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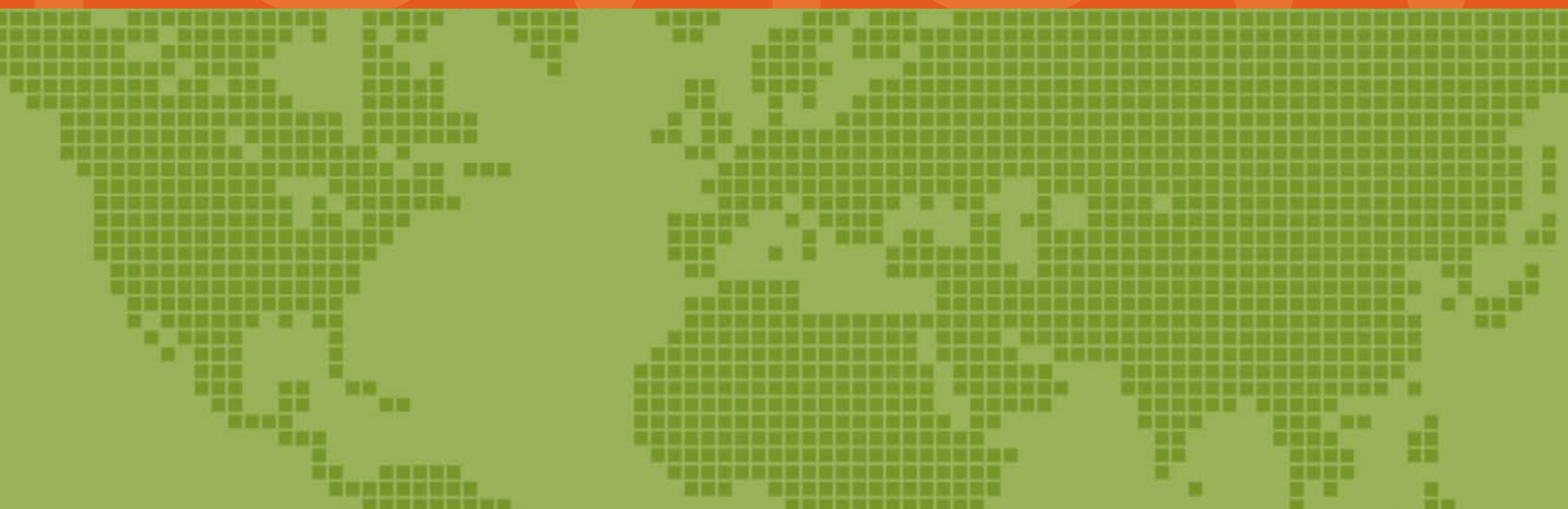

Select Broker-Dealer Enforcement Cases and Developments: 2014 Year in Review

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

The SEC

There were few significant personnel changes at the SEC last year. The Commission's composition was stable in 2014 with Chair Mary Jo White continuing to lead the SEC. The other commissioners are Luis A. Aguilar, Daniel M. Gallagher, Kara M. Stein, and Michael S. Piwowar. Notable changes were made with appointments in two major SEC divisions (Stephen Luparello was named the director of the Division of Trading and Markets, and Stephanie Avakian was named the new deputy director of the Division of Enforcement). New directors were also appointed to lead the Philadelphia and Atlanta regional offices.

The enforcement statistics compiled by the SEC during fiscal year 2014 (which ran from October 1, 2013 through September 30, 2014) set several records. Other aspects of the enforcement program led the Commission to dub fiscal year 2014 "A Year of Firsts."

In fiscal year 2014, the SEC brought a record 755 cases, a figure likely boosted by the number of open investigations carried over from the prior year. Moreover, the SEC's actions resulted in a record tally of monetary sanctions being imposed against defendants and respondents.

With respect to its caseload, in what has become a trend, the SEC brought 7% fewer cases against investment advisers and investment companies—130 cases in fiscal year 2014, compared to 140 actions in fiscal year 2013. To contrast, in fiscal year 2014, the SEC reversed its downward trend from fiscal year 2013, bringing 37% *more* actions against broker-dealers—166 in fiscal year 2014,

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[*] This outline was prepared by partners Timothy Burke, Amy Greer, Elizabeth Hoop-Fay, Ben Indek, and Amy Kroll; of counsel Mary Dunbar; associates Brian Baltz, Tabitha Wanjiru Bartholomew, Jennie Berman, Matthew Bohenek, Megan Braden, David Braun, Bruno Campos, Jacqueline Delbasty, Justin Drinkwine, Jane Dudzinski, Kathleen Garvey, Ariel Gursky, Elizabeth Hays, Kerry Land, Nicholas Losurdo, Grant MacQueen, Jeremy Menkowtiz, Justin Millette, Michael Moran, Kathy Mularczyk, Mary Pennisi, Hugo Ruiz, Ignacio Sandoval, Harya Tarekegn, and John Vassallo; and legal assistant Tanya Paul. Administrative support was provided by Veda Nieves. Morgan Lewis served as counsel in certain actions described herein.

compared to 121 in fiscal year 2013. Nevertheless, taken together, the SEC continues to devote significant resources to investigating regulated entities: cases in these areas have represented about 39% of the Commission's docket in each of the last two fiscal years.

After a sharp decline in 2013, the Commission brought 52 insider trading cases in fiscal year 2014, an 18% increase from fiscal year 2013, but this increased number is still lower than the fiscal year 2012 total. We will see in the coming year how changes to the legal landscape may affect the SEC's enforcement in this particular area.

Turning to monetary sanctions, in fiscal year 2014, the SEC obtained orders requiring the payment of $4.16 billion in penalties and disgorgement, a 22% increase from the amounts ordered in fiscal year 2013 and a record for the Commission. Last year, the SEC obtained orders in judicial and administrative cases that required the payment of approximately $1.378 billion in civil penalties and about $2.788 billion in disgorgement.

The SEC's Office of the Whistleblower program continued to receive a large number of leads for the Commission's investigators. Last year, whistleblowers submitted 3,620 tips, complaints, and referrals to the SEC, an increase of 382 (or approximately 11%) from the 3,238 received in fiscal year 2013. This last year, tips, complaints, and referrals came from all 50 states, the District of Columbia, Puerto Rico, Guam, the U.S. Virgin Islands, and 60 foreign countries. The United Kingdom (70), India (69), and Canada (58) led the way in referring complaints to the SEC from outside the country last year. Most complaints fell into three categories: corporate disclosure and financials (16.9%), offering fraud (16%), and manipulation (15.5%).

During the most recent fiscal year, the Division of Enforcement took 30 cases to trial, twice the number of cases tried in fiscal year 2013. Of those, Commission trial lawyers found themselves in federal courts more in fiscal year 2014 than in the prior 10 years, and more cases were tried to juries than in the previous three years *combined*. And, although, looking back over time, the SEC can say that it has won about 80% of the cases it has taken to trial, the Commission saw some mixed results at trial in fiscal year 2014. We can anticipate that all of these numbers will continue to climb as the SEC demands more in settlement in the way of sanctions and, in some cases, seeking admissions of wrongdoing, and gives less as waivers from statutory disqualifications become harder to obtain from the Commission.

In fiscal year 2014, the SEC Division of Enforcement pursued a number of creative strategies that allowed it to expand its reach in targeting misconduct. Chair White continues to concentrate the division's efforts on bringing new and innovative actions to expand the Commission's footprint and to strengthen the deterrent effect of its enforcement program. The Commission touted a number of first-time cases in areas, including the Market Access Rule, the Dodd-Frank Act's whistleblower anti-retaliation provisions, books and records, protection of

customer information, nonprosecution agreements (the first with an individual), and municipal securities. At the same time, the SEC continued its "broken windows" approach to enforcement and brought cases in connection with what seem like minor violations.

The Commission also continued to demand admissions in certain cases in fiscal year 2014 following Chair White's announcement of that approach in the prior year. Through November 2014, the Commission reported that it had obtained admissions in more than a dozen actions. Finally, the SEC has been increasingly bringing cases in its own administrative forum; in cases last fiscal year that were partially litigated, about 57% of those actions were reportedly filed in district court with the remaining 43% brought administratively. That approach has brought some criticism and even litigation.

We can anticipate continued focus in the coming year on municipal securities, thanks to several breakthrough actions in this area in fiscal year 2014, as well as the Municipalities Continuing Disclosure Cooperation Initiative. In addition, both the Microcap Fraud Task Force and the Broker-Dealer Task Force, which work across the SEC and with other regulators to coordinate information and expertise, will likely be significant sources of additional enforcement actions in the coming year. The entire enforcement program will no doubt benefit from the Commission's leveraging of "big data" collected through the examination program, through investigations, and from other sources, as it continues to not only use that data to identify areas of risk, but also analyze the information to try to work smarter in all areas.

FINRA

An interesting enforcement record emerged at FINRA last year. Although it instituted fewer disciplinary cases in 2014, its fines doubled from the prior year. Moreover, the amount of restitution that FINRA ordered in 2014 more than tripled the amount that had been returned to investors in 2013.

Specifically, in 2014, FINRA brought 1,397 new disciplinary actions, a noticeable decline from the 1,535 cases initiated in 2013. Along the same lines, FINRA resolved 1,110 formal actions last year; 197 fewer cases than it had in the prior year. With respect to penalties and restitution, in 2014, FINRA levied $134 million in fines (versus $60 million in 2013) and ordered $32.3 million to be paid in restitution to harmed investors (versus $9.5 million in 2013).

FINRA's use of Targeted Examination Letters seems to be declining. In 2014, FINRA posted only two letters on its website, versus three in 2013 and five in 2012. Last year's letters sought information on cybersecurity threats and order routing/execution quality. (In February 2015, FINRA published its *Report on Cybersecurity Practices*.)

There were two noteworthy enforcement developments in 2014.

First, in mid-2014, FINRA was criticized by SEC Commissioner Stein and the *Wall Street Journal* for its alleged failure to impose significant sanctions on brokerage firms and their executives. FINRA rejected those views. Interestingly, as described above, FINRA's fine levels doubled last year, and it returned more than three times the amount of money than it had in 2013.

At the time of the criticism regarding its enforcement program, FINRA announced that it would review its Sanction Guidelines. According to FINRA, it will focus particularly on repeat offenders and the largest broker-dealers. No timetable was set for the completion of the review.

Second, last year, FINRA announced two new regulatory service and market surveillance arrangements. In February 2014, FINRA announced that it had entered a regulatory service agreement with BATS Global Markets. Under this agreement, FINRA will provide cross-market surveillance services to BATS' four stock exchanges—BZX, BYX, EDGX, and EDGA, along with certain other regulatory services. This expands FINRA's cross-market surveillance program to 99% of all U.S. stock market trading. In December 2014, FINRA announced that it had signed an agreement with the Chicago Board Options Exchange (CBOE) and C2 Options Exchange (C2) to provide market surveillance, financial surveillance, examinations, investigations, and disciplinary services to CBOE and C2, in addition to other regulatory services. FINRA began performing these services as of January 1, 2015.

Looking ahead, it appears that FINRA will continue to focus its enforcement efforts in several areas, including fraud, misrepresentations, conversion and/or misuse of customer funds (particularly by individual financial advisers dealing with retail customers), anti-money laundering, suitability and supervision of complex products, trade execution and fair pricing, technology and operational issues, and cybersecurity.

Personnel Changes[1]

The Commission composition was stable in 2014. The current Commission is comprised of Chair Mary Jo White and four Commissioners: Luis A. Aguilar, Daniel M. Gallagher, Kara M. Stein, and Michael S. Piwowar.

As set forth below, there were some changes in key Staff positions during 2014.

Enforcement

On May 29, 2014, Stephanie Avakian was named Deputy Director of the Division of Enforcement. Ms. Avakian joined the SEC from the law firm of WilmerHale, where she was a partner in the New York office and vice chair of the securities practice. Ms. Avakian previously served as a Branch Chief in the New York Regional Office of the SEC, Division of Enforcement, and later as a counsel to SEC Commissioner Paul Carey.

On April 15, 2014, David Gottesman was named Deputy Chief Litigation Counsel for the Division of Enforcement. Mr. Gottesman had served in a supervisory role in the trial unit since 2011.

On September 8, 2014, Victor J. Valdez was named Chief Operating Officer and Managing Executive of the Enforcement Division, where he will oversee project management, information technology, human capital strategy, and risk management, among other functions. Prior to joining the SEC, Mr. Valdez held various positions at the Federal Deposit Insurance Corporation, the Office of the Director of National Intelligence, and the U.S. Air Force.

Regional Offices

New Directors were appointed in two of the SEC's 11 regional offices:

- Philadelphia Regional Office: Sharon Binger
- Atlanta Regional Office: Walter Jospin

[1] Unless otherwise noted, the information regarding these personnel changes was drawn from SEC Press Releases available on the Commission's website.

