

BEFORE THE NATIONAL ADJUDICATORY COUNCIL
FINANCIAL INDUSTRY REGULATORY AUTHORITY

In the Matter of the Continued Membership of Firm X with FINRA	<u>Redacted Decision</u> <u>Notice Pursuant to</u> <u>Rule 19h-1</u> <u>Securities Exchange Act</u> <u>of 1934</u> <u>SD13005</u> Date: 2013
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I. Introduction

On July 23, 2010, 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 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 as a result of a judgment entered against it in a United States District Court in July 2010 (the “Judgment”), which resulted in the Firm being statutorily disqualified. The Judgment, among other things, permanently enjoined the Firm from violating Section 17(a) of the Securities Act of 1933 (the “Securities Act”).¹ The Judgment was based on a complaint filed by the SEC alleging that the Firm and an employee made material and misleading statements and omissions in connection with a synthetic collateralized debt obligation (“CDO”), which the Firm structured and marketed to investors. The CDO was tied to the performance of certain underlying subprime residential mortgage-backed securities (“RMBS”). The complaint further

¹ Sections 3(a)(39) and 15(b)(4)(C) of the Securities Exchange Act of 1934 (“Exchange Act”) 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.

alleged that all marketing materials for the CDO represented that the underlying RMBS were selected by a third-party with experience analyzing credit risks in RMBS. The marketing materials failed to disclose that a hedge fund with economic interests directly adverse to investors' interests in the CDO (i.e., a short position), played a significant role in the selection of the underlying RMBS. Subsequently, the underlying RMBS were downgraded, which resulted in a loss to the CDO investors and a corresponding gain to the hedge fund.

The Judgment ordered that the Firm disgorge \$X million and pay a civil penalty. The Judgment also required the Firm to comply with certain undertakings for three years from the date of the Judgment, including: (i) expanding the role of its Capital Committee in the vetting and approval process for offerings of residential mortgage-related securities; (ii) requiring the Firm's legal and compliance department to review all written marketing materials used in connection with mortgage securities offerings; and (iii) requiring the Firm's outside counsel to review the term sheets, the offering circular or prospectus, and any other marketing materials used in connection with the offering.

In accordance with the Judgment, the Firm has submitted its required annual certifications as to its compliance in all material respects with the undertakings for the years 2011 and 2012. The Firm has paid the civil penalty and disgorgement amounts under the Judgment.

III. Background Information

The Firm has been a FINRA member since 1936. It has X branch offices, X of which are offices of supervisory jurisdiction. The Firm employs approximately X registered individuals and approximately X non-registered individuals.

The Firm has several past 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. Recent Routine Examinations

Preliminary examination findings for the Firm's 2012 cycle examination were recently conveyed to the Firm at an exit meeting, and FINRA has issued an examination report to the Firm that noted several exceptions. Although the Firm has not yet responded in writing to the findings, Member Regulation represents that it is not aware of any issues that would materially alter its recommendation.

In June 2012, FINRA issued the Firm a Cautionary Action, which cited the Firm for the following violations: (1) failure to maintain an adequate process to review intercompany account activity for netting purposes; (2) failure to notify FINRA of changes made to its portfolio margin program; (3) failure to timely report customer settlements; and (4) inadequate disclosures of primary offerings for municipal securities.

The Firm stated that it corrected all deficiencies cited in the Cautionary Action.

In June 2011, FINRA issued the Firm a Cautionary Action, which cited the Firm for the following violations: (1) failure to properly identify client specific balances and securities positions on Firm FOCUS reports; (2) delivery violations in connection with manual adjustments to two securities; (3) failure to properly calculate net capital; (4) failure to offer periodic training on confidentiality requirements of Designated Market Maker information, non-public order information, and material non-public confidential information; (5) failure to maintain adequate written supervisory procedures (“WSPs”) for record retention; (6) failure to timely and accurately report customer complaints and settlements; (7) failure to timely deliver an MSRB Investor Brochure; and (8) failure to keep current for registered representatives at the Firm Uniform Applications for Securities Industry Registration or Transfer.² The Firm stated that it corrected all deficiencies cited in the Cautionary Action.

B. Recent Regulatory Actions

Since the date of the Judgment, the Firm has had one action related to the Judgment. In October 2010, the Firm entered into a Letter of Acceptance, Waiver and Consent (“AWC”) with FINRA. Without admitting or denying the allegations, the Firm consented to findings that it violated NASD Rule 3010 and FINRA Rule 2010 concerning its failure to disclose the SEC’s investigations of employees involved in the CDO transactions that were subject to the statutorily disqualifying event. As a result, FINRA censured the Firm, fined it \$650,000, and ordered that it comply with undertakings related to its WSPs.

Additionally, during the past two years, the Firm has been the subject of a number of regulatory actions. Most recently, in 2013, the Firm entered into three AWCs with FINRA, an AWC with the NASDAQ Stock Market, a Letter of Consent with the Chicago Board of Trade, and a consent order with the Chicago Mercantile Exchange related to the Firm’s failure to meet certain transaction reporting obligations and related supervisory issues. The Firm was censured and paid fines totaling \$129,000 in connection with these matters.

