Enforcement Case Trends
Wednesday, May 23
9:00 a.m. – 10:15 a.m.

After this program, you will be able to:

- Discuss FINRA Enforcement priority program areas and recent trends in disciplinary actions to assist in focusing compliance efforts.
- 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.
- Summarize the investigation and disciplinary process to assist you in preparing for an investigation or disciplinary action.

Moderator: J. Bradley Bennett
Executive Vice President
FINRA Enforcement

Panelists: Gloria Greco
Managing Director
Bank of America

Thomas Lawson
Vice President and Chief Counsel
FINRA Enforcement

Susan Light
Senior Vice President
FINRA Enforcement

Pamela K. Ziermann
Senior Vice President, Compliance
Dougherty Financial Group LLC

Outline

FINRA Enforcement priorities

- Program changes
- Substantive priorities

Preparing for an enforcement investigation / proceeding

- What should be handled in-house as compared to what should be outsourced (issues, including independence, cost considerations, other considerations)
- Responding to information requests

Compliance trends – issues drawn from Enforcement investigations and actions

- Compliance areas of interest to small firms, including those areas where FINRA has found trends in enforcement cases / actions

Hot topics

- Managing responsibilities when associated person serves multiple functions at the firm
- FINRA Rule 4530 (self reporting) and impact on credit for cooperation / self-reporting
- Disciplinary actions against compliance professionals
- Sanction trends

Speaker Biographies

J. Bradley 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 law degree from Georgetown University Law Center.

Gloria Greco is Managing Director and the head of compliance for the Global Wealth & Investment Management organization at Bank of America. Ms. Greco also serves as co-Chief Compliance Officer for Merrill Lynch, Pierce, Fenner and Smith Incorporated. The team Ms. Greco leads performs various compliance functions related to the businesses serving retail clients, including providing advice to business management; participating in the management and governance of routines, developing compliance policies, training and supervisory controls; implementing independent testing and monitoring programs; and coordinating regulatory activities. The team also develops formal rule inventories, identifies key controls, conducts risk assessments and monitors regulatory changes to ensure appropriate modifications to the business and related controls are implemented. Ms. Greco specializes in topics related to broker-dealer and investment management regulations, and has experience dealing with compliance topics involving a broad array of investment and banking products, including investment advisory programs, mutual funds, alternative investments (private equity, hedge funds, commodities, real assets), structured investments, debt and equity products (new issue and secondary trading), insurance and annuities, lending and deposit banking products, foreign exchange, and options. Among her other areas of expertise are intellectual property rights and contract law, and compliance with anti-bribery, economic sanctions, campaign finance and anti-money laundering laws, ethical decision-making and managing conflicts of interest. Ms. Greco has a bachelor's of business administration degree in management from Pace University and a law degree from Brooklyn Law School, and is admitted to the New York State Bar. During her long career starting at Merrill Lynch, Ms. Greco has held positions in various areas, including accounting, finance, purchasing, and technology. For the past eighteen years, she has worked as a legal and compliance professional in a variety of disciplines, handling diverse matters and holding various leadership positions. Ms. Greco serves on industry committees and panels, including the SIFMA Compliance & Regulatory Policy Committee and the FINRA Compliance Advisory Committee.

Thomas B. Lawson is Vice President and Chief Counsel in the Department of Enforcement at the Financial Industry Regulatory Authority in Washington, D.C. Before working at FINRA, Mr. Lawson spent 11 years with the Division of Enforcement of the U.S. Securities and Exchange in Washington, D.C., serving the last three-and-one-half years as an assistant director in the Enforcement Division. He is a graduate of Hofstra University School of Law and Union College.

Susan Light has been Senior Vice President in the FINRA Department of Enforcement since the integration of NASD and portions of NYSE Regulation on July 30, 2007. Prior to the consolidation, she served as senior vice president and department head in the Division of Enforcement of New York Stock Exchange Regulation. She is responsible for managing attorneys and investigators who investigate and prosecute violations of FINRA rules and federal securities laws. Ms. Light supervises such matters as financial and securities fraud, money laundering, subprime and auction rate securities, Regulation SHO, insider trading, stock manipulation, sales practice violations, mutual fund abuses and financial and operational violations. She serves on many regulatory panels on enforcement topics. Ms. Light was the NYSE enforcement team leader on the integration team with the NASD. At the NYSE, she was a member of several Exchange management committees and served as an ambassador for the Exchange in hosting foreign agencies that visited the Exchange. Prior to joining the Exchange in 1988, Ms. Light was a prosecuting attorney and supervisor in the Bronx District Attorney's office for seven years. She received her bachelor's degree with honors in 1975 from the University of Michigan, her law degree in 1981 from Boston University School of Law, and her LL.M. in 1986 from New York University School of Law. Ms. Light has received the YWCA Women's Achiever Award and the Department of Defense Patriotic Employer award.

Pamela K. Ziermann, CSCP, is Senior Vice President, Compliance at Dougherty Financial Group LLC, where she has been for more than 19 years. Under the Dougherty Financial Group umbrella, Ms. Ziermann is responsible for compliance for one broker-dealer (Dougherty & Company LLC) and three investment advisers. Before joining Dougherty Financial, she was the trust and investment compliance officer for Marquette Banks. Prior to her compliance career, she was an auditor with Marquette Banks and Arthur Andersen. She has served on various industry committees. These include National Society of Compliance Professionals' committees and FINRA's Small Firm Advisory Board, New Account Form Task Force, Small Firm Rules Impact Task Force, Registration and Licensing Council and District Business Conduct Committee and Nominating Committee. She currently serves on the Municipal Securities Rulemaking Board Professional Qualifications Advisory Committee, the Securities Industry / Regulatory Council on Continuing Education and on the Board of Directors for the National Society of Compliance Professionals.

Financial Industry Regulatory Authority

FINRA Annual Conference

Washington, DC May 21 – 23, 2012

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Resources

FINRA Enforcement Priorities

I. Disciplinary Actions – Web-based Tool

In May 2011, FINRA launched the FINRA Disciplinary Actions Online database, a web-based searchable system that makes its disciplinary actions accessible via its website at *www.finra.org*.

The database enables users to perform searches for FINRA actions free of charge, seven days a week. Users may search for actions by case number, document text, document type, action date (by date range), a combination of document text and action date, individual name and Central Registration Depository (CRD®) number, or firm name and CRD number. The documents can be viewed online, printed or downloaded as text-searchable PDF files.

The new database makes available disciplinary action documents including Letters of Acceptance, Waivers and Consent (AWCs), settlements, National Adjudicatory Council decisions, Office of Hearing Officers decisions and complaints.

Disciplinary Actions discussed below can be found in the Disciplinary Actions Online database.

II. Substantive Areas of Interest

A. Fixed Income

1. Municipal Securities

a. On the whole, municipal securities may offer significant benefits to many investors and can be an important component of a diversified portfolio. With some municipal securities, however, the lack of timely disclosures and complete financials often inhibit individual retail investors from making informed investment decisions, and may preclude associated persons from having a reasonable basis to recommend such a security. Member firms are reminded of their obligation to make suitable recommendations to their clients with respect to trading in the secondary markets. This includes obtaining sufficient information about the issuer to provide a reasonable basis that the recommendation is suitable. Separate and independent of the suitability obligation, member firms are also required, under MSRB Rule G-17, to disclose to their customers, at or prior to a sale of securities to a customer, all material facts about the transaction known by the dealer as well as all material facts about the security that are reasonably accessible to the market.[1] Firms should ensure that representatives have access to this municipal issuer information (through MSRB's Electronic Municipal Market Access (EMMA) system and/or other sources) to meet these requirements. Firms are also obligated to trade with their customers at prices that are fair and reasonable (including any markup or markdown).

b. Cases / Investigations

1) Southwest Securities – Paying Former Texas Municipal Issuer Officials and Others to Solicit Municipal Securities Business on its Behalf

FINRA found that during the period from October 2006 through April 2009, Southwest paid five individuals, including three former Texas municipal issuer officials, to solicit municipal securities business on its behalf. The consultants assisted Southwest in obtaining a total of 24 municipal securities underwritings and two roles as financial advisor to Texas municipalities. Southwest paid the consultants more than $200,000 for their services.

Pursuant to the consulting agreements that Southwest had with two of the individuals, the consultants were contracted to "promote the capabilities of Southwest's municipal bond department in their desire to earn mandates as financial advisor and municipal underwriter for public entities throughout Texas." For their services, the consultants were promised, among other things, a percentage of Southwest's profits from any municipal securities business they helped to solicit.

In addition to the formal consulting arrangements, Southwest also made one-time payments totaling more than $26,000 to three other individuals in connection with their roles in obtaining municipal securities business for the firm.

FINRA also found that Southwest violated the MSRB's rules by failing to file 10 MSRB Forms G-36(OS) and G-36(ARD) in a timely manner and for inaccurately reporting more than 300 municipal securities transactions to the MSRB.