Trading and Markets

On February 20, 2014, Stephen Luparello was named Director of the Division of Trading and Markets. Mr. Luparello joined the SEC from WilmerHale, where he specialized in broker-dealer compliance and regulation, securities litigation, and enforcement. Mr. Luparello spent 16 years at FINRA, and its predecessor, the National Association of Securities Dealers (NASD), and immediately prior to coming to the SEC held the position of Vice Chairman of FINRA. Earlier in his career, Mr. Luparello spent nine years at the SEC, where he served as Branch Chief in the Office of Inspections in the Division of Market Regulation, now known as the Division of Trading and Markets.

On December 17, 2014, the SEC named Gary Barnett and Gary Goldsholle as Deputy Directors in the Division of Trading and Markets.

Mr. Barnett is responsible for the Office of Broker-Dealer Finances and the Office of Derivatives Policy and Trading Practices. Mr. Barnett joined the SEC from the Commodity Futures Trading Commission (CFTC), where he served as Director of the Division of Swap Dealer and Intermediary Oversight.

Mr. Goldsholle is responsible for the offices of the Chief Counsel, Clearance and Settlement, and Market Supervision. Prior to joining the SEC, Mr. Goldsholle served as General Counsel at the Municipal Securities Rulemaking Board (MSRB). Mr. Goldsholle's experience prior to the MSRB includes 15 years as Vice President and Associate General Counsel at FINRA, as well as positions at the CFTC and in private practice.

Office of Compliance Inspections and Examinations

On October 20, 2014, Marc Wyatt was named Deputy Director of the Office of Compliance Inspections and Examinations (OCIE). Mr. Wyatt joined the SEC in December 2012 as a senior specialized examiner focused on examinations of advisers to hedge funds and private equity funds. Prior to joining OCIE, Mr. Wyatt was a principal and senior portfolio manager at Stark Investments, a global hedge fund.

On September 23, 2014, Rhea Dignam was named as Senior Counsel to the Director of the OCIE. Ms. Dignam joined the SEC as the Director for the Atlanta Regional Office in March 2010. Prior to joining the SEC, Ms. Dignam's experience included positions as a principal with Ernst & Young LLP, Deputy General Counsel at New York Life Insurance Company, Executive Deputy Comptroller of New York City, Chief Assistant District Attorney in Kings County, New York, and she also served in several roles in the U.S. Attorney's Office for the Southern District of New York.

On December 10, 2014, Karol L. K. Pollock was named to lead the examination program in the Los Angeles Regional office. Ms. Pollock spent the past ten years in the Los Angeles office, starting as a Staff Attorney in the Enforcement

Division and later serving as Branch Chief. Mr. Pollock has nearly 25 years of experience in the securities enforcement and examination regulation fields, at the SEC, FINRA, New Mexico Securities Division, and in the private sector.

On November 26, 2014, Kevin Kelcourse was named Associate Director for OCIE in the SEC's Boston office. Mr. Kelcourse joined the SEC in 1999 as Senior Counsel in the Enforcement Division, and later served as a Branch Chief of the Boston office. He worked with the exam program since 2011, and served on the office's joint Enforcement Examination Referral Committee.

On October 28, 2014, Steven Levine was named Associate Director for the Investment Adviser/Investment Company examination program in the SEC's Chicago Regional office. Mr. Levine joined the SEC in 2000 as Senior Trial Counsel in the Enforcement Division of the Chicago office. In 2010, he joined the Investment Adviser/Investment Company examination program, where he served as one of its two acting Associate Directors since March 2013.

Enforcement Statistics[2]

In fiscal year 2014, the SEC brought a record 755 cases, a figure likely boosted by the number of open investigations carried over from the prior year. Moreover, the SEC's actions resulted in a record tally of monetary sanctions being imposed against defendants and respondents. Chair White stated that "[a]ggressive enforcement against wrongdoers who harm investors and threaten our financial markets remains a top priority," and the SEC will continue to bring "creative and important enforcement actions across a broad range of the securities market."[3]

A Record Number of Enforcement Actions Last Year; "High-Impact Enforcement Actions" for Fiscal Year 2015

The Commission initiated 755 enforcement actions in fiscal year 2014, the most ever filed in the history of the agency. New investigative approaches and the innovative use of data and analytical tools allowed the SEC to bring cases across the securities industry and contributed to a very strong year for Enforcement. The enforcement actions in 2014 included a number of first time cases and initiatives. Enforcement Director Andrew J. Ceresney said he is proud of the record of success and looks forward to a year filled with "high-impact enforcement actions."[4]

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2 Unless otherwise noted, the information in this section is drawn from the Commission's Press Release entitled "SEC's FY 2014 Enforcement Actions Span Securities Industry and Include First-Ever Cases," *available at*: http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543184660#.VMEkh2xOVfw. The SEC's FY 2014 ended on September 30, 2014.

3 *Id.*

4 *Id.*

The chart below reflects the cases brought by the SEC over the last decade:

Fiscal Year	Number of Enforcement Actions
2005	630
2006	574
2007	656
2008	671
2009	664
2010	681
2011	735
2012	734
2013	686
2014	755

Categories of Cases

The major categories of cases and the number of actions for fiscal year 2014 within each are as follows:

Type of Case	Number of Actions	Percentage of Total Actions
Broker-Dealer	166	22%
Investment Advisers/Investment Companies	130	17%
Securities Offering Cases	103	15%
Delinquent Filings	107	14%
Issuer Reporting and Disclosure	81	11%
Market Manipulation	63	8%
Insider Trading	52	7%
Miscellaneous	37	5%
FCPA	7	1%
Municipal Securities and Public Pensions	6	1%
Transfer Agent	7	1%

In what has become a trend, the SEC brought 7% fewer cases against investment advisers and investment companies, 130 cases in 2014, compared to 140 actions in 2013. This continued reduction is particularly noteworthy in a year when almost every other statistic is marked by increase. By way of contrast, in 2014, the SEC reversed its downward trend from 2013, bringing 37% *more* actions against broker-dealers, 166 in fiscal year 2014, compared to 121 in fiscal year 2013. Nevertheless, taken together, the SEC continues to devote significant resources to investigating regulated entities: cases in these areas have represented about 39% of the Commission's docket in each of the last two fiscal years.

After a sharp decline in 2013, the Commission brought 52 insider trading cases in fiscal year 2014, which represents an 18% increase over fiscal year 2013, but even this increased number is still lower than the fiscal year 2012 total of 58 insider trading actions. We will see in the coming year how changes to the legal landscape may impact the SEC's enforcement in this particular area.

Penalties, Disgorgement, and Distributions to Injured Investors

In fiscal year 2014, the SEC obtained orders requiring the payment of $4.16 billion in penalties and disgorgement, a 22% increase from the amounts ordered in fiscal year 2013 and a record for the Commission. Last year, the SEC obtained orders in judicial and administrative cases requiring the payment of approximately $1.378 billion in civil penalties, and about $2.788 billion in disgorgement.

Below is a chart reflecting the amount of fines and disgorgement orders obtained by the Commission between fiscal year 2005 and fiscal year 2014.

Fiscal Year	Penalties and Disgorgement
2005	$3.1 billion
2006	$3.275 billion
2007	$1.6 billion
2008	$1.03 billion
2009	$2.435 billion
2010	$2.85 billion
2011	$2.806 billion
2012	$3.0 billion
2013	$3.4 billion
2014	$4.16 billion

Additional Statistics

Recently, the Commission published its report titled "Select SEC and Market Data Fiscal 2014."[5] In the report's section on "Enforcement Milestones," the SEC noted the following fiscal year 2014 statistics:

- The Commission sought orders barring 57 individuals from serving as officers or directors of public companies.
- The SEC filed 12 actions to enforce its investigative subpoenas.
- The Commission went to federal court and sought temporary restraining orders to stop ongoing fraudulent conduct in 26 actions and sought asset freezes in 30 cases.
- The SEC halted trading in the securities of 589 issuers for which there was inadequate public disclosure.

Perhaps of more interest to those who are or may find themselves in the sights of the SEC Staff are the statistics about opened and closed investigations:[6]

- Investigations opened in fiscal year 2014 995
- Investigations closed in fiscal year 2014 822
- Investigations ongoing as of close fiscal year 2014 1,612

While it may seem heartening that the Commission is closing cases at such a high rate, even in a record year for Enforcement actions, when compared to fiscal year 2013, the numbers tell a very different tale.

- Investigations opened in fiscal year 2013 908
- Investigations closed in fiscal year 2013 1,187
- Investigations ongoing as of close fiscal year 2013 1,444

Based on the review of fiscal year 2013 investigations, it appears that the Enforcement Division has become somewhat slower to close investigations, and it also looks as though the Enforcement Division has a healthy head start on another record year for enforcement actions, simply based on its investigations inventory.

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[5] *See* Select SEC and Market Data Fiscal 2014 available on the Commissions website at https://www.sec.gov/about/secstats2014.pdf.

[6] *Id.*

Office of the Whistleblower[7]

The SEC's whistleblower program completed its fourth year of operation in fiscal year 2014. Persons who voluntarily provide the SEC with original information leading to a successful enforcement case resulting in monetary sanctions of more than $1 million, may be eligible to receive an award between 10 and 30% of the funds collected by the Commission or in a related enforcement case.

In fiscal year 2014, the SEC's Office of the Whistleblower received 3,620 tips, complaints, and referrals from whistleblowers, an increase of 382 (or approximately 11%) from the 3,238 received in fiscal year 2013. This past year, tips, complaints, and referrals came from all 50 states, the District of Columbia, Puerto Rico, Guam, the U.S. Virgin Islands, and 60 foreign countries. The United Kingdom (70), India (69), and Canada (58) led the way in referring complaints to the SEC from outside the country last year. Most complaints fell into three categories: corporate disclosure and financials (16.9%), offering fraud (16%), and manipulation (15.5%). The number of allegations received by the SEC in these and other categories is presented below.

Allegation Type	Number of Allegations	Approx. Percentage of Total Allegations
Corporate Disclosure and Financials	610	16.9%
Offering Fraud	581	16.0%
Manipulation	563	15.5%
Insider Trading	256	7.1%
Trading and Pricing	144	4.0%
FCPA	159	4.4%
Unregistered Offerings	102	2.8%
Market Event	139	3.8%
Municipal Securities and Public Pension	58	1.6%
Other	911	25.2%
Blank	97	2.7%

Last year, the SEC reported that it had paid nine whistleblowers a combined total of $1,932,863.92. However, that figure does not include awards that were authorized during fiscal year 2014, but paid after September 30, 2014. The largest award to date was authorized on September 22, 2014 in the amount of

[7] "Annual Report on the Dodd-Frank Whistleblower Program: Fiscal Year 2014" (Nov. 2014), *available at:* http://www.sec.gov/about/offices/owb/annual-report-2014.pdf.

over $30 million, which is more than double the previous highest award under the whistleblower program.

Key Enforcement Developments

A Record Year in Enforcement

As noted, fiscal year 2014 was a "banner year" for the SEC's Enforcement Division in terms of the number of cases and penalties imposed.[8] Fiscal year 2014 also saw a number of first time actions brought by the SEC, including its first cases involving violations of the Market Access Rule. The SEC also announced its largest ever whistleblower award of over $30 million. The SEC also tried more cases in federal court this past year than in any of the previous 10 years; and more Commission cases were tried to juries in fiscal year 2014 than in the previous three years combined.[9]

"A Year of Firsts"

In fiscal year 2014, the SEC Enforcement Division pursued a number of creative strategies, and employed new tools to collect data and meaningfully bring that information to bear in its cases, allowing the Enforcement Division to expand its reach in targeting misconduct. Chair White continues to concentrate the SEC's efforts on bringing new and innovative actions to expand the Enforcement footprint and to strengthen the deterrent impact of the Enforcement program.[10] These creative strategies, as well as a host of new regulations, resulted in fiscal year 2014 being dubbed by the SEC as "A Year of Firsts."[11]

First Market Access Rule Enforcement Actions

In 2010, the SEC adopted Rule 15c3-5 of the Securities Exchange Act of 1934, which requires firms to have adequate risk controls in place before providing customers with access to the market (the "Market Access Rule"). For years, the SEC worked to offer guidance on this complex regulation, finally issuing FAQ's in April 2014. However, even before that guidance was released, in the very first case brought under the rule, in October 2013, Knight Capital Americas LLC paid a $12 million penalty to settle charges that it violated the Market Access Rule for conduct relating to a trading incident that rapidly sent more than four million orders into the market, disrupting trading, when Knight was attempting to fill just

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8 *See* Director Ceresney's remarks titled "Remarks to the American Bar Association's Business Law Section Fall Meeting," Washington, D.C. (Nov. 21, 2014) *available at*: http://www.sec.gov/News/Speech/Detail/Speech/1370543515297#.VH3b-GxOU6Y.