² This examination also resulted in a referral to Market Regulation for improperly coding an error transaction in the Firm’s error account, in violation of NYSE Rule 132.30(9). This matter is currently pending.

The following summarizes other notable regulatory actions against the Firm during the past two years.³

In December 2012, the Firm entered into an AWC with FINRA for violations of MSRB Rules G-17 and G-27. Without admitting or denying the allegations, the Firm consented to findings that it unfairly requested and received reimbursements for certain State 1 Public Securities Association underwriting assessments and that the Firm failed to establish and maintain a supervisory system with WSPs reasonably designed to achieve compliance with disclosure requirements for municipal securities transactions. As a result, FINRA censured the Firm, fined it \$568,000, and ordered it to pay restitution in the amount of \$115,997.50 to the applicable issuers in State 1. The AWC also ordered the Firm to complete a review of its relevant WSPs and supervisory systems and to certify that it implemented necessary revisions to such procedures.

In December 2012, without admitting or denying the allegations, the Firm consented to the entry of an order with the CFTC for allegations relating to its risk management, compliance, and supervision programs, in violation of CFTC regulation 166.3. The CFTC imposed various undertakings and a civil monetary penalty in the amount of \$1.5 million.

From July to September 2012, the Firm entered into agreements with eight national securities exchanges (NASDAQ Options Market, NASDAQ OMX BX, NASDAQ OMX PHLX, the International Securities Exchange, BATS-Z Exchange, NYSE AMEX, NYSE ARCA, and the Chicago Board Options Exchange) for violating various rules of these exchanges as well as Exchange Act Section 17(a) and Rule 17a-3 thereunder, by improperly marking certain options orders as “customer” orders through various proprietary order entry systems employed by the Firm to send options orders to the respective exchanges. The Firm also failed to remediate certain coding deficiencies and to have supervisory systems in place reasonably designed to achieve compliance with each of the exchange’s origin code requirements. The Firm was censured and fined a total of \$6.75 million by the eight exchanges.

In September 2012, without admitting or denying the allegations, the Firm consented to a cease and desist order with the SEC for violating Exchange Act Section 15B(c)(1) and MSRB Rules G-8, G-9, G-17, G-27 and G-37 for failing to report and maintain records of political contributions and campaign work, as well as the failure to take steps to ensure that the attributed political contributions, campaign work, or related conflicts of interest were disclosed in bond offering documents. As a result, the SEC censured the Firm, ordered it to pay disgorgement in the amount of \$7,558,942 and prejudgment interest of \$670,033.

³ We agree with Member Regulation’s focus on the Firm’s regulatory actions that occurred between April 2011 and April 2013 and resulted in fines of \$100,000 or more, and discuss these matters herein.

In April 2012, without admitting or denying the allegations, the Firm entered into an AWC with FINRA, and it also agreed to a related consent order with the SEC, for violating Exchange Act Section 15(g), NASD Rules 3010 and 2110, and FINRA Rule 2010, by institutionalizing trading practices and data sharing in so-called “trading huddles” without establishing adequate policies, procedures and controls and for failing to adequately supervise research analyst communications. The Firm also violated FINRA Rules 5280 and 2010 by failing to establish and maintain policies and procedures reasonably designed to prevent trading ahead of research reports. As a result, the Firm was censured and fined \$22 million, and ordered to comply with various undertakings.

In June 2011, without admitting or denying the allegations, the Firm entered into a consent order with the State 2 Securities Division for alleged violations of Sections 204(A)(2)(G) and 204(A)(2)(J) of the State 2 Uniform Securities Act for failing to: (1) establish an adequate supervisory process to identify and manage conflicts of interests related to its research services; (2) have adequate procedures in place for the dissemination of certain information by equity analysts; (3) reasonably supervise equity analysts; (4) prevent the use and dissemination by equity analysts of certain information; and (5) deal fairly and objectively with all clients in connection with the dissemination of certain information by equity analysts. The Firm was fined \$10 million.

In connection with a global settlement in 2008, the Firm entered into various consent orders with state regulators for allegedly engaging in unethical practices in the offer and sale of auction rate securities (“ARS”) and failing to adequately supervise the marketing and sale of ARS. During the past two years, the Firm settled with state regulators for amounts ranging from \$47,378.98 to \$1,755,209.90.

IV. The Firm’s Proposed Continued Membership with FINRA and Proposed Supervisory Plan

The Firm seeks to continue its membership with FINRA notwithstanding the Judgment that triggered its statutory disqualification. The Firm included a supervisory plan with the Application to address deficiencies relating to the underlying cause of the statutory disqualification, which sets forth the following general categories where the Firm represents it has undertaken significant efforts to enhance compliance and supervision: (1) governance; (2) controls; (3) training and communications; and (4) policies and procedures. These enhancements include the recommendations of the Business Standards Committee (“BSC”) of the Firm’s parent company.