FINRA found that during the period from October 2006 through February 2009, Southwest had inadequate systems and procedures to supervise certain aspects of its municipal securities business. The firm's procedures had not been amended to reflect the 2005 amendment to MSRB Rule G-38 that prohibited payments to unaffiliated individuals for the solicitation of municipal securities business. In addition, the firm failed to enforce its procedures regarding compliance with the MSRB rule that regulates political contributions. The firm's procedures required that all municipal finance professionals clear their political contributions through the Compliance Department prior to making the contributions; however, no such pre-approval

[1] Regulatory Notice 10-41 (September 2010), (FINRA Reminds Firms of Their Sales Practice and Due Diligence Obligations When Selling Municipal Securities in the Secondary Market.)

process was ever implemented. In effect, Southwest's inadequate supervisory systems and procedures failed to detect that one of its municipal professionals had made a political contribution. This led to the firm engaging in prohibited municipal securities business in violation of MSRB Rule G-37, for which the Securities and Exchange Commission brought a regulatory action against Southwest in March 2010.

2) 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. Cal PSA (California Public Securities Association) is funded by fees charged underwriters doing business in the state of California. The fees are calculated as a small percentage of municipal issuances. Approximately 25 FINRA members are members of Cal PSA. Cal PSA controls two political action committees and engages in political activity.

3) Municipal Gas Bond

These formal disciplinary actions primarily concern firms failing to provide official statements to customers, either because they had deficient procedures, or had adequate procedures that they did not follow.

Settlements:
Alliant Securities (Fine: $15, 000) (Case #2009018036601)
Carty & Company (Fine: $25,000) (Case #200901803650)
FMS (Fine: $100,000) (Case #2009019191401)
GMS (Fine: $50,000) (Case #2009017280701)
Janney Montgomery (Fine: $75,000) (Case #2009018503501)
Lawson Financial (Fine: $25,000) (Case #2009018036301)
Oppenheimer (Fine: $100,000) (Case #2009018400501)

B. Specific Unconventional Instruments

1. Structured Products

a. Generally

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 a foreign currency.[2] There is no standardized definition of a structured product in the federal securities laws. Many structured products pay an interest or coupon rate substantially above the prevailing market rate. Broker dealers and their FAs may use these attractive yields or some level of principal protection to market the structured products to retail investors. However, structured products can be complex, and have cash flow characteristics and risk-adjusted rates of return that are uncertain or hard to estimate. These products generally lack any active secondary market, which means investors must be willing to assume considerable liquidity risk in addition to market risk and the credit risk associated with the issuer of the product. As a result of

[2] NASD NTM 05-59

these inherent risks, the products may be unsuitable for some retail investors.

For example, reverse convertibles (RevCons) are interest-bearing notes in which principal repayment is typically linked to the performance of a reference asset, often a stock, a basket of stocks, or an index. RevCons, which may offer a high rate of return, have complex payout structures often tied to a “knock-in” level,[3] and involve elements of options trading. RevCons not only expose investors to the financial risks associated with the debt obligation, but also to those risks associated with the reference asset.

b. Principal Protected Notes

Principal Protected Notes are a form of structured product. 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 typically combine a zero coupon bond with an option or other derivative product whose payoff is linked to an underlying asset, such as an equity index or basket of indices.[4] Principal protection levels can vary – some products guarantee 100 percent return of principal, others guarantee as little as 10 percent.

Pros and Cons of PPNs

Benefits of structured products may include:

- principal protection (depending on the type of structured product)
- enhanced returns 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; and
- 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.

Possible PPN-related Violative Conduct

PPNs were sold by a number of broker-dealers to retail customers. The sale of PPNs by broker-dealers and their registered representatives raises concerns including, but not limited to, the suitability of the investments; the adequacy of disclosures at the point of sale; and supervision related to the training, marketing and sales.

c. Structured Product and PPN Cases

1) Santander Securities of Puerto Rico (Case #20080117193-01) ($2

[3] At maturity if the value of the referenced asset has fallen below a certain level (i.e., the “knock-in”), the investor receives less than a full return of principal either in the form of cash or shares of the referenced asset.

[4] NASD NTM 09-73

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' deficiencies began with the firm's failure to have a process in place to review or approve structured products prior to permitting FAs to offer the product to a customer.

Santander Securities brokers bore the responsibility of evaluating structured products without sufficient suitability guidance or required training on structured products.

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 RevCons.

Some Santander Securities brokers recommended that customers use funds borrowed from the firm's banking affiliate to purchase RevCons, 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 structured product. However, the recommended use of leverage substantially increased the clients' risk. Many customers lost money and owed additional money to the bank when the value of the RevCon declined and they sold the product at a loss.

2) Morgan Stanley & Co. (Case #2008015963801) ($600,000 fine) (January 2012)

   Morgan Stanley failed to have a reasonable supervisory system and procedures in place to notify supervisors whether structured product purchases complied with the firm's internal guidelines related to concentration (the size of an investment in relation to the customer's liquid net worth) and minimum net worth. A sampling of structured product transactions revealed at least 14 unsuitable transactions for eight customers. Prior to settlement with FINRA (and as stated in the AWC) the firm entered into settlements with these customers.

3) Joey W. Dean (Case #2008012833801) (Default Decision, barring Dean in all capacities) (Feb. 1, 2011)

   Dean made material misrepresentations to eight customers in the sale of structured products issued by Morgan Stanley. These products 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 (five years). He also misrepresented the rate of return when he told the customers that there was a guaranteed rate of return of 10% (in two cases 8%) However, there was no guaranteed rate of return and they could cease paying interest according to the income formula.

In January 2008, the notes ceased paying monthly income. Dean did not inform three of the customers, knowing that they expected and withdrew 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.

4) Wells Fargo Investments LLC (Case #2008015651901)

In December 2011, FINRA announced that it had fined Wells Fargo $2 Million for unsuitable sales of reverse convertibles to elderly customers and failure to provide breakpoints on UIT sales. The firm consented to findings that it, through one of its representatives, engaged in unsuitable sales of reverse convertible securities to 21 customers. The firm also consented to findings that it failed to provide sales charge discounts on Unit Investment Trust (UIT) transactions to eligible customers and had insufficient systems and procedures to monitor for unsuitable reverse convertible sales and to ensure that UIT customers received discounts for which they were entitled.
As part of the settlement, the firm was required to pay restitution to customers who did not receive UIT sales charge discounts and to provide restitution to certain customers found to have unsuitable reverse convertible transactions.
FINRA also filed a complaint against the former Wells Fargo registered representative who recommended and sold the unsuitable reverse convertibles, and made unauthorized trades in several customer accounts, including accounts of deceased customers.

FINRA found that the representative recommended hundreds of unsuitable reverse convertible investments to 21 clients, most of who were elderly and/or had limited investment experience and low risk tolerance. As of June 2008, he had 172 accounts that held reverse convertibles, with 148 of those accounts having concentrations greater than 50 percent of their total account holdings, and 46 having concentrations greater than 90 percent. Fifteen of the 21 customers were over 80 years old. The reverse convertible transactions exposed these customers to risk inconsistent with their investment profiles, and resulted in overly concentrated reverse convertible positions in their accounts.

5) UBS Financial Services, Inc. (Case #2008015443301) ($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% PPNs Lehman Brothers Holdings Inc. issued prior to its September 2008 bankruptcy filing.

FINRA found that UBS:

- misled certain customers regarding the characteristics and risks associated with investing in the PPNs including material information regarding the 100% principal protection feature;
- did not provide financial advisors (FAs) with sufficient guidance regarding the impact of issuer credit risk and widening credit default swap spreads, as they related to Lehman's financial strength, on the PPNs and the communication of that information to clients;
- failed to establish an adequate supervisory system including written supervisory procedures and the training of FAs regarding the sale of the Lehman-issued PPNs;
- 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 related to issuer credit risk.

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 disclose that the issuer's credit risk could result in a loss of principal.

Suitability procedures were also lacking. UBS did not have risk profile requirements for certain PPNs; therefore, the PPNs were sold to some investors for whom the product was not suitable, including investors with "moderate" and "conservative" risk profiles.

2. Residential Mortgage-Backed Securities and Commercial Mortgage-Backed Securities (RMBS)/Collateralized Mortgage Obligations (CMOs)

a. Generally

Due to the embedded pre-payment option associated with mortgage-backed products, these securities carry significant re-investment risk, which can strongly affect the yield investors realize. Also, with collateralized mortgage obligations (CMOs), some tranches, such as interest-only strips or inverse floaters, carry much higher levels of risk than other tranches. Finally, the opaque nature of underlying collateral and the lack of a robust secondary market for some mortgage-backed securities should be considered when evaluating suitability.

With respect to Residential Mortgage-Backed Securities (RMBS), Issuers of subprime RMBS are required to disclose historical performance information for past securitizations that contain mortgage loans similar to those in the RMBS being offered to investors. Historical delinquency rates are material to investors in assessing the value of RMBS and in determining whether future returns may be disrupted by mortgage holders' failures to make loan payments. As there are different standards for calculating delinquencies, issuers are required to disclose the specific method it used to calculate delinquencies.

b. Cases

1) Northern Trust Securities (Case #2009018771601) ($600,000) (June 2011)

   On June 2, 2011, FINRA announced that it had fined Northern Trust Securities $600,000 for deficiencies in supervising sales of collateralized mortgage obligations (CMOs) and failure to have adequate systems in place to monitor certain high-volume securities trades.