9 *Id.*

10 *See* Chair White's remarks titled "The Challenge of Coverage, Accountability and Deterrence in Global Enforcement," delivered at the IOSCO 39th Annual Conference, Rio de Janiero (Oct. 1, 2014) *available at*: http://www.sec.gov/News/Speech/Detail/Speech/1370543090864#.VH3XtGxOU6Y.

11 *See* U.S. Securities and Exchange Commission "Fiscal Year 2014 Agency Financial Report," p.20.

212 customer orders.[12] In June 2014, the SEC filed a complaint charging Wedbush Securities Inc., one of the country's largest volume market access providers, with violations of the Market Access Rule, among other charges, alleging that the firm had failed to maintain direct and exclusive control over settings in trading platforms used by its customers to send orders to the markets.[13]

Whistleblower Anti-Retaliation

In 2011, a Commission rule adopted under the Dodd-Frank Act authorized the SEC to bring enforcement actions based on retaliation against whistleblowers who report potential securities law violations to the SEC. In the first case under this new authority, the SEC charged Paradigm Capital Management, a hedge fund advisory firm, for engaging in prohibited principal transactions and retaliating against the employee who reported the violative trading activity to the SEC. The firm and its owner paid $2.2 million to settle the charges.[14]

Failure to Provide Accurate "Blue Sheet" Data to the SEC

In its first action to enforce the recordkeeping requirements established by Rules 17a-25 and 17a-4(f)(3)(v) of the Exchange Act, the SEC charged Scottrade, a brokerage firm, with failing to provide the agency with complete and accurate information concerning trades executed by the firm and its customers over a six-year period. Scottrade paid $2.5 million to settle the charges, admitted that it violated the Federal securities laws, and retained an independent compliance consultant to review its protocols regarding the submission of blue sheets.[15]

Failure to Protect Customer Information

The SEC also brought its first action against a broker-dealer for failing to protect a customer's information from misappropriation by an employee. The SEC charged Wells Fargo Advisors LLC with failing to maintain and enforce procedures reasonably designed to prevent employees from misusing material

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12 *See* Press Release No. 2013-222, "SEC Charges Knight Capital With Violations of Market Access Rule" (Oct. 16, 2013), *available at:* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539879795#.VIigZmxOU6Y. Note that although this case was brought in October 2013, it fell with the SEC's 2014 fiscal year.

13 *See* Press Release No. 2014-115, "SEC Announces Charges Against Wedbush Securities and Two Officials for Market Access Violations" (June 6, 2014), *available at:* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542011614#.VIiiFmxOU6Y. That action was later settled by the SEC and Wedbush.

14 *See* SEC Press Release No. 2014-118, "SEC Charges Hedge Fund Adviser With Conducting Conflicted Transactions and Retaliating Against Whistleblower" (June 16, 2014), *available at:* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542096307#.VKqns2xOVfw.

15 *See* SEC Press Release No. 2014-17, "Scottrade Agrees to Pay $2.5 Million and Admits Providing Flawed "Blue Sheet" Trading Data" (Jan. 29, 2014), *available at:* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540696906#.VKqpXWxOVfw.

nonpublic information obtained from retail customers and clients. This action was also marked by compliance issues that arose during the course of the investigation, resulting in the Commission also bringing charges relating to delays in the production of documents during the investigation, and the production of an altered document. Wells Fargo settled the charges by admitting the wrongdoing, paying $5 million, and retaining an independent consultant.[16]

First Non-Prosecution Agreement with an Individual

In April 2014, the SEC entered into its first non-prosecution agreement with an individual.[17] A former executive was charged with insider trading prior to eBay's acquisition of the e-commerce company where he worked. The investigation uncovered a string of tippers and tippees, and ultimately led to actions against five traders, in addition to the non-prosecution agreement with the one individual. According to the SEC, the individual provided early and unconditional cooperation, as well as agreeing to disgorge his or her trading profits.

Two Firsts in the Municipal Securities Area

The SEC brought its first enforcement action against a municipal issuer in which it imposed a financial penalty, the state of Washington's Wenatchee Valley region, which settled charges that it misled investors and agreed to pay a $20,000 penalty.[18] The SEC also brought a companion case against the underwriter, Piper Jaffray and Co. and an investment banker. Separately, the Commission also filed an emergency action and obtained a court order against the City of Harvey, Illinois, stopping the City from proceeding with a bond offering.[19] The Complaint alleged that the offering was fraudulent, since material facts about prior offerings were not disclosed.[20]

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[16] *See* SEC Press Release No. 2014-228, "Wells Fargo Advisors Admits Failing to Maintain Controls and Producing Altered Document, Agrees to Pay $5 Million Penalty" (Sept. 22, 2014), *available at:* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543012047#.VL6bLmxOVfw.

[17] *See* SEC Press Release No. 2014-85, "SEC Charges Six Individuals With Insider Trading in Stock of E-Commerce Company Prior to Acquisition by eBay" (Apr. 25, 2014), *available at:* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541642140#.VKrHVWxOVfw.

[18] *See* SEC Press Release No. 2013-235, "SEC Charges Municipal Issuer in Washington's Wenatchee Valley Region for Misleading Investors" (Nov. 5, 2013), *available at:* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540262235#.VMcOkWxOUcA.

[19] *See* SEC Press Release No. 2014-122, "SEC Obtains Court Order to Halt Fraudulent Bond Offering by City of Harvey, Ill." (June 25, 2014), *available at:* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542163027#.VMcO6mxOUcA.

[20] *Id.*

Areas of Focus for the Enforcement Division

Municipal Securities

In fiscal year 2014, the SEC continued its focus on the municipal securities market, including conflicts of interest and pay-to-play schemes. In March 2014, Enforcement launched the Municipalities Continuing Disclosure Cooperation (MCDC) initiative to encourage issuers and underwriters to self-report certain violations of the Federal securities laws relating to the continuing disclosure obligations specified in Rule 15c2-12 under the Exchange Act.[21] Under the initiative, Enforcement will recommend standardized, favorable settlement terms to those who self-report violations. In a press release, Director Ceresney stated: "Those who do not self-report and instead decide to take their chances can expect to face increased sanctions for violations."[22]

In its first action under the MCDC initiative, the SEC settled charges against Kings Canyon Joint Unified School District concerning an inaccurate continuing disclosure affirmation made in connection with a 2010 bond offering.[23] Kings Canyon consented to a cease-and-desist order, and adopted new policies and procedures.

The Microcap Fraud Task Force

In July 2013, the SEC announced the creation of a new enforcement initiative in the form of a specialized task force targeting abusive and fraudulent conduct in securities issued by microcap companies, with an emphasis on those that do not regularly report their financial results to the public. In the last fiscal year, the Commission reported that Enforcement actively combated microcap fraud by suspending trading in securities that are likely objects of pump and dump schemes, including 255 dormant shell companies; targeting recidivists who facilitate these schemes; and working to strengthen the SEC's relationships with other regulators and law enforcement partners that have jurisdiction and interest in this area.[24] The Commission's website devotes a page to the Microcap Fraud Task Force, which is regularly updated, where Investor Alerts, as well as information about Task Force cases and targeted companies, can be found.[25]

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[21] *See* SEC Press Release No. 2014-46, "SEC Launches Enforcement Cooperation Initiative for Municipal Issuers and Underwriters" (Mar. 10, 2014), *available at:* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541090828#.VKqvq2xOVfw.

[22] *Id.*

[23] *See* SEC Press Release No. 2014-133, "SEC Charges California School District with Misleading Investors" (July 8, 2014), *available at:* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542256676#.VKq0X2xOVfw.

[24] *See* U.S. Securities and Exchange Commission "Fiscal Year 2014 Agency Financial Report," p.24.

[25] http://www.sec.gov/spotlight/microcap-fraud.shtml.

The Broker-Dealer Task Force

In December 2013, the SEC announced that it would create a new Enforcement task force to increase its focus on the activities of broker-dealers. As described more recently in the agency's 2014 Financial Report, the Broker-Dealer Task Force will continue to be focused on current issues and practices within the broker-dealer community and develop national initiatives for potential investigations.[26] According to Enforcement Director Ceresney, the SEC will use this task force to coordinate broker-dealer related initiatives across the agency.[27] The Broker-Dealer Task Force will also coordinate with OCIE and with FINRA to generate quality referrals and investigations. Early efforts include initiatives relating to anti-money laundering regulations and recidivist brokerage firms that shelter rogue brokers and/or engage in abusive activities.[28] The spike in cases against broker-dealer firms in fiscal year 2014 may be coincidental, but it could very well be the result of the increased attention brought to bear by this Task Force.

Using "Big Data" Across The Agency

In the past year, Commission personnel spoke often about their great strides in leveraging data and technology to enhance their ability to detect and pursue misconduct.[29] One key development is the use of new analytical tools to increase the SEC's capability to detect insider trading.[30] A number of cases brought this past year were built using this sort of data analytics.[31] The Commission is also sifting through nonpublic clearing firm data for problematic patterns in the sale and trading of certain asset-backed securities and other complex products.[32] The Broker-Dealer Task Force also has developed initiatives utilizing technology and data-driven analyses to target excessive trading in customer accounts and inadequate compliance with the anti-money laundering and Bank Secrecy Act regulations.[33] The SEC is also using the data it collects to examine and monitor market structure and integrity and, it has developed an analytics tool for use in the examination program that permits the review of years of trading data in a matter of minutes.[34] According to the SEC,

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26 *Id.* at p.40.

27 *See* Director Ceresney's Keynote Address at Compliance Week 2014 (May 20, 2014), *available at:* http://www.sec.gov/News/Speech/Detail/Speech/1370541872207#.VKq61GxOVfw.

28 *Id.*

29 *See* Director Ceresney's remarks titled "Remarks to the American Bar Association's Business Law Section Fall Meeting," Washington, D.C. (Nov. 21, 2014) *available at*: http://www.sec.gov/News/Speech/Detail/Speech/1370543515297#.VH3b-GxOU6Y.

30 *Id.*

31 *Id.*

32 *Id.*

33 *Id.*

34 *See* SEC Agency Financial Report Fiscal Year 2014 at p. 29.

leveraging across the agency all of the data and information that the Commission receives and obtains from all of its different sources - investigations, examinations, referrals, tips, and more - is the future of regulation and enforcement and continues to be an area of significant focus.[35]

"Broken Windows" Enforcement

In October 2013, Chair White emphasized the agency's commitment to pursuing violations large and small, and stated that the SEC would look for violations in all corners of the market.[36] She analogized this enforcement strategy to the so-called "broken windows" strategy employed by former New York Mayor Rudolph Giuliani and made it clear that the SEC would pursue strategic prosecution of smaller violations in an effort to send a broader deterrent message. In March 2014, Chair White reiterated the SEC's approach that no violation is too small to ignore, and that the enforcement program is like "the police officer who protects the entire neighborhood."[37]

In fiscal year 2014, in addition to large, complex cases, the SEC remained focused on pursuing smaller, compliance-related violations under its "broken windows" policy. For example, the SEC sanctioned three firms under its Compliance Program Initiative, which targets firms that have failed to act upon previous warnings by SEC examiners about compliance deficiencies.[38] In another action, the SEC charged 28 individuals and six companies for violating the Federal securities laws requiring prompt reporting of transactions and holdings.[39] A total of 33 of the 34 individuals and companies named in the SEC's orders agreed to settle the charges and pay financial penalties totaling $2.6 million.[40]

Enforcement also continued to target violations of Rule 105, an anti-manipulation rule that prohibits firms from participating in public offerings after short-selling those same stocks within a restricted period. In its second sweep targeting these violations, the SEC settled with 19 firms and one individual for their Rule 105

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35 *See* SEC Agency Financial Report Fiscal Year 2014 at, *e.g.*, p. 14.

36 *See* Chair White's remarks at the Securities Enforcement Forum (Oct. 9, 2013), *available at:* http://www.sec.gov/News/Speech/Detail/Speech/1370539872100.

37 *See* Chair White's remarks to the Annual Forum of the Australian Securities and Investments Commission (ASIC) (Mar. 24, 2014), *available at:* http://www.sec.gov/News/Speech/Detail/Speech/1370541253621#.VLQ8bmxOVfw.

38 *See* SEC Press Release No. 2013-226, "SEC Sanctions Three Firms Under Compliance Program Initiative" (Oct. 13, 2013), *available at:* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540008287#.VLQBTmxOVfw.

