since the Judgment and related state securities-regulator actions, FINRA's examinations of the Firm have not detected repeat violations in this area. We agree with Member Regulation that Firm X's disciplinary history should not prevent it from continuing as a FINRA member.

At this time, we are satisfied, based in part upon the Firm's representations concerning its compliance with the plan, Member Regulation's representations concerning FINRA's future monitoring of the firm, and the record currently before us, that the Firm's continued membership in FINRA is consistent with the public interest and does not create an unreasonable risk of harm to the market or investors. Accordingly, we approve the Firm's Application to continue its membership in FINRA.

FINRA certifies that the Firm meets all qualification requirements and represents that it is registered with several other self-regulatory organizations, including AMEX, CBOE, CHX, ISE, NSX, NYSE, NYSE ARCA, NQX, and BATS. The Firm also represents that it employs a number of individuals who are subject to a statutory disqualification.

Accordingly, we approve the Firm's Application to continue its membership in FINRA as set forth herein. In conformity with the provisions of SEC Rule 19h-1, the continued membership of the Firm will become effective within 30 days of the receipt of this notice by the Commission, unless otherwise notified by the Commission.

On Behalf of the National Adjudicatory Council,

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Marcia E. Asquith  
Senior Vice President and Corporate Secretary

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<sup>5</sup> We have also considered that the Commission, in connection with the Judgment, has granted the Firm certain waivers, exemptions, and "no-action" relief under the Exchange Act, the Securities Act, the Investment Advisers Act of 1940, the Investment Company Act of 1940, and the rules and regulations promulgated thereunder.