   FINRA found that from October 2006 through October 2009, Northern Trust failed to monitor customer accounts for potentially unsuitable levels of concentration in CMOs, in large part because it used an exception reporting system that failed to capture or analyze substantial portions of the firm's business, including all CMO transactions, certain trades of 10,000 equity shares or more, and certain trades of 250 or more of fixed-income bonds. FINRA found that from January 2007 to June 2008, 43.5 percent of the firm's business was excluded from review.

   The absence of systems to monitor equity trades of over 10,000 shares or fixed income trades of over 250 bonds also resulted in a failure to review these trades for suitability, concentration, excessive trading, excessive mark- ups or commissions, or for trading in restricted stocks.

2) Credit Suisse Securities (Case #200801280890) ($4.5 million) and Merrill Lynch (Case #2008012808201) ($3 million)

   On May 26, 2011, FINRA announced that it had fined Credit Suisse Securities (USA) LLC $4.5 million, and Merrill Lynch $3 million for misrepresenting delinquency data and inadequate supervision in connection with the issuance of residential subprime mortgage securitizations (RMBS).

   FINRA found that in 2006, Credit Suisse misrepresented the historical delinquency rates for 21 subprime RMBS it underwrote and sold. Although Credit Suisse knew of these inaccuracies, it did not sufficiently investigate the delinquency errors, inform clients who invested in these securitizations of the specific reporting discrepancies or correct the information on the website where the information was displayed. Credit Suisse also failed to name or define the methodology used to calculate mortgage delinquencies in five other subprime securitizations. Additionally, Credit Suisse failed to establish an adequate system to supervise the maintenance and updating of relevant disclosure on its website.

   In a separate case, FINRA found that Merrill Lynch negligently misrepresented the historical delinquency rates for 61 subprime RMBS it underwrote and sold. However, in June 2007, after learning of the delinquency errors, Merrill Lynch promptly recalculated the information and posted the corrected historical delinquency rates on its website. Merrill Lynch also failed to establish a reasonable system to supervise and review its reporting of historical delinquency information. On January 1, 2009, Merrill Lynch was acquired by Bank of America, but the firm continues to do brokerage business under its own individual broker-dealer registration.

3) Barclays Capital (Case #2008012808801)

On December 22, 2011, FINRA announced that it had fined Barclays Capital $3 Million for misrepresentations related to subprime securitizations. The firm consented to findings that it misrepresented delinquency data and had supervisory deficiencies vis-à-vis the issuance of residential subprime mortgage securitizations (RMBS).

FINRA found that from March 2007 through December 2010, Barclays misrepresented the historical delinquency rates for three subprime RMBS it underwrote and sold. The inaccurate delinquency data posted on Barclays' website was referenced as historical information in five subsequent RMBS investments and contained errors significant enough to affect an investor's assessment of subsequent securitizations. Additionally, Barclays failed to establish an adequate system to supervise the maintenance and updating of relevant disclosure on its website.

3) Non-Traded REITs

a. Generally

Although non-traded REITs may offer diversification benefits as a part of a balanced portfolio, they do have certain underlying risk characteristics that can make them unsuitable for certain investors. As an unlisted product without an active secondary market, these products offer little price transparency to investors and little liquidity. The related financial information for these products may often be unclear to the investor, which makes the true associated risks and value difficult to ascertain. With many products, there are questions about valuation and concerns that in some cases distributions to investors are paid with borrowed money, over a lengthy period of time, with newly raised capital, or by a return of principal rather than a return on investment. The source of the distribution may not be transparent.

On Oct. 4, 2011, FINRA issued an Investor Alert called *Public Non-Traded REITs – Perform a Careful Review Before Investing* to help investors understand the benefits, risks, features and fees of these investments.

b. Cases

1) Wells Investment Securities, Inc. (Case #2009019893801)

In November 2011, FINRA announced that it had fined Wells Investment Securities, Inc. $300,000 for using misleading marketing materials in the sale of a non-traded Real Estate Investment Trust (REIT).

Wells was the dealer-manager and wholesaler for the public offering of the REIT, which invested in timber-producing land. As the wholesaler, Wells reviewed, approved and distributed the marketing materials for the REIT. FINRA found that from May 2007 through September 2009, Wells reviewed, approved and distributed 116 advertising and sales materials containing misleading, unwarranted or exaggerated statements. For example, the REIT’s initial offering prospectus stated that it intended to qualify as a REIT for the tax year that ended Dec. 31, 2006; however, it did not qualify for REIT election until the tax year that ended Dec. 31, 2009. The majority of the advertisements and sales literature failed to disclose the significance of the issuer’s non-REIT status or suggested that the issuer was a REIT at a time when in fact it had not qualified as a REIT. The communications also contained misleading statements regarding the issuer's portfolio diversification and ability to make distributions and redemptions.

Although non-traded REITs are generally illiquid, often for periods of eight years or more, they can avoid particular tax consequences if they qualify under certain Internal Revenue Service requirements. The advertisements at issue did not make it clear to potential investors who might be seeking such favorable tax treatment, that the investment at issue was not yet a REIT and therefore would not be able to offer the desired tax benefits at the time the ads were being used.

FINRA's investigation also found that Wells failed to have supervisory procedures in place to ensure that sensitive customer and proprietary information stored on laptops were being adequately safeguarded by appropriate encryption technology.

2) David Lerner Associates, Inc. – Complaint (Case #2009020741901)

On May 31, 2011, FINRA announced that it had filed a complaint against David Lerner & Associates, Inc. (DLA), of Syosset, NY, charging the firm with soliciting investors to purchase shares in Apple REIT Ten, a non-traded $2 billion Real Estate Investment Trust (REIT), without conducting a reasonable investigation to determine whether it was suitable for investors, and with providing misleading information on its website regarding Apple REIT Ten distributions. DLA has sold and continues to sell Apple REIT Ten targeting unsophisticated and elderly customers with unsuitable sales of the illiquid security.

Since January 2011, as sole underwriter for Apple REIT Ten, DLA has sold over $300 million of an open $2 billion offering of the REIT's shares. Apple REIT Ten invests in the same extended stay hotel properties as a series of other Apple REITs closed to investors. Apple REIT Ten and the closed Apple REITs were founded by the same individual, and are all under common management. DLA has been the sole underwriter for Apple REITs since 1992, selling nearly $6.8 billion of the securities into approximately 122,600 DLA customer accounts. DLA earns 10 percent of all offerings of Apple REIT securities as well as other fees. Apple REIT sales have generated $600 million for DLA, accounting for 60 to 70 percent of DLA's business annually since 1996.

The complaint against DLA alleges that since at least 2004, the closed Apple REITs have unreasonably valued their shares at a constant price of $11 notwithstanding market fluctuations, performance declines and increased leverage, while maintaining outsized distributions of 7 to 8 percent by leveraging the REITs through borrowings and returning capital to investors. As sole distributor, DLA did not question the Apple REITs' unchanging valuations despite the economic downturn for commercial real estate.

FINRA alleges that DLA failed to sufficiently investigate the valuation and distribution irregularities of the closed Apple REITs prior to selling Apple REIT Ten. As the sole underwriter of all of the Apple REITs, DLA was aware of the Apple REITs' valuation and distribution practices. Rather than conduct due diligence into those valuations and distribution irregularities to determine that they were reasonable and that the Apple REITs were suitable, DLA accepted the valuations and continued to record them on customer account statements.

In its solicitation of customers to purchase Apple REIT Ten, DLA's website provided distribution rates for all of the previous Apple REITs. These distribution figures were misleading and omitted material information because they did not disclose recent distribution rate reductions or that distributions far exceeded income from operations and were funded by debt that further leveraged the REITs.

3) David Lerner Associates, Inc. and David E. Lerner (Amended Complaint) (Case #2009020741901)

On December 13, 2011, FINRA amended its Complaint against David Lerner Associates. The FINRA complaint alleges that the firm recommended and sold over $442 million of a $2 billion non-traded real estate investment trust (REIT) without performing adequate due diligence in violation of its suitability obligations. The complaint alleges that earlier REITs under the same management inappropriately valued the REITs' shares at a constant artificial price notwithstanding years of market fluctuations, performance declines, increased leverage and excessive return of capital to investors. The firm, in its capacity as best efforts underwriter for all of the REITs, continued to solicit thousands of customers to purchase the REIT without performing adequate due diligence to determine that there was a reasonable basis to recommend the security to any customer. The complaint also alleges that the firm failed to disclose material information and made misleading omissions regarding prior REIT distributions on its website.

The complaint further alleges that the firm, through David Lerner and other representatives, repeatedly gave seminar presentations to investors using seminar slides that were not fair and balanced, and did not provide a sound basis for evaluating the facts in regard to the REITs.