39 *See* SEC Press Release No. 2014-190, "SEC Announces Charges Against Corporate Insiders for Violating Laws Requiring Prompt Reporting of Transactions and Holdings" (Sept. 10, 2014), *available at:* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542904678#.VLQCOWxOVfw.

40 *Id.*

violations, obtaining a combined total of more than $9 million in disgorgement, interest and penalties.[41]

Insider Trading

Insider trading continues to be an important area of focus for the SEC's Enforcement Division. And, while only 7% of the agency's enforcement actions are classified as insider trading cases, the headline value is enormous. Moreover, the Commission plainly believes it has only just begun to utilize tools to analyze data that will eventually help the Staff to find and prosecute insider trading in a more meaningful way.

That said, a recent decision of the U.S. Court of Appeals for the Second Circuit in a criminal insider trading case brought by the U.S. Department of Justice, could limit what had been the expanding reach of insider trading law. In *U.S. v. Newman*, Todd Newman, a former portfolio manager at Diamondback Capital Management, and Anthony Chiasson, co-founder of Level Global Investors, were charged with several counts of securities fraud based on trading on alleged tips about Dell and NVIDIA earnings. The inside information was allegedly conveyed through multiple layers of analysts, making Newman and Chiasson "remote" or "downstream" tippees. Both defendants were found guilty at trial before U.S. District Judge Richard J. Sullivan of the Southern District of New York in late 2012.

On appeal, the Second Circuit held that "in order to sustain a conviction for insider trading, the government must prove beyond a reasonable doubt that the tippee knew that an insider disclosed the confidential information and that he did so in exchange for a personal benefit."[42] The Court also found that the government's evidence of personal benefit was insufficient, and there was no evidence that the defendants even knew of a benefit.[43] In further defining "personal benefit," the Court said that there must be a "meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similar valuable nature."[44] The U.S. Attorney for the Southern District of New York has sought rehearing and rehearing *en banc* of the Second Circuit decision,[45] and therefore it may be a while until this issue is settled. However, the *Newman* decision is currently the law, which already has resulted in the successful

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41 *See* U.S. Securities and Exchange Commission "Fiscal Year 2014 Agency Financial Report," p. 27.

42 *United States v. Newman*, 773 F.3d 438 (2d Cir. Dec. 10, 2014), Nos. 13-1837-cr (L), 13-1917-cr (CON), 2014 WL 6911278, at *1.

43 *Id.*

44 *Id.* at *10.

45 Petition of the United States of America for Rehearing and Rehearing En Banc, *United States v. Newman*, 773 F.3d 438 (2d Cir. Dec. 10, 2014), Nos. 13-1837-cr (L), 13-1917-cr (CON).

withdrawal of guilty pleas and other courts seeking briefing from the parties on the decision's impact.[46]

Insider trading has historically received significant attention from the SEC, as well as criminal prosecutors.[47] In fiscal year 2014, the SEC brought 52 insider trading actions.[48] These cases involved a wide range of entities and individuals including financial professionals, lawyers, and corporate insiders. Given the substantial hurdles presented by *Newman*, the SEC will have to carefully consider the facts presented in cases that involve tipping.

The Changing Nature of Settlements and Trials

SEC's Trial Record

As Chair of the Commission, Mary Jo White has been unequivocal in expressing that the SEC is ready and willing to take cases to trial. In November 2013, Chair White reiterated this theme in a speech entitled "The Importance of Trials to the Law and Public Accountability."[49] Fiscal Year 2014 gave the Enforcement Division plenty of opportunity to "walk that talk." During the most recent fiscal year, the SEC took 30 cases to trial, twice the number of cases tried in fiscal year 2013.[50] Of those, Commission trial lawyers found themselves in federal courts more in fiscal year 2014 than in the prior ten years, and more cases were tried to juries than in the previous three years *combined*. And, while, looking back over time, the SEC can say that it has won about 80% of the cases it has taken to trial,[51] the Commission saw some mixed results at trial in 2014.

The SEC won two trials early in fiscal year 2014, in October 2013. In a case alleging a $21 million offering fraud by a real estate lending fund, after a five-week trial, the jury returned a verdict finding the defendants liable on all

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[46] *See* Order, *United States v. Conradt, et al.*, No. 12-cr-887 (ALC) (S.D.N.Y. 2012); Order, *United States v. Goffer*, No. 10-cr-56 (RJS) (S.D.N.Y. 2010); In the Matter of Gregory T. Bolan, Jr. & Joseph C. Ruggieri, Exchange Act Release No. 2256 (Jan. 26, 2015) (order), available at: http://www.sec.gov/alj/aljorders/2015/ap-2256.pdf; Respondents' Motion for Summary Disposition, In the Matter of Gregory T. Bolan, Jr. & Joseph C. Ruggieri, Respondents, Admin. Pro. File No. 3-16178 (Jan. 8, 2015), available at: http://www.sec.gov/litigation/apdocuments/3-16178-event-26.pdf.

[47] *See* Chair White's remarks titled "All-Encompassing Enforcement: The Robust Use of Civil and Criminal Actions to Police the Markets," (Mar. 31, 2014), *available at*: http://www.sec.gov/News/Speech/Detail/Speech/1370541342996#.VLbcYGxOVfw.

[48] *See* U.S. Securities and Exchange Commission "Fiscal Year 2014 Agency Financial Report," p. 22.

[49] *See* Chair White's remarks titled "The Importance of Trials to the Law and Public Accountability," delivered at the 5th Annual Judge Thomas A. Flannery Lecture, Washington, D.C. (Nov. 14, 2013), *available at*: http://www.sec.gov/News/Speech/Detail/Speech/1370540374908.

[50] *See* Director Ceresney's remarks titled "Remarks to the American Bar Association's Business Law Section Fall Meeting," Washington, D.C. (Nov. 21, 2014) *available at*: http://www.sec.gov/News/Speech/Detail/Speech/1370543515297#.VH3b-GxOU6Y.

[51] *Id.*

charges.[52] In another case, in which the SEC had charged AIC, Inc., a financial services holding company, with an unregistered offering fraud targeting elderly, unsophisticated brokerage customers, the jury found defendants liable on all counts.[53]

Then, in December 2013, the SEC lost two cases, each charging individuals with misconduct in connection with financial fraud at public companies. On December 4, a Kansas City jury cleared Stephen Kovzan, an executive at the technology company NIC, Inc., of all charges. The SEC had accused Kovzan of concealing a payment of more than $1.8 million to NIC's then-CEO and circumventing accounting controls.[54] Just one week later, following an eight-day bench trial, a California court rejected the SEC's accounting fraud allegations against two former executives of Basin Water, Inc., holding that the SEC had failed to meet its burden of proof.[55]

Insider trading cases were particularly tough for the SEC in fiscal year 2014. In October 2013, a jury ruled in favor of Mark Cuban on all counts in a high-profile SEC insider trading trial.[56] In January 2014, the SEC lost a circumstantial tipping case.[57] In another loss for the SEC in January 2014, a jury found that an employee who surmised an impending transaction from activity at the company where he worked and then traded on those suspicions could not be found to have violated the securities laws.[58]

In May 2014, the SEC lost a trial against a hedge fund manager and analyst at Wynnefield Capital, and a former GE Capital employee who worked on a 2001 corporate takeover, in which the SEC alleged insider trading.[59] One week later, the SEC lost another trial where circumstantial evidence was presented concerning what the trader knew and disclosed about certain contracts at a time when he sold his securities.[60]

But not every insider trading case resulted in a complete loss for the SEC; the Commission was successful in some instances in getting mixed verdicts. In one case, the defendants were found not to have used inside information concerning a management buyout in connection with their trading, but were held liable for

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52 *SEC v. True North Finance Corporation et al.*, Civil Action No. 10-3995-DWF/JJK (D. Minn. filed Sept. 21, 2010).

53 *SEC v. AIC, Inc., et al.*, Civil Action No. 3:11-cv-00176 (E.D. Tenn. filed Apr. 18, 2011).

54 *SEC v. Kovzan*, Civil Action No. 2:11-CV-02017 (JWL) (D. Kan. filed Jan. 12, 2011).

55 *SEC v. Jensen, et al.*, Civil Action No. 2:11-CV-05315 (C.D. Cal. filed June 27, 2011).

56 *SEC v. Mark Cuban*, Civil Action No. 3-CV-2050-D (SF) (N.D. Tex. filed Nov. 17, 2008).

57 *SEC v. Schvacho*, Civil Action No. 12-CV-02557 (N.D. Ga. filed July 24, 2012).

58 *SEC v. Steffes*, Civil Action No. 10-CV-06266 (N.D. Ill. filed Sept. 30, 2010).

59 *SEC v. Obus*, Civil Action No. 06-CV-03150 (S.D.N.Y. filed Sept. 20, 2010).

60 *SEC v. Moshayedi*, Civil Action No. 12-CV-01179 (C.D. Cal. filed July 19, 2012).

front-running.[61] In another mixed verdict case, involving a company that sells to investors the right to receive insurance policy death benefits, the SEC was successful on counts relating to revenue recognition, but lost on counts relating to disclosure and accounting fraud, as well as insider trading.[62]

Despite a number of losses and mixed verdicts, the SEC did win several important trials in the fiscal year. In May 2014, in one of its biggest wins of the year, a jury returned a verdict in favor of the SEC on all counts alleged against two corporate insider brothers, though the Court did dismiss the insider trading claim, after the jury verdict.[63] The SEC alleged that the two brothers were behind a complex 13-year scheme to hold and trade tens of millions of securities of public companies while serving as company board members and without disclosing any securities-related activity. The brothers were ordered to pay more than $187 million in disgorgement. In August 2014, a Florida jury found that Edward Hayter, CEO and president of BIH Corp., orchestrated a pump-and-dump scheme and defrauded investors by selling unregistered stock and providing false information about the company.[64] Also in August 2014, the SEC won a verdict against Sage Advisory Group, LLC and its principal in a fraud case alleging that defendants had made materially false and misleading statements to customers in a scheme to induce former brokerage customers to transfer assets to his new advisory firm.[65]

Notwithstanding the SEC's somewhat mixed record of trial outcomes in the last year, the Commission is likely to continue to take cases to trial, rather than accept what it perceives as weak settlements. Nonetheless, the SEC must contend with the pragmatic reality of its own limited resources. This reality will undoubtedly be tested by issues that have changed the calculus of settlements for those facing a potential enforcement action.

Settlement or Trial? A New Analysis

Those who find themselves evaluating whether to settle with the SEC or go to trial now also have to factor into that decision the Commission's determination that it will seek admissions of wrongdoing as a condition of settlement in some cases; the fact that the process for obtaining waivers from certain statutory disqualifications that could result from the settlement of certain types of charges has significantly changed; and the Enforcement Division's increased use of Administrative Proceedings post-Dodd-Frank, which impose a "rocket docket" with procedural limitations on litigants. Where a putative defendant or respondent might well have settled with the SEC to avoid the financial and other

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61 *SEC v. Yang*, Civil Action No. 12-CV-02473 (N.D. Ill. filed April 4, 2012).

62 *SEC v. Life Partners Holdings, Inc.*, Civil Action No. 12-CV-00033 (W.D. Tex. filed Dec. 3, 2013).

63 *SEC v. Samuel E. Wyly, et al.*, 10-CV-5760 (S.D.N.Y filed July 29, 2010).

64 *SEC v. BIH Corp. et al.*, Civil Action No. 2:10-CV-00577 (M.D. Fla. filed Sept. 20, 2010).

65 *SEC v. Sage Advisory Group et al.*, 1:10-CV-11665 (D. Mass. filed Sept. 29, 2010).

costs associated with a trial before, these new issues fundamentally alter that decision.

Admissions As The Price of Settlement

The idea that a settling defendant might have to admit to anything was, until recently, unheard of in SEC practice. However, this issue has changed quickly, thanks to a push from Judge Jed Rakoff, of the U.S. District Court for the Southern District of New York, and to a more aggressive Division of Enforcement.

First, in November 2011, Judge Rakoff refused to enter an order approving a settlement reached by the SEC and Citigroup. The SEC had filed a complaint against Citigroup alleging claims arising out of the structuring and marketing of a largely synthetic collateralized debt obligation. Shortly after the filing, the SEC filed a proposed Consent Judgment, reflecting the parties' settlement. Subsequently, the district court issued an order declining to approve the Consent Judgment. In his written opinion, Judge Rakoff stated that he was without an evidentiary basis to determine reasonableness, fairness, adequacy, or whether the settlement was in the public's interest.[66] Both the SEC and Citigroup appealed.