With respect to governance, the Firm represents that the parent company created a number of new committees, which impact the day-to-day operations of the Firm. These committees include: (1) the Committee Operating Group, which sets standards for the establishment of new committees, requirements of committee charters, policies and procedures for committee structure and operations, reporting requirements and other committee governance policies and procedures, and requires each subject committee to conduct an annual performance evaluation of its activities and effectiveness; (2) the Event Review Group, which performs a limited number of time-sensitive, high-profile

targeted reviews of certain incidents or other significant matters of concern and documents and disseminates its findings to the appropriate committees or other employees; (3) the Client and Business Standards Committee, which focuses the parent company's committees on the interrelationship between client service, business practices and reputational risk management; (4) the Divisional and Regional Client and Business Standards Committees, which are accountable for client service, business standards and reputational risk management; (5) the Suitability Committee, which is responsible for setting standards and policies for product, transaction and client suitability to promote consistency across divisions, regions and products regarding suitability assessments, reviewing suitability matters escalated by certain other committees and for overseeing certain other related committees;⁴ and (6) the New Activity Committee, which is responsible for reviewing and approving new activities and, where necessary, imposing conditions on the activity or preliminary tasks prior to commencement of the activity.

With respect to controls, the Firm represents that it has conducted supervisory mapping; has adopted policies and procedures relating to information barriers, origination and underwriting; and has adopted review procedures for written communications. Specifically, the Firm has established a consistent and maintainable process of mapping every employee to a supervisor (and to the applicable compliance officer responsible for coverage of the employee) within each revenue-producing division; implemented a management information system to provide supervisors in revenue-producing divisions with information concerning each supervised employee's compliance with certain Firm and regulatory requirements; adopted procedures to ensure that informational wall-crosses will be subject to approval by a senior supervisor not directly involved in the transaction or project; implemented new policies and procedures that apply to all newly issued securities created within the Securities Divisions and offered or sold by the Firm by the means of an offering document, whether issued by the Firm, an affiliate, or a third party; and implemented a certification policy that requires Securities Division personnel to submit certain written communications into a review system before any external or broad internal dissemination.

With respect to training and communications, the Firm represents that it has enhanced its training and development programs regarding conflicts resolution and structured products, and has thus far developed more than 35 new training programs specifically meant to address the recommendations of the BSC while integrating content from the BSC report into more than 90 existing training and professional development programs. The Firm also updated its Restricted Trading List ("RTL") Policy pertaining to underwriting and advisory assignments to restrict Securities Division and Private Wealth Management personnel from disseminating broadly to clients written sales communications either (1) recommending an investment or transaction subject to the RTL Policy, or (2) expressing a view regarding the issuer or client, its securities or other

⁴ The Suitability Committee generally reviews complex, strategic transactions on a weekly basis.

financial instruments, or regarding other affected transaction parties and their securities or their other instruments for certain periods of time. The Firm also created a forum to conduct in-depth discussions and case studies.

Finally, the Firm represents that it has enhanced its policies and procedures. For example, the Firm published a new Code of Business and Ethics that added sections and guidance on personal conflicts of interest, corporate opportunities, fair and ethical competition, the protection of confidential information, public disclosure, equal employment opportunities and diversity, political contributions, and the protection and proper use of Firm assets. Employees are required to certify each year that they have read and will comply with this code. Further, the Firm updated and implemented the Conflicts Clearance Policy and Procedures to enhance the Firm's conflicts-related protocol for various divisions. The Firm also updated its due diligence and approval guidelines for complex and strategic transactions, which are subject to heightened review depending on the type of product and the client segment.

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. 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 record shows, however, that the Firm has to date fully complied with all of the terms of the Judgment. The Firm has paid all amounts due under the Judgment, and has submitted to the SEC its required annual certifications to its compliance in all material respects with the undertakings for the years 2011 and 2012. The Firm also

represents that it has undertaken significant efforts to enhance compliance and supervision at the Firm, including with respect to Firm governance, controls, training and communications, and policies and procedures. The Firm's plan sets forth extensive provisions regarding these matters. The Firm also represents that it has enhanced and updated its policies and procedures, including those related to residential mortgage-related securities, to address deficiencies related to the Judgment.⁵

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 the Firm'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 NSX and NYSE ARCA, as well as AMEX, CBOE, CHX, ISE, NYSE, NQX, NASDAQ OMX PHLX, NASDAQ OMX BX, NASDAQ LMX BX, NASDAQ LMX Futures Exchange, BATS, DTC, NSCC, and FICC, which concur with the Firm's proposed continued membership.

⁵ We have also considered that the SEC, 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.

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 SEC, unless otherwise notified by the SEC.

On Behalf of the National Adjudicatory Council,

Marcia E. Asquith
Senior Vice President and Corporate Secretary