In addition, the complaint alleges that Lerner made oral presentations regarding the REITs at seminars, which constituted a public appearance and were communications with the public under the FINRA advertising rules. The seminar slides and Lerner's seminar presentations were not fair and balanced and omitted numerous material facts and qualifications that caused the communications to be misleading. The seminar slides and Lerner's seminar presentations contained numerous false, exaggerated, unwarranted or misleading statements and claims regarding the valuations, performance, prospects, risks and practices of the REIT programs, as well as customer insurance protection through the firm and the prospects for a merger of the closed REITs.

Moreover, the complaint alleges that to counter negative media attention regarding the firm and the REITs following the filing of the original complaint in this proceeding, Lerner sent letters to all of the firm's customers that omitted material information causing the communication to be misleading. The letters also contained exaggerated, false and misleading statements regarding the valuations, performance, prospects, risks and practices of the REIT programs. The complaint also alleges that to induce new and existing customers to purchase the REIT, Lerner and the firm negligently made untrue representations of material fact or omissions of material fact regarding the prior performance, steady distribution rates, unchanging valuations, and prospects of the closed REITs and/or the current REIT. The firm and Lerner made the untrue statements and omitted the material facts with intent to defraud investors or with recklessness.

4) Bond Funds

a. Morgan Keegan (Case #2007011164502)

On June 22, 2011, FINRA, the SEC and 5 state regulators from Alabama, Kentucky, Mississippi, South Carolina and Tennessee announced that each had settled enforcement proceedings against Morgan Keegan & Company, Inc. Morgan Keegan will pay restitution of $200 million for customers who invested in seven affiliated bond funds, including the Regions Morgan Keegan Select Intermediate Bond Fund (Intermediate Fund). Morgan Keegan's affiliate, Morgan Asset Management, managed the funds.

FINRA found that from the beginning of Jan. 2006 to the end of Sept. 2007, Morgan Keegan marketed and sold the Intermediate Fund to investors using sales materials that contained exaggerated claims, failed to provide a sound basis for evaluating the facts regarding the fund, were not fair and balanced, and did not adequately disclose the impact of market conditions in 2007 that caused substantial losses to the value of the Intermediate Fund.

The Intermediate Fund invested predominantly in structured products, including mezzanine and subordinated tranches of structured securities including sub-prime products. Morgan Keegan marketed the Intermediate Fund as a relatively safe, investment-grade fixed income mutual fund investment when, in fact, the fund was exposed to risks associated with its investments in mortgage-backed and asset-backed securities, and subordinated tranches of structured products. By the beginning of 2007, Morgan Keegan was aware that the Intermediate Fund was experiencing difficulties related to the holdings in the fund impacted by turmoil in the mortgage-backed securities market yet failed to adequately disclose those risks in the sales materials or internal guidance. In March 2007, when adverse market conditions began to affect the fund, over 54 percent of the portfolio was invested in asset-backed and mortgage-backed securities, and 13.5 percent was invested in subprime products.

b. Charles Schwab (Case #2008012876902)

FINRA ordered Charles Schwab & Company, Inc., to pay $18 million into a Fair Fund to be established by the Securities and Exchange Commission (SEC) to repay investors in YieldPlus, an ultra short-term bond fund managed by Schwab's affiliate, Charles Schwab Investment Management. The $18 million consists of the $17.5 million in fees that Schwab collected for sales of the fund, plus a fine of $500,000, both of which will have been designated as restitution to customers.

FINRA's investigation found that despite changes in YieldPlus' portfolio that caused the fund to be disproportionately affected by the turmoil in the mortgage-backed securities market, Schwab failed to change its marketing of the fund. In written materials and in conversations with customers, some Schwab representatives omitted or provided incomplete or inaccurate material information relating to the fund's characteristics, risk and diversification, and continued to represent YieldPlus as a relatively low-risk alternative to money market funds and other cash alternative investments that had minimal fluctuations in net asset value (NAV).

Between Sept. 1, 2006, and Feb. 29, 2008, Schwab sold over $13.75 billion in shares of YieldPlus to customers, which accounted for approximately 98 percent of the amount Schwab customers invested in ultra short-term bond funds. During this time period, Schwab's solicited sales of YieldPlus totaled approximately $3.36 billion, approximately 40 percent of which were to customers 65 years of age or older. Schwab collected approximately $17.5 million in fees from sales of the fund.

5) UIT and Floating Rate Notes

a. Generally

A UIT is an investment product that consists of a diversified basket of securities, which can include risky, speculative investments such as high-yield/below investment-grade or "junk" bonds. Floating-rate loan funds are mutual funds that generally invest in a portfolio of secured senior loans made to entities whose credit quality is rated below investment-grade, or "junk."

b. Chase Investment Services Corporation (Case #2008015078603)

In November 2011, FINRA announced that it ordered Chase Investment Services Corporation to reimburse customers more than $1.9 million for losses incurred from recommending unsuitable sales of unit investment trusts (UITs) and floating rate loan funds. FINRA also fined Chase $1.7 million.

Chase consented to findings that Chase brokers recommended the purchase of UITs and floating rate loan funds to unsophisticated customers with little or no investment experience and conservative risk tolerances, without having reasonable grounds to believe that those products were suitable for the customers. FINRA also found that Chase failed to implement supervisory procedures to reasonably supervise its sales of UITs and floating rate loan funds.

FINRA found that Chase did not provide its brokers with sufficient training and guidance regarding the risks and suitability of UITs and floating-rate loan funds. Two of the UITs on Chase's list of approved products held a large percentage of assets in closed-end funds that contained a significant percentage of high-yield or junk bonds. Due to their composition, these particular UITs were not suitable investments for customers who had little or no investment experience and a conservative risk tolerance. Chase brokers made almost 260 unsuitable recommendations to purchase these UITs to customers with little or no investment experience and a conservative risk tolerance. The customers suffered losses of approximately $1.4 million as a result of investing in these unsuitable transactions.

Similarly, the floating-rate loan funds sold by Chase were subject to significant credit risks and certain of the funds could also be illiquid. Accordingly, concentrated positions in the funds were not suitable for certain investors with conservative risk tolerances or those seeking preservation of principal. Despite this, Chase brokers recommended the purchase of floating-rate loan funds to customers who had conservative risk tolerances, were seeking preservation of principal or were seeking a highly liquid investment. These customers suffered unreimbursed losses of nearly $500,000 as a result of these unsuitable recommendations.

c. UVEST (Case #2009016347101) (April 3, 2012)

The firm consented to a $230,000 fine plus an undertaking to pay approximately $44,000 in restitution to customers. It also consented to findings that it, among other things, violated:

- FINRA Rule 2010 and NASD Rules 2110 and 3010(a) and (b) when, between July 9, 2007 and September 20, 2009, it failed to apply "breakpoint" and "rollover and exchange" discounts (collectively "sales charge discounts") to eligible customer purchases of Unit Investment Trusts. Also between July 9, 2007 and September 20, 2009, UVEST failed to establish, maintain and enforce an adequate supervisory system and WSPs reasonably designed to achieve compliance with its obligation to identify and ensure customers received sales charge discounts on all eligible UIT purchases.

- FINRA Rule 2010, NASD Rule 2110 and 3010(a) and (b) when, between July 9, 2007 and September 20, 2009, UVEST customers purchased UITs in 3,194 brokerage accounts, and UVEST failed to establish, maintain and enforce an adequate supervisory system and WSPs reasonably designed to achieve compliance with its obligation to provide UIT prospectuses to customers.

6) Complex Exchange-Traded Products

Complex Exchange-Traded Products: Certain exchange-traded products that employ sophisticated strategies or access more exotic markets can expose investors to unexpected results or unforeseen risks. For example, exchange-traded funds (ETFs) that employ optimization strategies using synthetic derivatives can expose individual investors to the risk of significant tracking errors. In other words, the performance of the ETF may differ from that of the underlying benchmark during times of stress or volatility in unanticipated ways. These risks can be exacerbated when the ETFs employ significant leverage.

7) Variable Annuities

Although variable annuity products can offer valuable benefits to investors seeking predictable annuity streams, tax deferral for investment gains and flexible investment choices, they do have certain risk characteristics that can make them unsuitable for some investors. These products often have long holding periods and significant surrender fees, making them unsuitable for investors who have a need for liquidity. High fees and expenses may result in reduced performance in the underlying holdings, and high commissions make the product a target for switching. FINRA Rule 2330 imposes enhanced responsibilities on member firms with respect to variable annuities. Among other things, the rule requires that the firm or associated person have a reasonable basis to believe that a customer would benefit from certain features of a deferred variable annuity, such as tax-deferred growth, annuitization, or a death or living benefit, and that the particular recommended deferred variable annuity as a whole, the underlying subaccounts to which funds are allocated, and any rider or similar policy enhancements accompanying it are suitable for the customer. The rule, moreover, requires that the firm or associated person have a reasonable basis to believe that the customer has been informed, in general terms, of various features of deferred variable annuities. Firms are also required to implement surveillance procedures to detect any registered persons who are effecting deferred variable annuity exchanges at a rate that could indicate non-compliance with securities laws and rules, and to have procedures for taking corrective action if such activity is detected. The rule has a training component as well.