In August 2014, the United States Court of Appeals for the Second Circuit vacated and remanded Judge Rakoff's refusal to approve the parties' settlement.[67] The Second Circuit held that Judge Rakoff had applied an incorrect legal standard for evaluating the parties' settlement.[68] The Court of Appeals further opined that it is an abuse of discretion for a court to require the SEC to establish the "truth" of allegations against a settling defendant as a precondition of settlement, noting that, "[t]rials are primarily about the truth. Consent decrees are primarily about pragmatism."[69]

As the *Citigroup* case was playing out in the courts, in June 2013, in a significant departure from past practice, Chair White announced that the SEC would begin requiring admissions of facts and misconduct from defendants as a condition of settlement in cases where there was a heightened need for public accountability. Throughout fiscal year 2014, Enforcement Director Ceresney has stated that admissions will be considered in certain types of cases, including those where large numbers of investors were harmed, where the markets or investors were placed at significant risk, where the wrongdoer posed a particular future threat to investors or the markets, where the defendant engaged in unlawful obstruction of

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[66] *See SEC v. Citigroup Global Mkts, Inc.*, 827 F. Supp.2d 328, 335 (S.D.N.Y. 2011).

[67] *See SEC v. Citigroup Global Mkts., Inc.*, 752 F.3d 285 (2014).

[68] *Id.*

[69] *Id.* at 295.

the Commission's processes, or where admissions would significantly enhance the deterrence message of the action.[70]

Since the implementation of the new policy, the SEC has obtained admissions in over a dozen cases.[71] The admissions have come from a variety of types of defendants – firms and individuals, as well as regulated and unregulated entities – and involve a broad range of conduct, including both scienter and non-scienter based violations. Cases from fiscal year 2014 in which the SEC obtained admissions included those involving fraud on clients concerning trading practices,[72] a longstanding failure to comply with registration provisions,[73] and failures to provide the Commission with accurate information during its investigations,[74] among other types of violations.

Although one can expect that the number of cases in which the SEC will require admissions as a condition of settlement to increase, from fiscal year 2014 it is clear that egregiousness of conduct is not the sole measure, since many large, and seemingly important, scienter-based cases settled without admissions. Since Enforcement Director Ceresney has also announced that once sought, admissions will not be subject to negotiation,[75] it appears to be crucial during an investigation to clarify for the investigative staff early on that admissions are not possible in settlement and explain why that is important, so as to avoid issues later. Certainly, the potential for admissions alters the risk/benefit calculus of settling a matter with the Commission and will require a settling party to factor in the impact of admissions on potential collateral actions. For regulated entities and individuals, an SEC demand for admissions also reframes the issue of the advisability of litigating against one's primary regulator.

Well-Known Seasoned Issuer and Other Waivers from Disqualifications

Final judgments or orders entered in SEC enforcement matters, criminal actions and state actions, whether by settlement or after a proceeding, all can result in

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[70] *See* Director Ceresney's remarks titled "Remarks to the American Bar Association's Business Law Section Fall Meeting," Washington, D.C. (Nov. 21, 2014) *available at*: http://www.sec.gov/News/Speech/Detail/Speech/1370543515297#.VH3b-GxOU6Y.

[71] *Id.*

[72] *See* SEC Press Release No. 2013-266, "SEC Charges ConvergEx Subsidiaries With Fraud for Deceiving Customers About Commissions" (Dec. 18, 2013), *available at:* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540521484#.VKq_mmxOVfw.

[73] *See* SEC Press Release No. 2014-39, "Credit Suisse Agrees to Pay $196 Million and Admits Wrongdoing in Providing Unregistered Services to U.S. Clients" (Feb. 21, 2014), *available at:* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540816517#.VKq_7WxOVfw.

[74] *See* SEC Press Release No. 2014-207, "Wells Fargo Advisors Admits Failing to Maintain Controls and Producing Altered Document, Agrees to Pay $5 Million Penalty" (Sept. 22, 2014), *available at:* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543012047#.VKrAV2xOVfw.

[75] *See* Yin Wilczek, Court Approves SEC No-Admit Deal With Analyst, Bloomberg BNA (May 2, 2014), *available at:* www.bna.com/court-approves-sec-n17179890133/.

disqualifications under the federal securities laws from which the SEC has the authority to issue waivers. Criminal actions, injunctive actions, and actions alleging fraud have the widest reach, resulting in potential disqualification from, among other things, regulatory status as a "well-known seasoned issuer (WKSI)," which will impede and issuers from raising money immediately through security offerings, without first obtaining SEC approval.[76] Such actions also can result in disqualification from relying on a number of exemptions for offerings of securities, including Regulation A, Regulation E, and both Rules 505 and 506 of Regulation D under the Securities Act, disqualification from providing certain services to registered investment companies,[77] and disqualification from providing certain services to unregistered issuers, including, but not limited to, unregistered funds, such as hedge funds and private equity funds (the so-called "bad actor" provisions).[78]

While, generally, waivers have been granted for these disqualifications, except in especially egregious situations, in 2014, the SEC turned its full attention to these disqualifications, scrutinizing both individual waiver requests, as well as the historic practices of the SEC Staff. For example, in the past, waivers from WKSI disqualification were granted by the SEC Staff, pursuant to authority formally delegated to the Staff by the Commission. Similarly, once effective in 2013, waivers from the Rule 506 "bad actor" disqualification also were granted by the SEC Staff, pursuant to delegated authority. Since May 2014, however, each WKSI waiver and each Rule 506 waiver granted through January 2015 has been considered by, and voted on by the Commission. Based on the published statements and dissents by individual Commission members, each vote has been the subject of much philosophic discord. In addition, based on current SEC practices, one seeking a waiver will have to demonstrate current business activities relying on a statutory or regulatory provision from which a disqualification would arise. In other words, prophylactic waivers to avoid adverse impact on future activities have become more difficult, if not impossible, to obtain.

As a result, prior to settling cases with the SEC or other regulators it is now critically important to evaluate the potential disqualifications that could arise from a settlement, and to assess whether waivers are likely to be available. Statements by individual Commissioners, as well SEC Staff guidance,[79] provide some indications of situations where it may be difficult to receive a waiver. In particular, it may prove particularly challenging to obtain waivers in connection with settlements of actions alleging or finding scienter-based fraud, criminal

76 *See* Rule 405 under the Securities Act of 1933 (the "Securities Act").

77 *See* Section 9(a) of the Investment Company Act of 1940.

78 *See* Rule 506(d) under the Securities Act.

79 *See* U.S. Securities and Exchange Commission "Revised Statement on Well-Known Seasoned Issuer Waivers" (Apr. 24, 2014), *available at*: http://www.sec.gov/divisions/corpfin/guidance/wksi-waivers-interp-031214.htm.

actions, and actions alleging violations of Section 5(a) of the Securities Act (disclosure and registration issues).

Even as the Commissioners themselves continue to argue the policy and the law around these issues, the SEC is likely to continue to take a tougher stance in granting waivers, and we may see more creative or flexible arrangements going forward.[80]

Administrative Proceedings vs. Federal Court[81]

The SEC has been using administrative proceedings throughout the 42-year history of the Division of Enforcement, and SEC administrative law judges (ALJs) have adjudicated hundreds of enforcement matters over the years.[82] Until 2010, although the SEC had authority to proceed against unregistered persons in administrative proceedings, only limited relief could be obtained against them in that forum. This circumstance changed with the passage of the Dodd-Frank Act, which provided the authority to obtain penalties in administrative proceedings against unregistered parties comparable to those obtained from registered persons.[83] Enforcement Director Ceresney has confirmed that the SEC is using the administrative forum more often now than in past years, given the Dodd-Frank changes. He maintains that of all actions filed last year on a partially litigated basis, approximately 57 percent were filed in district court, and about 43 percent were filed administratively.[84]

In defending the Enforcement Division's transition to the Administrative Proceedings, Director Ceresney noted four benefits of the administrative forum. First, administrative actions produce prompt decisions since, in most cases, an ALJ has 300 days from when a matter is instituted to issue an initial decision. Second, administrative proceedings have the benefit of specialized fact-finders,

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[80] *See* Commissioner Kara M. Stein, "Dissenting Statement in the Matter of The Royal Bank of Scotland Group, plc, Regarding Order Under Rule 405 of the Securities Act of 1933, Granting a Waiver From Being an Ineligible Issuer" (Apr. 28, 2014), *available at*: http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370541670244#.VMEUEGxOVfw; Commissioner Stein's remarks titled "Remarks Before the Consumer Federation of America's 27th Annual Financial Services Conference," Washington D.C. (Dec. 4, 2014), *available at*: http://www.sec.gov/News/Speech/Detail/Speech/1370543593434#.VMEU2mxOVfw; Commissioner Daniel M. Gallagher "Statement on WKSI Waivers" (Apr. 29, 2014), *available at*: http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370541680627#.VMEPQWxOVfw.

[81] For more information on this topic, please see the Morgan Lewis law flash entitled "There's No Place Like Home: SEC Increasingly Uses Administrative Proceedings" (Dec. 22, 2014), *available at*: http://www.morganlewis.com/pubs/Securities_LF_SECIncreasinglyUsesAdministrativeProceedings_22dec14.

[82] *See* Director Ceresney's remarks titled "Remarks to the American Bar Association's Business Law Section Fall Meeting," Washington, D.C. (Nov. 21, 2014) *available at*: http://www.sec.gov/News/Speech/Detail/Speech/1370543515297#.VH3b-GxOU6Y.

[83] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, § 929P(a).

[84] These figures do not include certain types of cases, including delinquent filings or follow-ons to administrative proceedings.

since the Commission ALJs hear and decide securities cases year after year. Third, SEC considers freedom from the Federal Rules of Evidence a benefit. The rules governing administrative hearings provide that ALJs can consider all relevant evidence, giving each piece of evidence the weight that he or she deems appropriate. Finally, there are certain types of charges, for example, failure to supervise or "causing" violations, which only can be brought in the administrative forum.[85]

Nonetheless, the SEC has faced criticism as to the fairness of the administrative proceedings, perhaps because the SEC has not lost an administratively filed case since October 2013. Moreover, the limited discovery, short time frame for hearing preparation, lack of real evidentiary rules, and other safeguards notable in the federal system – not to mention, the lack of access to a jury – has left many defendants crying foul, and even challenging the constitutionality of the process.[86] Director Ceresney has consistently defended the Commission's practice, and has boldly challenged anyone to identify a case in which an ALJ erroneously ruled in favor of the SEC where the Commission did not later reverse the decision.[87]

Looking Ahead

The SEC enforcement program under Chair White has been marked by an emphasis on deterrence, as reflected in aggressive charging decisions; the pursuit of stronger sanctions, including record monetary penalties and disgorgement; the requirement of admissions as a condition of settlement in certain cases; and close coordination with other regulatory and criminal law enforcement agencies, both domestic and international. Further, current SEC leadership has tried to work smarter, increasing the use of data analytics to focus Enforcement resources on practices and industries where the likelihood or risk of misconduct is highest.

In the coming year, we can expect to see more of the same, together with a renewed focus on cases involving financial reporting and accounting issues, including fraud and internal controls cases, as well as cases against auditors; microcap fraud cases, particularly those involving repeat offenders and the lawyers who enable them; market structure cases against exchanges, Alternative Trading Systems (ATS) and broker-dealers; insider trading actions; asset management focused cases, especially cases relating to misrepresentations of fund performance and/or conflicts of interest; as well as more FCPA cases, more

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85 *See* Director Ceresney's remarks titled "Remarks to the American Bar Association's Business Law Section Fall Meeting," Washington, D.C. (Nov. 21, 2014) *available at*: http://www.sec.gov/News/Speech/Detail/Speech/1370543515297#.VH3b-GxOU6Y.

86 *See Stilwell v. SEC*, 14-CV-07931 (S.D.N.Y. filed Oct. 1, 2014); *Duka v. SEC*, 15-cv-00357 (S.D.N.Y. filed Jan. 16, 2015).

87 *See* Director Ceresney's remarks titled "Remarks to the American Bar Association's Business Law Section Fall Meeting," Washington, D.C. (Nov. 21, 2014) *available at*: http://www.sec.gov/News/Speech/Detail/Speech/1370543515297#.VH3b-GxOU6Y.

cases involving complex products, more cases relating to credit ratings, and additional matters arising out of the MCDC initiative.[88] In connection with enforcement actions in the coming year, the Commission has promised to continue to seek admissions as a term of settlement and we can expect that more of these actions will be filed as Administrative Proceedings, whether litigated or settled.

SEC Enforcement Priorities Relating to Broker-Dealers

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

Sales Practices/Fraud

- Unsuitable recommendations of higher yield and complex products (e.g., leveraged ETFs and structured products), as well as the adequacy of due diligence;
- Suitability and disclosures around interest rate sensitive fixed income securities;
- Suitability, disclosure, and diligence relating to "alternative" mutual funds;
- Microcap fraud and pump-and-dump schemes;
- Suitability, representations, advertising, or churning when recommending the movement of assets from a retirement plan to an IRA rollover account;
- Suitability/disclosures around variable annuity sales; and
- Affinity fraud targeting seniors or other groups.