8) Unregistered Securities Acquired in Secondary Markets

As many high-profile companies have elected to remain private, secondary trading markets have emerged for their securities. However, despite their profile, many of these companies are difficult to value, as the issuers may not make financial statements publicly available. Acquiring interests in such securities through a pooled investment or single security "fund" introduces another layer of costs to the investor as well as risk associated with the fund manager.

9) Church Bonds

The credit quality of the underlying issuer and its true financial condition are often not transparent. Investors may be unaware of the substantial credit and market risk they are assuming with such investments. The source and nature of the underlying revenue streams of the issuer that are required to service the instruments are often less than clear. Further, as sales are frequently made on an affinity basis, these securities can be vehicles for fraud.

II. Anti-Money Laundering

A. Master/Sub Accounts

1. 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; and,
- 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.

b. Cases

1) Generally

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.

B. Direct Market Access

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.

C. Suspicious Activity Monitoring

1. First Clearing Corporation ($400,000 fine) (Case #2008012791101) (Jan. 26, 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).

D. 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 do not seem to understand the risk of this business, particularly if it is new to them.

1. AIS Financial, Inc. (Expulsion) (Case #2008012169101) (March 3, 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.

2. Merrill Lynch, Pierce, Fenner & Smith (Case #2009020383001)

   On July 26, 2011, FINRA issued an AWC finding that Merrill Lynch failed to enforce its anti-money laundering compliance program ("AMLCP") and written procedures by accepting third-party checks for deposit into a customer's account that, contrary to the procedures, did not identify that customer by name. As a result, Maxwell Baldwin Smith ("Smith"), a registered representative at another member firm, was able to move over $9 million of misappropriated funds through his personal Merrill Lynch cash management brokerage account. FINRA censured the firm and imposed a $400,000 fine.

   From 1992 through at least June 2008, Smith convinced seven individuals, at least four of whom were elderly, to invest over $9 million in a private placement of an investment called a Health Care Financial Partnership Direct loan ("HCF"). One of the customers, who is now 95 years old, accounted for at least $8.6 million of the funds invested. Smith, however, did not invest the funds on the customers' behalf. Unbeknownst to the customers, Health Care Financial was a sham entity and HCF was a fictitious investment. Instead of investing the funds as promised, Smith misappropriated the customers' money by depositing their checks into his Merrill Lynch account, which, from 1992 through at least June 2008, was not used to effect any securities transactions. He then transferred those funds to a personal bank account by writing large dollar checks payable to himself and to cash. Smith used those funds to make purported "interest payments" to the unsuspecting customers or to purchase real estate, antiques and vacations for himself.

The HCF investor checks were non-personal checks made payable to Merrill Lynch and, in most instances, Smith's account number had been written on the check by the customer. The absence of Smith's name on the checks gave no indication to those outside of Merrill Lynch, including Smith's investors that the money was going to Smith's personal account.

In accepting these deposits, the firm failed to follow its written procedures because these "non-personal checks" were accepted for deposit without containing the name of the Merrill Lynch client (Smith in this case) who owned the account. Had Merrill Lynch enforced its procedures, Smith would not have been able to move the proceeds of his misappropriation scheme through Merrill Lynch. Moreover, Merrill Lynch disregarded certain indications of Smith's misconduct, such as the fact that he was: 1) depositing large amounts of money into, and then moving large amounts of funds out of, an account that had no market investment activity through the use of large dollar checks payable to himself or to cash; and 2) depositing the funds of third parties with whom he had no apparent family or fiduciary relationship. By failing to enforce its written procedures and to develop and implement a reasonably-designed AMLCP, Merrill Lynch violated NASD Conduct Rules 3011(a), 3011(b) and 2110.

E. Foreign Finders

1. General

Foreign finders and related foreign affiliates pose compliance risks and may elevate a firm's AML risk level. Recent examinations and enforcement cases have uncovered problematic arrangements with foreign finders. NASD Rule 1060(b) permits member firms, in limited circumstances, to pay transaction-related compensation to non-registered foreign persons or foreign finders. Specifically, the <u>sole</u> involvement of the foreign finder in the member firm's business must be the initial referral of non-U.S. customers to the firm. FINRA reminds firms that the scope of permissible business activities and the associated regulatory requirements differ between foreign finders and foreign associates. Examiners have found finders whose activities go beyond an initial referral of non-U.S. customers to the firm and who are involved in the servicing of non-U.S. customer accounts, including having trading authority over accounts, entering customer orders directly to the clearing firm's online platform, and processing new account documents and funds transfers. As a result of such activities, the foreign finders provisions in NASD Rule 1060(b) are not applicable, and the finder is required to be registered as a Foreign Associate pursuant to NASD Rule 1100, or in another appropriate registration category and be supervised as an associated person of the firm. Firms that engage foreign finders should ensure their procedures appropriately address the limited scope of activities permissible under such arrangements and potential risks. See *Notices to Members 01-81* and *95-37*.

A firm's AML risk may be elevated by foreign finders and related foreign affiliates depending on the geographical regions involved, types of customers introduced, and products and services offered. Some of the red flags observed include customer accounts exhibiting significant account activity with very low levels of securities transactions, significant credit or debit card activity/withdrawals with very low levels of securities transactions, wire transfers to/from financial secrecy havens or high-risk geographic locations without an apparent business reason, and payment by third-party check or money transfer without an apparent connection to the customer. Relationships with foreign finders and related foreign entities have also been used to hide securities activities and payment of transaction-based compensation to previously disciplined individuals, and to engage in cross-trading for the inappropriate benefit of the finder. Prior to entering into these relationships, firms must have reasonably designed procedures to, among other things, assess and address the potential AML risks associated with the business, and monitor any subsequent activity conducted with foreign finders and related foreign entities.

a. Bulltick Securities, LLC (Case #2009015969501)

Bulltick was fined $125,000 for making transaction-based payments to a non-registered foreign asset manager (foreign finder). FINRA also found that a non-registered foreign finder referred customer accounts to the firm that generated gross commissions of approximately $600,000 through the unsolicited, short-term trading of collateralized mortgage obligations. The firm was also found to have a deficient anti-money laundering program and supervisory systems and procedures. (Dec. 13, 2011).

III. Section 5

A. 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.

1. Seaboard Securities Inc. (Case #2007008724801)

On August 9, 2010, in an Order Accepting an Offer of Settlement, Seaboard was fined $125,000, $10,000 of which was joint and several with Anthony J. DiGiovanni, Sr. and $10,000 of which was joint and several with Sonya T. Hill. The firm was found to have 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. The firm was also required to retain and independent consultant to review procedures to conduct a comprehensive review of the adequacy of the Firm's AML program and its policies, systems and procedures (written and otherwise) and training relating to determining whether securities are freely tradable.

2. Joseph Padilla (Hearing Panel Decision) (Case #2006005786501)

A Hearing Panel (in a decision issued in October 18, 2010) 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.

3. Felix Investments LLC (Case #2010020933302)

On March 14, 2012, FINRA issued an AWC from Felix Investments LLC and brokers William L. Barkow, Emilio A. DiSanluciano and Frank G. Mazzola. The Firm was censured, fined $250,000, and required to complete an undertaking. The undertaking requires the Firm to retain an independent consultant, who will review the adequacy of the Firm's policies, systems and procedures and training, and recommend any changes, which the Firm shall implement, regarding ensuring: (1) Compliance with Section 5 of the Securities Act, in connection with solicitations of unregistered securities offerings; (2) All communications by the Firm and its brokers with the public comply with the content standards set forth in NASD Rule 2210(d); and (3) Supervisory reviews of email communications, and documentation of such reviews, as required by NASD Rule 3010(d)(1). Barkow and Mazzola were each separately fined $30,000 and suspended 15 business days. DiSanluciano was fined $20,000 and suspended for ten business days.

The respondents consented to findings that Felix, acting through Barkow and Mazzola, marketed two unregistered offerings to potential investors through general solicitations, and thereby engaged in the public offering and sale of unregistered securities, in contravention of Section 5 of the Securities Act of 1933 and violation of FINRA Rule 2010. The offerings were for interests in private limited liability companies formed to invest in shares of Facebook, Inc..

The AWC also included findings of other violations including exaggerated, unwarranted and misleading statements and claims, in connection with the marketing of the offerings, books and records failures (emails), net capital deficiencies and related supervisory failures.

On the same day that FINRA issued the AWC, the SEC filed a civil action in the U.S. District Court for the Northern District of California against Felix Investments LLC , Mazzola, and Facie Libre Management Associates LLC (owned and managed by Mazzola and Barkow) for fraud in connection with (1) the unregistered offerings of interests in LLCs formed to invest in shares of Facebook, relating to (a) self-dealing – earning secret commissions, (b) misrepresenting, among other things, that (i) they were selling funds with underlying Facebook shares when they knew the funds lacked ownership of certain Facebook shares, (ii) the LLCs were approved by Facebook, (iii) the LLCs possessed Facebook stock at $66 per share; and (2) false statements to investors in other pre-IPO funds, including about Twitter's revenue and ownership of Zynga stock. The SEC seeks court orders prohibiting the defendants from engaging in securities fraud and requiring them to disgorge their ill-gotten gains and pay financial penalties. The fraud charges assert that the defendants violated Exchange Act of 1934 Section 10(b) and Rule 10b-5, Section 17(a) of the Securities Act, and that defendants Mazzola and Facie Libre Management Associates LLC violated Section 206(A) of the Advisers Act and Rule 206(4)-8 thereunder.