Trading

- Best execution;
- Market access controls related to erroneous orders;
- Use of technology, with a focus on algorithmic and high-frequency trading;
- Information leakage and cybersecurity;
- Market manipulation (practices such as marking-the-close, parking, spoofing, and excessive markups and markdowns);

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[88] *Id.*

- Relationships between broker-dealers and ATSs; and
- Application of the Market Access Rule (15c3-5) to proprietary trading.

Internal Controls

- Effectiveness of key control functions (liquidity, credit, and market risk management practices);
- Valuation practices, particularly for infrequently traded securities;
- Branch office supervision; and
- Overall compliance function.

Anti-Money Laundering

- Focus on AML programs of broker-dealers that offer customers the ability to deposit or withdraw cash and/or that allow customers direct access to the markets from higher-risk jurisdictions.

Fixed Income Market

- The structure and transparency of the market and its effect on the quality of executions;
- Use of filters by market participants to control what is displayed by fixed income ATSs; and
- Focus on transparency in the municipal securities market.

SEC Enforcement Actions[89]

Anti-Retaliation

Last year, the SEC used its anti-retaliation power for the first time.

A. *In the Matter of Paradigm and Weir, Proc. File No. 3-15930 (June 16, 2014)*

1. On June 16, 2014, the SEC brought the first-ever action filed under its new anti-retaliation enforcement authority.
2. This action stems from a series of transactions between Paradigm (a hedge fund advisory firm) and a broker-dealer also owned by Weir, with which Weir was placing trades on behalf of a client

89 The cases described herein are settlements in which respondents neither admitted nor denied the allegations against them, unless the description explicitly states otherwise.

hedge fund. According to the SEC, because these were principal transactions, effective written disclosure was required to be given to the hedge fund and the hedge fund's consent obtained.

3. Weir attempted to satisfy the disclosure and consent provisions by forming a conflicts committee within Paradigm that would review and approve each of the principal transactions made on behalf of the hedge fund. The committee was comprised of Paradigm's Chief Financial Officer and Chief Compliance Officer, each of whom essentially reported to Weir, and the CFO was also the CFO of the broker-dealer. As a result, the SEC found that the conflicts committee was, itself, conflicted.

4. Paradigm's head trader made a whistleblower submission to the SEC revealing the transactions between Paradigm and Weir's broker-dealer. When Paradigm learned of this, according to the SEC, it engaged in a series of retaliatory actions, including: changing the whistleblower's job function; stripping him of supervisory responsibilities; denying him access to his work e-mail; and directing him to work offsite. Paradigm asked the former head trader to prepare a report detailing the facts that he believed supported the potential violations he reported to the SEC. According to the whistleblower, he was asked to review 1,900 pages of hard copy documents, and told that he could not return to the trading floor until he could identify specific conduct to substantiate his claims. Paradigm gave the head trader permission to use his personal e-mail address to conduct this research, since Paradigm had restricted his access to his work e-mail. One month later, Paradigm reprimanded him for sending confidential documents from his personal e-mail account in violation of the confidentiality agreement he signed when he joined Paradigm. The next day, the head trader resigned from his position.

5. The SEC's order found that Weir caused Paradigm's violation of the anti-retaliation provision of the Advisers Act. Weir and Paradigm agreed to cease and desist future violations, without admitting or denying the findings.

6. Paradigm Capital Management and its owner, Candace King Weir made – and the SEC accepted – an Offer of Settlement for $2.2 million: $1.7 million in disgorgement (to be distributed to compensate investors), $181,771 in prejudgment interest, and a civil penalty of $300,000. In addition, Paradigm also agreed to an undertaking to retain an independent compliance consultant.

Blue Sheets

The below case is interesting in that it is in an area generally reserved for FINRA enforcement and also because it was settled with an admission.

A. *In the Matter of Scottrade, Inc., Admin. Proc. File No. 3-15702 (January 29, 2014)*

1. On January 29, 2014, the SEC instituted a settled administrative proceeding against Scottrade, Inc., alleging that the company failed to provide the SEC with complete and accurate "blue sheet" data in violation of Section 17(a) of Exchange Act. "Blue sheets" provide detailed information about trades done by a firm and its customers.

2. The SEC found that from March 2006 through April 2012, Scottrade failed to report "error account trades" in its blue sheet responses to the SEC due to coding error. The SEC found that Scottrade failed to provide the information on 1,231 occasions. In addition, the SEC found that Scottrade did not have an audit system at this time to detect the problem.

3. The SEC discovered Scottrade's violations when, in December 2011, it sent Scottrade blue sheet requests regarding securities involved in suspicious trades. Scottrade provided blue sheet data that failed to include responsive data for several instances of trading in securities in September and October 2011. On April 25, 2012, Scottrade informed the SEC that it had corrected the deficient code for the program that had caused the incomplete blue sheet responses.

4. The SEC found that Scottrade willfully violated Section 17(a) by failing to maintain and provide accurate and complete blue sheet data to the SEC as well as by failing to have an audit system in place regarding such records.

5. Scottrade was ordered to cease and desist from continued violations of the Exchange Act and to pay a civil money penalty of $2.5 million. Scottrade was also ordered to comply with an undertaking to retain an independent consultant. This consultant will review Scottrade's policies and procedures designed to detect and prevent violations of securities laws related to blue sheet submissions and prepare a report to be submitted to the SEC. Within one year following the date of the Order, Scottrade is required to certify in writing its compliance with the required undertakings.

6. Scottrade agreed to settle the charges by paying the above fine and admitting it violated the noted books and records provisions of the federal securities laws.

Broker-Dealer Registration

Last year, the SEC brought two interesting cases in the broker-dealer registration area. One of those matters settled with an admission of wrongdoing.

A. *In the Matter of Credit Suisse Group AG, Admin. Proc. File No. 3-15763 (Febuary 21, 2014).*

1. On February 21, 2014, the SEC filed a settled administrative proceeding against Zurich-based Credit Suisse Group AG ("Credit Suisse"), alleging that it provided cross-border brokerage and investment advisory services to U.S. clients without first registering with the SEC in violation of Section 15(a) of the Exchange Act and Section 203(a) of the Advisers Act.

2. According to the SEC, Credit Suisse began conducting cross-border advisory and brokerage services for U.S. clients starting in 2002. During the period 2002 to 2008, Credit Suisse had as many as 8,500 U.S. client accounts, which contained an average of $5.6 billion in total assets. Credit Suisse was not registered with the SEC as a broker-dealer or as an investment adviser and was not exempt from registration.

3. Relationship managers at Credit Suisse made approximately 107 trips to the United States between 2001 and 2008. During these trips, they provided broker-dealer and advisory services to existing clients and solicited prospective clients. In addition, the relationship managers communicated with clients in the U.S. via mail, phone, and e-mail to make recommendations regarding types of accounts and investments.

4. In October 2008, Credit Suisse began taking steps to exit the business of providing cross-border advisory and brokerage services to U.S. clients. This decision coincided with the publicized civil and criminal tax investigation of Switzerland-based UBS AG related to its cross-border banking, broker-dealer, and investment adviser services to U.S. clients. The number of Credit Suisse's U.S. client accounts decreased starting in 2009, and the majority of accounts were closed or transferred by 2010. Credit Suisse did not completely exit the cross-border business until 2013 because it continued to collect broker-dealer and investment adviser fees on some accounts.

5. According to the SEC, Credit Suisse was aware of the registration requirements and undertook initiatives designed to prevent violations of the federal securities laws. However, the SEC found that these initiatives failed because they were not effectively implemented or monitored. For example, Credit Suisse created a Swiss-based SEC-registered company to service U.S. clients in 2000, but it took more than six years to transfer existing U.S. clients to the new entity.

6. The SEC found that Credit Suisse willfully violated Section 15(a) of the Exchange Act and Section 203(a) for the Advisers Act.

7. Credit Suisse was ordered to cease-and-desist continued violations of the Exchange Act and to pay $82,170,990 in disgorgement, $64,240,024 in prejudgment interest, and a $50 million penalty. Credit Suisse was also ordered to comply with an undertaking to retain an independent consultant.

8. In settling this case, Credit Suisse admitted wrongdoing to resolve the SEC's charges.

B. *In the Matter of Visionary Trading LLC, et al., Admin. Proc. File No. 3-15823 (April 4, 2014).*

1. The SEC filed a settled administrative proceeding against Visionary Trading LLC ("Visionary") and Lightspeed Trading LLC ("Lightspeed"), along with several individual owners of Visionary, and Lightspeed's former COO, Andrew Actman, for manipulative trading of publicly traded stocks and certain registration violations.

2. The SEC found that Joseph Dondero ("Dondero"), along with three other owners of Visionary, operated Visionary as a brokerage firm, even though it was not registered as required. The SEC concluded that Lightspeed, a registered broker-dealer, aided and abetted these registration violations.

3. The SEC found that from May 2008 until November 2011, Visionary and its four owners improperly received from Lightspeed a share of commissions generated from trading by Visionary customers. The Order also found that Lightspeed aided and abetted the violation by ignoring red flags that Visionary and its owners were receiving transaction-based compensation, even though Visionary was not registered as a broker-dealer and its owners were not associated with a registered broker-dealer.

4. The SEC also found that Dondero manipulated the markets for listed and over-the-counter stocks by engaging in the practice of "layering." Dondero placed buy (or sell) orders that he intended to

have executed, and then immediately entered numerous non-bona fide sell (or buy) orders for the purpose of attracting interest to the bona fide order. Dondero placed these non-bona fide orders to trick market participants into executing against the initial, bona fide order. Dondero engaged in this manipulative strategy repeatedly, placing hundreds of thousands of manipulative orders.

5. Dondero agreed to pay disgorgement of more than $1 million, plus interest and penalties, and also agreed to a bar from the securities industry. Visionary's other owners agreed to pay disgorgement of more than $100,000 each plus interest and penalties, and agreed to two-year bars from the securities industry. Lightspeed agreed to pay more than $300,000 in disgorgement plus interest and a penalty of $100,000. Actman agreed to pay a penalty of $10,000 and accepted a supervisory bar for at least one year.

Dark Pools

Regulators are increasingly focused on trading in so-called "dark pools." Below is a case brought by the SEC last year.

A. *In the Matter of Liquidnet, Admin. Proc. File No. 3-15912 (June 6, 2014).*

1. On June 6, 2014, the SEC instituted a settled administrative proceeding against Liquidnet, Inc., a New York-based brokerage firm that operates a block-trading alternative trading system ("ATS"), or dark pool, for large institutional investors.

2. In 2009, Liquidnet launched its Equity Capital Markets ("ECM") initiative to offer block execution services to corporate issuers, control persons of corporate issuers, and private equity and venture capital firms looking to execute large equity capital markets transactions with minimal market impact.

3. ATSs are subject to Regulations ATS and NMS, Exchange Act Rule 15c3-5 (the market access rule), and other rules and regulations including Rule 301(b)(10) of Regulation ATS, which requires that an ATS establishes safeguards and procedures to protect subscribers' confidential trading information and adopt and implement adequate oversight procedures to ensure that the safeguards and procedures for protecting subscribers' confidential trading information are followed. According to the SEC, these requirements address the risk that a broker-dealer that operates an ATS may have business units separate from the ATS, but within the same legal entity or separately incorporated affiliates, that, if given access to the confidential trading information of the ATS's subscribers, could benefit from such information.

4. The SEC found that Liquidnet violated its regulatory obligations, and its own promises to its ATS subscribers, when it improperly allowed ECM employees to access Liquidnet members' confidential trading information. The SEC concluded that, because ECM employees neither operated the Liquidnet ATS nor were responsible for its functions, their access to the confidential information violated the specific requirements of Regulation ATS.

5. The SEC also found that Liquidnet had informed its members that it had "established and implemented policies to maintain the segregation of sales, trading desk, and members services functions," but that it did not disclose the existence of the ECM group or the fact that ECM employees had access to detailed and confidential trading information. The SEC found that such an omission was materially misleading.

6. Finally, the SEC found that Liquidnet improperly used the confidential trading data of dark pool subscribers in two ATS sales tools.

7. Liquidnet consented to the SEC's order, which censured the firm and required it to pay a civil money penalty of $2 million.

Insider Trading

As noted above, insider trading remains an important area of emphasis for the SEC's Division of Enforcement. Summarized below are cases involving an investment banker and broker. In addition, there is a summary of a case involving inadequate policies and procedures in this area.

A. *SEC v. Frank Perkins Hixon, Jr., No. A14 CV 0158SS (W.D. Tex. February 20, 2014).*

1. On February 20, 2014, the SEC brought a civil action against New York investment banker Frank Perkins Hixon, Jr. for tipping and trading on inside information resulting in profits of at least $950,000. Hixon, who was employed by Evercore Group, L.L.C., received material, nonpublic information regarding Westway Group, Inc., Titanium Metals Corporation, and Evercore Partners, Inc. The SEC named two individuals, Frank P. Hixon, Sr. and Destiny W. Robinson, as relief defendants. The U.S. Attorney's Office for the Southern District of New York brought parallel criminal charges against Hixon.

2. As an investment banker, Hixon specialized in the mining, metals, and materials industries. Westway was a client of Evercore, and Hixon advised Westway in the negotiations to sell its business units in 2011 and 2012. Titanium Metals was a potential client of

Evercore, and Hixon learned that Titanium was going to be acquired by Precision Castparts by the end of 2012. Finally, Hixon learned the financial results of Evercore Partners, of which Evercore Group is a subsidiary, in advance of an announcement of record earnings in 2013.

3. According to the SEC's complaint, Robinson's brokerage account showed timely trades from October 2011 through January 2013 in Westway, Titanium, and Evercore stock. The SEC alleged that Hixon had online access to Robinson's brokerage account and made trades in that account from several locations, including Hixon's office in New York as well as Austin, Texas, London, and Japan. Hixon had previously had a relationship with Robinson, and they had a child together. The SEC alleged that text messages between Hixon and Robinson suggest that the trading proceeds were a substitution for child support payments.

4. The SEC alleged that Hixon's father's brokerage account showed timely trades from October 2012 through January 2013 in Titanium and Evercore stock.

5. When confronted by Evercore, Hixon initially denied knowing Robinson and his father. Evercore terminated Hixon in January 2014.

6. The SEC's complaint charged Hixon with violating Section 10(b) of the Exchange Act, Rule 10b-5, Section 14(e) of the Exchange Act, Rule 14e-3(a), and Rule 14e-3(d). In April 2014, Hixon pled guilty to the related criminal charges in New York. In August 2014, he was sentenced to 30 months in prison. He was also ordered to pay $100,000 in fines, forfeit $710,000 in illegal profits, and return $1.2 million as restitution to Evercore.

7. In August 2014, Hixon was sentenced to 30 months in prison for insider trading.

8. According to a September 2014 filing, it appears that Hixon is in settlement discussions with the SEC.

B. *SEC v. Vladimir Eydelman & Steven Metro, Case No. 3:14-cv-01742 (D. N.J. 2014).*

1. On March 19, 2014, the SEC filed a civil complaint in the United States District Court of the District of New Jersey against a stockbroker and a managing clerk at a law firm for insider trading generating illicit profits of $5.6 million surrounding more than a dozen mergers or other corporate transactions during a four-year period.

2. The Complaint alleged that Steven Metro ("Metro"), a clerk at the law firm of Simpson Thacher & Bartlett in New York, obtained material nonpublic information about corporate clients involved in pending deals, and provided the nonpublic information to a middleman, who has now been identified as Frank Tamayo ("Tamayo"). The Complaint alleges that Tamayo would later meet Vladimir Eydelman ("Eydelman"), who was his stockbroker, in Grand Central Terminal and pass along the information. Eydelman would then trade on the information for his own benefit, as well as for family members, Tamayo, and other customers. The Complaint alleged that Tamayo allocated a portion of his profits for eventual payback to Metro. According to the Complaint, Metro received approximately $168,000.00 in kickbacks.

3. According the SEC's Complaint, Metro tipped, and Eydelman traded on, inside information regarding some dozen or more companies. The Complaint alleges that, in order to hide evidence, Tamayo often chewed or ate the tip (which was written on a post-it note or napkin) after showing it to Eydelman. Once in possession of the tip, Eydelman would send e-mails to Tamayo containing research and other thoughts about the stock, intended to create a paper trail with plausible justification for engaging in the transactions.

4. The Complaint alleges that Metro and Eydelman violated Sections 10(b) and 14(e) of the Securities Exchange Act of 1934, and Rules 10b-5 and 14e-3 and Section 17(a) of the Securities Act of 1933. The SEC also filed a complaint against Tomayo on September 19, 2014 in the District of New Jersey.

5. In both cases, the SEC seeks disgorgement of profits, as well as interest, penalties and a permanent injunction against future violations. The SEC's civil cases are still pending.

6. On September 19, 2014, the U.S. Attorney's Office for the District of New Jersey brought criminal charges against Tamayo. The U.S. Attorney had previously brought criminal charges against Metro and Eydelman.

C. *In the Matter of Wells Fargo Advisors, LLC ("WFA"), Admin. Proc. File No. 3-16153 (September 22, 2014).*

1. In September 2014, the SEC filed a settled administrative proceeding against WFA, a dually registered investment adviser and broker-dealer, for allegedly maintaining inadequate policies and procedures to prevent insider trading, and for failing to produce documents properly during an SEC examination.

2. The SEC alleged that a financial advisor associated with WFA traded on, and tipped others (including three WFA customers) who traded on material nonpublic information ("MNPI") concerning a yet-to-have-been announced private equity firm's acquisition of Burger King. The advisor allegedly received the information from one of his brokerage customers.

3. According to the SEC, WFA's policies and procedures concerning the misuse of MNPI were deficient because they did not address how three units – the Retail Control Group ("RCG"), the anti-money laundering unit, and the central supervision unit – shared responsibility for monitoring the misuse of MNPI and how the units should coordinate their efforts to do so. WFA's procedures were also allegedly deficient because they did not provide guidance on related topics, such as identifying market-moving events to be monitored, how to perform a "further review" of certain categories of transactions indicative of insider trading, and discussion of "red flags" and the process for managerial review of such red flags. The SEC also alleged that WFA failed to adequately maintain its policies and procedures because it did not consider options trading in its reviews until July of 2010. In addition, the SEC alleged that WFA failed to adequately enforce the policies and procedures it had in place concerning the misuse of MNPI, such as performing daily reviews of trades indicative of insider trading, printing, and retaining news stories concerning market-moving information, and reviewers' contacting the branch when certain red flags were detected. According to the SEC, these alleged deficiencies caused insider trading by the financial advisor to go undetected by WFA.

4. The SEC also alleged that WFA unreasonably delayed producing certain documents related to the RCG's review of trading in Burger King by the financial advisor, and produced a trading review log that had been altered after the SEC requested the document but prior to its production.

5. The SEC's settled order charged WFA with violations of Sections 15(g), 17(a), and 17(b) of the Exchange Act and Rule 17a-4(j) promulgated thereunder, and Sections 204A and 204(a) of the Advisers Act.

6. WFA consented to a cease and desist order, a censure, and undertook to hire an independent consultant to review and recommend changes to WFA's policies and procedures and to adopt and implement the consultant's recommendations. In addition, WFA consented to pay a civil money penalty of $5 million.

7. On October 15, 2014, the SEC announced charges against a former WFA compliance officer for allegedly altering a document

that summarized a review she conducted of a WFA broker's trading. The document was created in September 2010, and then allegedly altered in December 2010, after the broker was charged with insider trading, to give the appearance that a more thorough review had occurred.

Market Access Rule

In October 2013, the SEC brought its first Market Access Rule case. Last year, the SEC continued to bring cases in this area.

A. *In the Matter of Wedbush Securities Inc., Admin. Proc. File No. 3-15913 (November 20, 2014).*

1. On November 20, 2014, the SEC announced that Wedbush Securities Inc. ("Wedbush") agreed to settle charges that it had violated the Market Access Rule, Exchange Act Rule 15c3-5, which requires a broker-dealer having or providing others with market access to establish, document, and maintain a system of risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory, and other risks presented by the firm's market access business. The SEC found that Wedbush failed to adopt and implement risk management controls that were reasonably designed to ensure compliance with relevant regulatory requirements governing the market access business. According to the SEC, Wedbush's lack of appropriate risk management controls allegedly resulted in violations of other regulatory requirements, including Regulations SHO and NMS. Two Wedbush officials in its Correspondent Services Division, Jeffrey Bell, former Executive Vice President, and Christina Fillhart, Senior Vice President, also agreed to settlements finding that they were causes of Wedbush's violations of Rule 15c3-5. The settlement came after the filing of an Order Instituting Proceedings.

2. The settlement found that Wedbush allowed the majority of its market access customers to send orders directly to trading venues using trading platforms over which Wedbush did not have the requisite direct and exclusive control. Wedbush did not directly set or monitor risk settings and controls in third party or client-proprietary trading platforms, which approximately 80% of Wedbush's customers were using to access the market. As a result, customers could access and alter risk settings without Wedbush's knowledge or consent. Further, Wedbush relied on its customers to pre-approve and authorize individual traders who received market access through Wedbush, without reasonably designed controls and supervisory procedures to restrict market access to persons pre-approved and authorized by Wedbush. Finally, the SEC found that Wedbush did not have any written

procedures for regularly reviewing the effectiveness of its market access controls and procedures, in violation of the Market Access Rule.

3. The SEC also found that, on at least three occasions, Wedbush's deficient risk management controls resulted in its customers submitting short sale orders without locates in violation of Regulation SHO. The violations occurred because a third-party trading platform had used an incorrect version of Wedbush's list of easy-to-borrow securities for which no locate was required.

4. Further, the SEC found that Wedbush did not have any controls or procedures in place to ensure that customers who were submitting intermarket sweep orders ("ISOs") had swept the market of all better-priced protected quotations, in compliance with Regulation NMS. The SEC found two instances in which a Wedbush customer submitted ISOs, even though Wedbush had not authorized the customer to do so, and thus had not implemented procedures to ensure compliance with Regulation NMS for such ISOs.

5. The SEC also found that Wedbush failed to have risk management controls and supervisory procedures that complied with applicable suspicious activity reporting and recordkeeping requirements, in violation of Section 17(a) of the Exchange Act and Rule 17a-8 thereunder. Specifically, Wedbush did not require customers to use anti-wash sale functionality, and its response to reports of apparent wash sales or prearranged trading, and potential layering activity by customers, led to only two suspicious activity report filings related to potential wash sales or pre-arranged trading and none related to potential layering. Wedbush also did not conduct its own reviews of customer activity to detect a variety of potential manipulative trading practices.

6. Finally, the SEC found that Wedbush failed to preserve for three years originals of all communications received and copies of all communications sent, with respect to trading instructions relating to ISOs, as required by Section 17(a) of the Exchange Act and Rule 17a-4(b)(4) thereunder.

7. Bell and Fillhart, individually, settled cases under Section 21C (a) of the Exchange Act as persons whose acts or omissions were a cause of the underlying violation of the Market Access Rule by Wedbush, in that their actions or omissions contributed to the violation and they knew or should have known that their conduct would do so. Bell agreed to pay disgorgement of $25,000, prejudgment interest of $1,478.31, and a civil penalty of $25,000. Fillhart agreed to pay disgorgement of $25,000, prejudgment interest of $1,478.31, and a civil penalty of $25,000, but $15,000 of

such amount were waived based on her Statement of Financial Condition.

8. Wedbush consented to an order imposing a censure and ordering it to cease and desist from committing or causing violations of the noted rules, and agreed to pay a $2,447,043.38 penalty and retain an independent consultant to conduct a comprehensive review of the firm's controls and procedures to ensure compliance with the Market Access Rule.

9. As part of the settlement, Wedbush admitted the facts set forth on an annex to the SEC's order and acknowledged that its conduct violated the federal securities laws.

B. *In the Matter of Morgan Stanley & Co. LLC, Admin. Proc. File No. 2-1630 (December 10, 2014).*

1. On December 10, 2014, the SEC announced that Morgan Stanley & Co. LLC ("Morgan Stanley") agreed to settle charges that it had violated the Market Access Rule, Exchange Act Rule 15c3-5, and in particular the Rule's requirement that broker-dealers reasonably design controls and supervisory procedures to prevent the entry of orders that exceed pre-set aggregate credit thresholds for customers.

2. The SEC found that on October 25, 2012, David Miller, a registered representative at Rochdale Securities LLC ("Rochdale") (a registered broker-dealer that accessed the market via Morgan Stanley's platform), was instructed by a Rochdale customer to purchase 1,625 shares of Apple. Instead, in a scheme to personally profit, Miller purchased 1,625,000 shares of Apple at a cost of almost $1 billion. When Apple's share price began dropping, Miller falsely claimed that the additional shares were mistakenly purchased. Miller's actions caused Rochdale to suffer a loss of approximately $5.3 million. Miller was charged civilly and criminally for his actions, and on November 19, 2013, was sentenced to 30 months' imprisonment, followed by three years of supervised release.