B. Securities Offered Through Private Placements

1. Generally

Certain issuers seek to raise capital by offering unregistered securities in private placements. Many firms also offer securities in private placements to accredited investors under SEC's Regulation D. Firms conducting private placements under Regulation D or any other applicable exemption from registration must conduct a reasonable investigation of the issuer, based upon the facts and circumstances, with careful attention to any "red flags," to comply with the anti-fraud provisions and other FINRA rules, such as suitability. Proposed FINRA Rule 5123 (Private Placements of Securities)[5] would help ensure that member firms and associated persons that sell applicable private placements provide relevant disclosures to each investor, and would also require that the private placement memorandum, term sheet or other disclosure document be filed with FINRA to help inform FINRA's regulatory programs. In addition, firms are reminded that the definition of accredited investor has changed.[6]

[5] See Securities Exchange Act Release No. 65585 (October 24, 2011) and Securities Exchange Act Release No. 66203 (January 26, 2012).

[6] See Securities Act Release No. 9287 (December 21, 2011).

2. MedCap, Provident, DBSI – Cases

Certain firms sold interests in private placements offered by Medical Capital Holdings, Inc., Provident Royalties, Inc., and DBSI, that ultimately failed. These issuers made a series of offerings, and the later offerings were often marketed based on the success of the earlier ones.

FINRA issued ten AWCs and several complaints, mainly against principals and chief compliance officers. On April 7, 2011, FINRA announced the first group of AWCs, sanctioning two firms and seven individuals for selling private placements in MedCap and Provident without conducting a reasonable investigation:

- Workman Securities Corp. was ordered to pay $700,000 in restitution to affected customers. (Case #20090188184) Robert Vollbrecht, Workman's former President, was barred in principal capacity, and fined $10,000. (Case #20090188184)

- Timothy Cullum, former Chief Executive Officer, and Steven Burks, former President, of Cullum & Burks Securities, Inc. were each suspended in principal capacity for six months and fined $10,000. (Case #2009018818001)

- Jeffrey Lindsey (Case #2009019125901) and Bradley Wells (Case #2009019125902), two former executives with Capital Financial Services, Inc., were each suspended for six months principal capacity and fined $10,000.

- Jay Thacker, former Chief Compliance Officer for Meadowbrook Securities, LLC (f/k/a Investlinc Securities, LLC) was suspended for six months in any principal capacity and fined $10,000. (Case #2009019070101)

- David Dube, former Owner, President, Chief Compliance Officer and Anti-Money Laundering Compliance Officer of (now-defunct) Peak Securities Corporation, was barred for due diligence and AML violations. (Case #2008011713801)

In addition, FINRA issued the following AWCs:

- Askar Corporation, $45,000 fine for due diligence violations related to its DBSI offerings. (Case #2009018558601)
- Capital Financial Services, Inc., ordered to pay partial restitution of $200,000 for violations of NASD Conduct Rules 2310, 3010 and 2110 and FINRA Rule 2010 related to MedCap and Provident offerings. (Case #2009019125903) and Brian W. Boppre, a former principal, was suspended in any principal capacity for six months and fined $10,000 in connection with the sale of three Provident Royalties private placements and a Medical Capital private placement. (Case #2009019125904)
- Investors Capital Corporation, ordered to pay partial restitution of approximately $400,000 for violations of NASD Conduct Rules 3010 and 2110 and FINRA Rule 2010 related to Provident offerings (as well as an offering of an additional private placement). (Case #2009019069701)
- NEXT Financial Group, Inc. and Steven Lynn Nelson (Case #2009019063801) – ordered to pay $2 million in restitution to affected customers and fined $50,000; Steven Lynn Nelson, the firm's Vice President for Investment Products and Services, was suspended in any principal capacity for six months and fined $10,000 in connection with the sale of three Provident Royalties private placements.
- Garden State Securities and Kevin John DeRosa (Case #2009018819201– Garden State Securities, Inc. and Kevin John DeRosa, a co-owner of the firm,

were ordered to pay $300,000 in restitution on a joint-and-several basis to affected customers in connection with the sale of a Medical Capital private placement. DeRosa was also suspended for 20 business days in any capacity and for an additional two months in any principal capacity, and fined $25,000. Vincent Michael Bruno, the firm's Chief Compliance Officer at the time, was suspended for one month in a principal capacity and fined $10,000. (Vincent Michael Bruno – Case #2009018771701)

- National Securities Corporation and Matthew G. Portes (Case #2009019068201) was ordered to pay $175,000 in restitution to affected customers, and Matthew G. Portes, Director of Alternative Investments/Director of Syndications, was suspended in any principal capacity for six months and fined $10,000 in connection with the sale of three Provident Royalties private placements and a Medical Capital private placement.
- Equity Services, Inc. (Case #2009017240702) was censured, fined $50,000 and ordered to pay nearly $164,000 in restitution in connection with the sale of a private placement DBSI, Inc. issued; Stephen Anthony Englese, (Case #2009017240703), Senior Vice President for Securities Operations, was suspended from association with any FINRA-regulated firm in any capacity for 30 business days and fined $10,000; and Anthony Paul Campagna (Case #2009017240701), a registered representative, was suspended from association with any FINRA-regulated firm in any capacity for 30 business days and fined $25,000.
- Securities America, Inc. (Case #2010022518101) – censured and fined $250,000 in connection with the sale of two Provident Royalties private placements.
- Newbridge Securities Corporation (Case #2009016159401) – fined $25,000; Robin Fran Bush (Case #2009016159402), the former Chief Compliance Officer of Newbridge, was suspended in any principal capacity for six months and fined $15,000 in connection with the sale of four DBSI private placements and a Medical Capital private placement.
- Leroy H. Paris, II (Case #2009019070102), former President and Chief Executive Officer for the now-defunct Meadowbrook Securities, LLC (f/k/a Investlinc Securities, LLC), of Jackson, MS, was suspended for six months in any principal capacity and fined $10,000 in connection with the sale of two Provident Royalties private placements and a Medical Capital private placement.
- Michael D. Shaw (Case #2009019388001) – formerly associated with VSR Financial Services, Inc., was barred from the industry in connection with the sale of a private placement offered by DBSI, Inc. and several additional private placements offered by other issuers. In addition, Shaw falsified customer account documents.

The *Findings:* The MedCap/Provident/DBSI-related AWCs include 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
- Suitability (reasonable basis and customer specific)
- Unregistered offerings in violation of Section 5

C. Microcap Fraud

Microcap or penny stocks are particularly vulnerable to market manipulation given the lack of transparency in their underlying business, lack of verifiable financial history and the opaque nature of their operations. We are particularly concerned with fraud schemes that can harm retail investors. FINRA's focus includes, among other issues:

- bulletin board postings or email spam that distributes false or misleading information by fraudsters attempting to pump up a microcap;
- high pressure sales tactics employed by sales personnel;
- the use of paid promoters to dispense "unbiased" opinions related to these microcaps; and
- individuals who use brokerage firms to liquidate microcap holdings, whereby the firm may be facilitating an unregistered distribution. As part of their anti-money laundering (AML) responsibilities, member firms are obligated to monitor for suspicious activity and to file Suspicious Activity Reports where warranted.

D. Reverse Mergers

The reverse merger market (where a private company merges into a public shell or so-called "backdoor registration") represents a path for issuers to enter the U.S. public capital markets while foregoing the formal registration process associated with an IPO. Significant allegations of fraud have surfaced relative to this practice, particularly related to issuers based in China. Current and accurate information on these issuers is often scarce, and concerns have been raised regarding the quality of their audited financial statements. In December 2010, the SEC disciplined a U.S. auditor for overstating revenues of Chinese issuers. The heightened risk associated with these foreign issuers, who never went through an IPO or registration process in the U.S., increases the risk that any due diligence failures on the part of the broker-dealer may result in harm to investors.

IV. Regulation S-P

A. Generally

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.

1. Lincoln Financial Securities, Inc. (Case #2009018720501)/Lincoln Financial Advisors Corp. (Case #2009020074601) (February 2011)

   On February 16, 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.

V. Advertising

A. 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.

a) James McKelvain – Case No. 20070088994-Offer of Settlement
b) Russell Roeber – Case No. 2009 019041801-AWC
c) Conrad Lawrence – Case No. 20090190422-Offer of Settlement
d) Robert DeWald – Case No. 20090190416-AWC
e) James J. Ahmann – Case No. 20090190410-AWC
f) Jack Kennebeck – Case No. 20090190420-AWC
g) Robert Pollock – Case No. 20090190423-AWC
h) Randolph Andrew Fisher, Jr. – Case No. 2009019041802-Offer of Settlement
i) Harry Derrick Winters – Case No. 2009019042401-Complaint
j) Scott Browning – Case No. 20090190413-9552

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

A. Generally

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.

1. BNP Paribas Securities ($650,000) (February 2011) (Case #2008013504201)

   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.

2. UBS ($600,000 fine) (September 2010) (Case #2010022093601)

   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.

VII. Theft flowing from Supervisory Lapses

A. Citigroup Global Markets, Inc. (Case #2008013231502)

On August 9, 2011, FINRA announced that it fined Citigroup Global Markets, Inc. $500,000 for failing to supervise a former registered sales assistant at the firm's branch office in Palo Alto, California. Over an 8 year period, the assistant misappropriated $749,978 from 22 customers, falsified account records and engaged in unauthorized trades in customer accounts.

The Assistant took advantage of Citigroup's supervisory lapses at the branch and targeted elderly, ill or otherwise vulnerable customers whom she believed were unable to monitor their accounts. The Assistant's victims included elderly widows, a senior with Parkinson's disease and her own father. FINRA previously barred the assistant for her actions.

FINRA found that Citigroup failed to detect or investigate a series of "red flags" that upon further inquiry should have alerted the firm to the assistant's improper use of customer funds. The red flags included exception reports highlighting conflicting information in new account applications and customer account records reflecting suspicious transfers of funds between unrelated accounts. Citigroup also failed to implement reasonable systems and controls regarding the supervisory review of customer accounts, thus enabling the assistant to falsify new account applications and other records.

1. Merrill Lynch, Pierce, Fenner & Smith Inc. (Case #2608013990502)

   On October 3, 2011, FINRA fined Merrill Lynch, Pierce, Fenner & Smith Inc., $1 million for supervisory failures that allowed a registered representative at Merrill Lynch's branch office in San Antonio, Texas, to use a Merrill Lynch account to operate a Ponzi scheme.

Bruce Hammonds, the registered representative, convinced 11 individuals to invest more than $1 million in a Ponzi scheme he created and ran as B&J Partnership for over 10 months. Merrill Lynch supervisors approved Hammonds' request to open a business account for B&J and failed to supervise funds that customers deposited and Hammonds withdrew. FINRA permanently barred Hammonds from the securities industry in December 2009. Merrill Lynch reimbursed all investors who were harmed by Hammond's misconduct.

FINRA found that Merrill Lynch failed to have an adequate supervisory system in place to monitor employee accounts for potential misconduct. Merrill Lynch's supervisory system automatically captured accounts an employee opened using a social security number as the primary tax identification number. However, if the employee's social security number was not the primary number associated with the account, the system failed to capture the account in its database. Instead, Merrill Lynch solely relied on its employees to manually input these accounts into its supervisory system. FINRA also found that from January 2006 to June 2010, Merrill Lynch failed to monitor an additional 40,000 employee/employee-interested accounts, which were not reported for certain periods of time and therefore not available on the supervisory system.

B. Hedge Funds

1. Fraud – MICG/Martinovich (February 2011) (Case #2009016230501)

On February 3, 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.

C. 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.

1. ***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."

2. ***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.)

3. ***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.

4. ***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).

D. Regulation SHO

1. Generally

In a short sale, the seller sells a security it does not own. When it is time to deliver the security, the short seller either purchases or borrows the security in order to make the delivery. Reg SHO requires a broker or dealer to have reasonable grounds to believe that the security could be borrowed and available for delivery before accepting or effecting a short sale order. Requiring firms to obtain and document this "locate" information before the short sale is entered reduces the number of potential failures to deliver in equity securities. In addition, Reg SHO requires a broker or dealer to mark sales of equity securities as long or short.

2. UBS Securities LLC (Case #20080144511)

In October 2011 FINRA announced that it fined UBS Securities $12 Million for violating Regulation SHO (Reg SHO) and failing to properly supervise short sales of securities. As a result of these violations, millions of short sale orders were mismarked and/or placed to the market without reasonable grounds to believe that the securities could be borrowed and delivered.

FINRA found that UBS' Reg SHO supervisory system regarding locates and the marking of sale orders was significantly flawed and resulted in a systemic supervisory failure that contributed to serious Reg SHO failures across its equities trading business.

- First, FINRA found that UBS placed millions of short sale orders to the market without locates, including in securities that were known to be hard to borrow. These locate violations extended to numerous trading systems, desks, accounts and strategies, and impacted UBS' technology, operations, and supervisory systems and procedures.

- Second, FINRA found that UBS mismarked millions of sale orders in its trading systems. Many of these mismarked orders were short sales that were mismarked as "long," resulting in additional significant violations of Reg SHO's locate requirement.

- Third, FINRA found that UBS had significant deficiencies related to its aggregation units that may have contributed to additional significant order-marking and locate violations.

As a result of its supervisory failures, many of UBS' violations were not detected or corrected until after FINRA's investigation caused UBS to conduct a substantive review of its systems and monitoring procedures for Reg SHO compliance. FINRA found that UBS' supervisory framework over its equities trading business was not reasonably designed to achieve compliance with the requirements of Reg SHO and other securities laws, rules and regulations until at least 2009.

3. Credit Suisse Securities (USA) LLC (Case #20080144512)

December 27, 2011, FINRA accepted an AWC whereby Credit Suisse Securities consented to a $1.75 million fine and findings that it violated Regulation SHO (Reg SHO) and failed to properly supervise short sales of securities and marking of sale orders. As a result of these violations, Credit Suisse entered millions of short sale orders without reasonable grounds to believe that the securities could be borrowed and delivered and mismarked thousands of sales orders.

FINRA found that from June 2006 through December 2010, Credit Suisse's Reg SHO supervisory system regarding locates and the marking of sale orders was flawed and resulted in a systemic supervisory failure that contributed to significant Reg SHO failures across its equities trading business. During the time period, Credit Suisse released millions of short sale orders to the market without locates, including threshold and hard to borrow securities. The locate violations extended to numerous trading systems, aggregation units and strategies. In addition, Credit Suisse mismarked tens of thousands of sale orders in its trading systems. The mismarked orders included short sales that were mismarked as "long," resulting in additional violations of Reg SHO's locate requirement.

As a result of its supervisory failures, many of Credit Suisse's violations were not detected or corrected by the firm until after FINRA's investigation caused Credit Suisse to conduct a substantive review of its systems and monitoring procedures for Reg SHO compliance. FINRA found that Credit Suisse's supervisory framework over its equities trading business was not reasonably designed to achieve compliance with the requirements of Reg SHO and other securities laws, rules and regulations throughout the period at least June 2006 through at least December 2010.

E. Research Analyst/Research Reports/Trading Huddles

1. Citigroup Global Markets (Case #20080123101)

On January 18, 2012, FINRA accepted an AWC whereby Citigroup Global Markets consented to a $725,000 fine and findings that it failed to disclose certain conflicts of interest in its research reports and research analysts' public appearances.

Citigroup failed to disclose potential conflicts of interest inherent in their business relationships in certain research reports it published from January 2007 through March 2010. Citigroup and/or its affiliates managed or co-managed public securities offerings, received investment banking or other revenue from, made a market in the securities of and/or had a 1 percent or greater beneficial ownership in covered companies, and did not make these required disclosures in certain research reports.

In addition, Citigroup research analysts failed to disclose these same potential conflicts of interest in connection with public appearances in which covered companies were mentioned.

FINRA found that Citigroup failed to disclose the required information because the database it used to identify and create the disclosures was inaccurate and/or incomplete due primarily to technical deficiencies. In addition, Citigroup failed to have reasonable supervisory procedures in place to ensure that the firm was populating its research reports with required disclosures.

F. Prospectus Delivery

1. Wells Fargo Advisors, LLC (Case #20100229218)

On May 5, 2011, FINRA announced that it had fined Wells Fargo Advisors, LLC, $1 million for, among other things, its failure to deliver prospectuses in a timely manner to customers who purchased mutual funds in 2009.

FINRA found that Wells Fargo failed to deliver prospectuses within three business days of the transaction, as required by federal securities laws, to approximately 934,000 customers who purchased mutual funds in 2009. The customers received their prospectuses from one to 153 days late. Wells Fargo had failed to take corrective measures to ensure timely delivery of the prospectuses after its third-party service provider, which Wells Fargo contracted with to mail prospectuses to customers, provided the firm with regular reports indicating that a number of customers had not received the prospectuses on time.

Wells Fargo contracted with a third-party service provider in 2009 to mail the prospectuses to customers. However, after receiving quarterly reports showing that between four percent and nine percent of the firm's mutual fund customers failed to receive required prospectuses on time and after being notified in daily reports that a number of prospectuses still required delivery, Wells Fargo did not take adequate corrective measures to ensure future delivery of the prospectuses in a timely manner.

G. Confirmations

1. National Financial Services (Case #2010021681701)

On July 25, 2011, FINRA issued an AWC finding that National Financial Services LLC ("NFS") issued order confirmations to customers reporting a lower sales load percentage than the customers actually paid for certain Unit Investment Trust ("UIT") transactions. NFS was censured, fined $200,000 and ordered to notify all affected customers that they received inaccurate confirmations from the firm with respect to the percentage sales loads charged on UIT transactions executed from February 2007 to November 2009 – and provide an explanation of the reason for the inaccurate sales load information on the confirmations.

From about February 2007 to November 2009, NFS issued approximately 90,000 confirmations to customers for UIT transactions that reported an inaccurate sales load percentage. The percentage listed on the confirmations as the sales load was actually the dealer concession. The sales load that the customers paid was correct (within the range listed in the prospectus), but the confirmations reflected a lower percentage sales load than what was actually charged. In preparing the confirmations during this time period, NFS relied on a faulty data feed from a third-party provider.

NFS also misstated the valuation methods used for the prices of nine alternative investment securities on customer account statements. As a clearing firm, NFS contracted with a third-party vendor that provided it with valuations for alternative investments held in customer accounts. NFS employees would manually input that information obtained from the vendor into the firm's electronic systems. At various times from about April 2006 to August 2010, however, NFS employees mistakenly inputted the wrong information into the firm's electronic systems. NFS placed the erroneous data on customer account statements, thereby misstating the valuation methods that were used to determine the prices of nine alternative investments.

FINRA found that this conduct violated Rule 10b-10 of the Securities Exchange Act of 1934, NASD Rules 2230 and 2110 and FINRA Rule 2010.

H. Postage and Handling

FINRA fined five broker-dealers for understating the amount of total commissions charged to customers in trade confirmations and on fee schedules by mischaracterizing a portion of the commission charges as fees for handling services. With respect to each of these firms, the handling fees were designed to serve as a source of additional transaction based remuneration for the firm and thus were far in excess of the cost of the handling-related services the firms provided.

The cases resulted from a targeted review of improper fees charged by broker-dealers in which FINRA found that the firms were routinely charging customers for handling fees that far exceeded the actual cost of the direct handling-related services the firms incurred in processing securities transactions. In some cases, firms charged a handling fee of almost $100 per transaction and earned a substantial percentage of their revenue from these fees.

FINRA sanctioned the following firms:

- Pointe Capital, Inc. (Case #2009015974701) (n/k/a JHS Capital Advisors, Inc.), of Boca Raton, Florida, was fined $300,000. The firm charged customers a handling fee as high as $95 per trade in addition to a commission. (Additional violations included inadequate supervisory procedures.)
- John Thomas Financial , of New York, NY, (Case #20090l634801) was fined $275,000. The firm charged its customers a handling fee as high as $75 per trade in addition to a commission. (Additional violations included effecting material changes in its business operations without prior approval from FINRA, and deficiencies in complaint reporting, supervisory controls and certifications, branch office supervision and recordkeeping.)
- First Midwest Securities, Inc., of Bloomington, IL, (Case #2009016348801) was fined $150,000. The firm charged customers a handling fee as high as $99 per trade in addition to a commission. (Additional violations included unfair and unreasonable markups/markdowns and inadequate written supervisory procedures.)
- A&F Financial Securities, Inc., of Syosset, NY, (Case #2009016292001) was fined $125,000. The firm charged its customers a handling fee of $65 per trade in addition to a commission. (Additional violations included inadequate supervisory system and procedures, and failure to comply with continuing education requirement.)
- Salomon Whitney LLC, of Babylon Village, NY (Case #2010022181901) was fined $60,000. The firm charged its customers a handling fee as high as $69 per trade in addition to a commission.

In settling FINRA’s actions, the firms agreed to implement corrective action to remedy the handling fee-related violations. The firms agreed to fully and accurately disclose the specific service performed and the related fee on confirmations and any other communications with a customer where fees are discussed. In addition, they will identify all transaction-based remuneration as commissions or mark-ups (mark-downs) rather than as postage, handling or any other miscellaneous fee. The firms also agreed to revise their written supervisory procedures and to provide training to the firms' registered representatives and associated persons related to transaction-based remuneration, reasonable fees, their appropriate disclosure to customers and retention of related records.

I. Failure to Supervise Tax Dividends

a. Morgan Stanley & Co. Inc. n/k/a Morgan Stanley & Co. LLC. (Case #2008015717101)

On June 28, 2011, FINRA issued an AWC fining the firm $575,000 for failing to establish and/or enforce adequate written supervisory procedures, and failing to adequately supervise total return swaps and off-shore stock loans. These transactions were designed to generate for certain off-shore clients a perceived tax advantage related to dividend income on U.S. equities. The advantage was known by various terms, including yield enhancement, and represented the amount that would have been withheld in taxes on a dividend, but that the client obtained through a transaction with the firm and/or its affiliates. In both types of transactions, the client did not hold the stock on the dividend record date but, instead, the firm structured the transaction as a swap or loan, and provided yield enhancement as part of a securities derivative or stock loan-related payment.

The clients sold the underlying equity before entering the swap, and brought that equity back after the swap terminated. The yield enhancement payments were appropriate only if the client surrendered beneficial ownership of the underlying equity during the life of the swap and engaged in market risk in the buying and selling of the equity. The firm was unable to substantiate the propriety of some yield enhancement payments because of supervisory deficiencies involving the use of transactions known as "crosses," short-term transactions and market-on-close pricing.

Regarding off-shore stock loans, FINRA found that the firm failed to establish written supervisory procedures and lacked effective working control of business operations that involved firm clients, client securities that were custodied in accounts at the firm, and firm personnel. The firm allowed affiliates to initiate and conduct the off-shore stock loan transactions without sufficient oversight from the firm. As a result, the firm was unable to substantiate that these transactions were conducted in a manner that made certain the yield enhancement payments were appropriate.

J. Arbitration

a. Attempts to limit the arbitrability of claims

i. Merrill Lynch (Case #2009020188101)

In January 2012, FINRA accepted an AWC whereby Merrill Lynch, Pierce, Fenner & Smith consented to a $1 million fine and findings that it failed to arbitrate disputes with employees relating to retention bonuses. Registered representatives who participated in the bonus program had to sign a promissory note that prevented them from arbitrating disagreements relating to the note, forcing the registered representatives to resolve disputes in New York state courts.

FINRA found that Merrill Lynch, after merging with Bank of America in January 2009, implemented a bonus program to retain certain high-producing registered representatives and purposely structured it to circumvent the requirement to institute arbitration proceedings with employees when it sought to collect unpaid amounts from any of the registered representatives who later left the firm. FINRA rules require that disputes between firms and associated persons be arbitrated if they arise out of the business activities of the firm or associated person.

In January 2009, Merrill Lynch paid $2.8 billion in retention bonuses structured as loans to over 5,000 registered representatives. The promissory notes required registered representatives to agree that actions regarding the notes could be brought only in New York state court, a state that greatly limits the ability of defendants to assert counterclaims in such actions.

Also, Merrill Lynch structured the program to make it appear that the funds for the program came from MLIFI, a non-registered affiliate, rather than from the firm itself, allowing it to pursue recovery of amounts due in the name of MLIFI in expedited hearings in New York state courts to circumvent Merrill Lynch's requirement to arbitrate disputes with its associated persons.

Later that year, after a number of registered representatives left the firm without repaying the amounts due under the loan, Merrill Lynch filed over 90 actions in New York state court to collect amounts due under the promissory notes, thus violating a FINRA rule that requires firms to arbitrate disputes with employees.

2. Restricting ability to participate in class actions.

a. Charles Schwab (Case #2011029760201)

FINRA filed a complaint against Charles Schwab & Company charging the firm with violating FINRA rules by requiring its customers to waive their rights to bring class actions against the firm. FINRA's complaint charges that in October 2011, Schwab amended its customer account agreement to include a provision requiring customers to waive their rights to bring or participate in class actions against the firm. Schwab sent the amended agreements to nearly 7 million customers. The agreement also included a provision requiring customers to agree that arbitrators in arbitration proceedings would not have the authority to consolidate more than one party's claims. FINRA's complaint charges that both provisions violate FINRA rules concerning language or conditions that firms may place in customer agreements.

FINRA's complaint seeks an expedited hearing because Schwab's conduct is ongoing, as the firm has continued to use account agreements containing these provisions in opening more than 50,000 new customer accounts since October 2011.

III. PROCEDURAL ISSUES

A. Credit for Cooperation

1. <u>Guidance Regarding Credit for Extraordinary Cooperation, FINRA *Regulatory Notice 08-70* (November 2008)</u>

<u>www.finra.org/Industry/Regulation/Notices/2008/P117453</u>

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.

b. UBS Securities LLC (Case #20080144511) (Reg SHO, see above)

The Firm's Corrective Actions during the Course of FINRA Enforcement's Investigation

FINRA notes that as the system-related locate and order marking problems described above were identified during the course of FINRA Enforcement's investigation, the Firm implemented changes to its systems and procedures that were designed to prevent a recurrence of these violations.

This Firm's Substantial Assistance to FINRA Enforcement's Investigation

FINRA acknowledges that in 2010, the Firm undertook an internal review of its supervisory policies, procedures and systems relating to Reg SHO. The Firm reported the findings of its internal investigation to FINRA. The sanctions … reflect the credit that UBS has been given for conducting an investigation of these issues and providing the results to FINRA.

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

New FINRA Rule 4530(b), which became 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.