3. Before Miller began purchasing the Apple shares, Rochdale was subject to a $200 million aggregate credit threshold. In order to accommodate Miller's orders, Morgan Stanley twice raised Rochdale's aggregate credit threshold – first from $200 million to $500 million, and then from $500 million to $750 million. Miller never sought the credit increases; rather, a Morgan Stanley employee requested the increases when she noticed that Miller's orders would exceed the threshold, and upon confirming with Miller that the orders were not erroneously entered. Morgan Stanley

never notified Rochdale or Miller that Rochdale's aggregate credit threshold was being increased.

4. The SEC found that Morgan Stanley had no criteria or guidance for personnel to consider in deciding whether to modify customers' aggregate credit thresholds, and as a result, these decisions were made without proper due diligence to ensure that such increases were warranted.

5. Morgan Stanley consented to an order imposing a censure and ordering it to cease and desist from further violations of the Market Access Rule, and agreed to pay a $4 million civil penalty.

Mortgage-Backed Securities

In 2014, the SEC brought another action in the mortgage-backed securities area and a long-running saga over a settlement finally reached its conclusion.

A. *In re Morgan Stanley & Co. LLC, Morgan Stanley ABS Capital I Inc., and Morgan Stanley Mortgage Capital Holdings LLC, Admin. Proc. File No. 3-15982 (July 24, 2014).*

1. On July 24, 2014, the SEC filed a settled administrative proceeding against Morgan Stanley & Co. LLC, Morgan Stanley ABS Capital I Inc., and Morgan Stanley Mortgage Capital Holdings LLC (collectively, "Morgan Stanley"), alleging that Morgan Stanley violated Section 17(a)(2) and (3) of the Securities Act of 1933 by making materially false or misleading statements regarding two 2007 residential mortgage-backed securities ("RMBS") offerings.

2. Regulation AB required Morgan Stanley to disclose the criteria used to select mortgages to be used as collateral for the RMBS offerings, including the method of determining delinquencies, the total amount of delinquent assets as a percentage of the total pool, and any other material information concerning delinquent assets.

3. The SEC's findings concerned two RMBS transactions collateralized by loans acquired through public auctions of loans originated by New Century Mortgage Corporation ("New Century"), after New Century filed for bankruptcy in April 2007. Morgan Stanley sponsored, issued, and underwrote the transactions, and made certain representations concerning the collateral loans, including concerning delinquencies.

4. The SEC found that Morgan Stanley misrepresented the current or historical delinquency status of certain collateral loans. The SEC found that in one transaction, certain loans were made current only after the securitization's "cut-off date" but were excluded from

delinquency figures, and other loans were not included in delinquency figures despite having a historical delinquency. The SEC found that another transaction closed weeks after its cut-off date, but Morgan Stanley's delinquency data did not include delinquent loans of which Morgan Stanley became aware in the interim.

5. The SEC ordered the Morgan Stanley entities, jointly and severally, to disgorge $160,627,852, to pay prejudgment interest of $17,995,437, and to pay a civil penalty of $96,376,711.

B. *SEC v. Citigroup Global Markets, Inc. ("Citigroup"), 11 CV 7387 (S.D.N.Y. August 5, 2014).*

1. In October 2011, the SEC filed a complaint against Citigroup, alleging that Citigroup negligently misrepresented its role in structuring a billion-dollar fund primarily collateralized by subprime mortgage securities. The SEC alleged that Citigroup told investors the portfolio was chosen by an independent advisor when Citigroup itself selected a substantial portion of the portfolio and bet against it. When the fund performed poorly, the SEC alleged Citigroup realized profits of roughly $160 million, while investors lost millions of dollars.

2. Shortly after filing the complaint, the SEC filed a proposed consent judgment in which Citigroup agreed to: (i) an injunction barring it from violating the Securities Act of 1933, Sections 17(a)(2) and (3); (ii) disgorge its $160 million in profits; (iii) pay $30 million in prejudgment interest; (iv) pay a civil penalty of $95 million; (v) refuse to seek any offset in any related investor actions; and (vi) make internal changes to prevent similar violations in the future. The consent decree did not impose an admission of guilt or liability.

3. In November 2011, the Honorable Judge Jed Rakoff of the United States District Court for the Southern District of New York conducted a hearing to address his concerns with the proposed consent judgment. Both parties responded to his concerns, but Judge Rakoff issued an order rejecting the proposed consent judgment. Judge Rakoff was not convinced the consent judgment was fair, reasonable, adequate, or in the public interest. Specifically, he was concerned that the proposed consent judgment made no stipulations of fact, thus making it difficult to gauge the consent judgment's adequacy.

4. Immediately thereafter, the SEC and Citigroup sought to stay Judge Rakoff's order and filed for an appeal, principally claiming that the District Court failed to adhere to the correct standard of deference for reviewing SEC consent judgments.

5. In June 2014, the United States Court of Appeals, Second Circuit held that Judge Rakoff applied the incorrect standard of deference when reviewing the proposed consent decree. The correct standard, it held, requires the district court to determine "whether the proposed consent decree is fair and reasonable, with the additional requirement that the 'public interest would not be disserved'. . . in the event that the consent decree includes injunctive relief." *SEC v. Citigroup Global Mkts., Inc.*, 752 F.3d 285 (2014) (internal citations omitted). Importantly, the Court of Appeals omitted "adequacy" from the standard and also emphasized that a failure to stipulate facts is acceptable, as consent decrees are primarily about pragmatism, not necessarily absolute truth. Thus, the Court of Appeals stated that the primary focus of a district court's review should be to ensure the consent decree is procedurally proper, taking care not to infringe on the SEC's discretionary authority to settle cases. Accordingly, the Court of Appeals vacated Judge Rakoff's order and remanded the case to the District Court for further proceedings.

6. In August 2014, Judge Rakoff approved the consent decree, stating that "[u]pon review of the underlying record in this case, the Court cannot say the proposed Consent Judgment is procedurally improper" or fails to comport with the "very modest standard imposed by the Court of Appeals."

Municipal Securities

Last year, the SEC brought several significant municipal securities actions. Examples involving broker-dealers are summarized below.

A. *In the Matter of Charles Schwab & Co. Inc. ("Charles Schwab"), Admin. Proc. File No. 3-16232 (Nov. 3, 2014); Hapoalim Securities USA, Inc. ("Hapoalim"), Admin. Proc. File No. 3-16233 (Nov. 3, 2014); Interactive Brokers LLC ("Interactive"), Admin. Proc. File No. 3-16234 (Nov. 3, 2014); Investment Professionals Inc. ("Investment Professionals"), Admin. Proc. File No. 3-16235 (Nov. 3, 2014); J.P. Morgan Securities LLC ("J.P. Morgan"), Admin. Proc. File No. 3-16236 (Nov. 3, 2014); Lebenthal & Co., LLC ("Lebenthal"), Admin. Proc. File No. 3-16241 (Nov. 3, 2014); National Securities Corp. ("National Securities"), Admin. Proc. File No. 3-16242 (Nov. 3, 2014); Oppenheimer & Co., Inc. ("Oppenheimer"), Admin. Proc. File No. 3-16243; Riedl First Securities Co. of Kansas ("Riedl"), Admin. Proc. File No. 3-16244 (Nov. 3, 2014); Stifel Nicolaus & Co., Inc. ("Stifel"), Admin. Proc. File No. 3-16237 (Nov. 3, 2014); TD Ameritrade, Inc. ("TD Ameritrade"), Admin. Proc. File No. 3-16238 (Nov. 3, 2014); UBS Financial Services Inc. ("UBS"), Admin. Proc. File No. 3-16239 (Nov. 3, 2014); Wedbush Securities Inc. ("Wedbush"), Admin. Proc. File No. 3-16240 (November 3, 2014)*

1. In November 2014, the SEC filed settled administrative proceedings against 13 firms, each of which was a registered broker-dealer, municipal securities dealer and municipal securities broker, finding that each firm violated Section 15B(c)(1) of the Securities Exchange Act of 1934 and MSRB Rule G-15(f).

2. According to the SEC, the violations stemmed from sales of the Puerto Rico General Obligations Bonds of 2014, Series A (the "Bonds"), which are non-investment grade securities. Each firm sold the Bonds to customers in denominations less than the $100,000 minimum amount specified by the Official Statement for the Bonds, in violation of MSRB Rule G-15(f). Respondents executed between one and twenty-eight transactions in denominations below $100,000. Additionally, the SEC found that three firms (Charles Schwab, TD Ameritrade, and Oppenheimer) lacked policies and procedures concerning MSRB Rule G-15(f).

3. These cases arose out of the SEC Enforcement Division's Municipal Securities and Public Pensions unit detection of sales below the $100,000 minimum threshold though the Unit's surveillance of municipal bond trading.

4. Each firm consented to the entry of a cease-and-desist order, a censure, and an undertaking to review the adequacy of its existing policies and procedures relating to compliance with MSRB Rule G-15(f) and to make any changes necessary to comply with the Rule, including adopting new policies and procedures within six months of the Order. Each firm also consented to pay a civil monetary penalty in the following amounts:

    - Charles Schwab & Co. – $61,800
    - Hapoalim Securities USA – $54,000
    - Interactive Brokers LLC – $56,000
    - Investment Professionals Inc. – $67,800
    - J.P. Morgan Securities – $54,000
    - Lebenthal & Co. – $54,000
    - National Securities Corporation – $60,000
    - Oppenheimer & Co. – $61,200
    - Riedl First Securities Co. of Kansas – $130,000

- Stifel Nicolaus & Co. – $60,000
- TD Ameritrade – $100,800
- UBS Financial Services – $56,400
- Wedbush Securities Inc. – $67,200

5. In considering each settlement, the SEC took into account the remedial actions promptly undertaken by each firm. Each firm cancelled the transactions that were allegedly below the minimum denomination of the issue. Additionally, Interactive, Charles Schwab, and UBS all amended their policies and procedures, and J.P. Morgan conducted additional compliance training concerning MSRB Rule G-15(f).

6. These cases were the first by the SEC under MSRB Rule G-15 (f). At the time they were announced, the SEC said its investigation was continuing.

National Securities Exchanges

Continuing a trend from prior years, in 2014, the SEC filed an administrative proceeding against a major exchange and its affiliates. Once again, this case resulted in a monetary penalty being imposed upon the exchanges.

A. *In the Matter of New York Stock Exchange LLC, et al., Admin. Proc. File No. 3-15860 (May 1, 2014).*

1. The SEC filed a settled administrative proceeding against New York Stock Exchange LLC ("NYSE"), and affiliated exchanges, New York Stock Exchange Arca, Inc. ("Arca"), New York Stock Exchange MKT LLC, f/k/a NYSE Amex LLC ("Amex"), along with Archipelago Securities, LLC ("Archipelago"), (collectively, "NYSE Entities"), for their failure to comply with certain responsibilities of self-regulatory organizations ("SROs"). The failures included: (i) failing to seek and obtain SEC approval to maintain and use an "error account"; (ii) providing co-location services to customers on disparate contractual terms without an exchange rule in effect that permitted and governed such services; (iii) providing a block trading facility that did not function in accordance with the rules submitted by NYSE and approved by the SEC; (iv) distributing closing order imbalance information in violation of the exchange rule; and (v) executing mid-point passive liquidity orders in violation of the exchange rule.

2. According to the SEC's findings, the NYSE Entities repeatedly engaged in business practices that either violated exchange rules or required a rule when the exchanges had none in effect.

3. The SEC found that the NYSE Entities used an error account from 2005 until October 2010, which was maintained at Archipelago, to assume and trade out of securities positions without a rule in effect that permitted such trading. Moreover, the maintenance of the error account was inconsistent with the rules for Archipelago, which limited Archipelago's activity primarily to outbound and inbound routing of orders on behalf of NYSE and the affiliated exchanges. The SEC told Arca senior management that error account trading on behalf of Arca and the other affiliated exchanges should be described in an effective exchange rule. Nevertheless, the SEC found that Arca and NYSE continued to trade in the error account on at least 31 additional occasions.

4. The SEC also found that the NYSE Entities provided co-location services without an effective exchange rule from at least 2006 until September 2010. Prior to offering co-location services, NYSE did not file a proposed rule with the SEC relating to co-location, nor did any rule of the exchange in effect at that time provide for or permit the operation of the co-location business.

5. The SEC also found that NYSE operated a block trading facility ("NYBX"), which, for a period of time, did not function in accordance with the rules submitted by NYSE and approved by the SEC. The rule in question specifically indicated that when processing orders, NYBX would have access to NYSE's order book, including certain information about non-displayed liquidity. However, the SEC found that the NYBX system did not operate in the manner described in the rule due to failures by the NYSE rule writing group and the software design and operation staff.

6. The SEC also found that NYSE distributed an automated feed of closing order imbalance information to its floor brokers at an earlier time than was specified in NYSE's rules. Specifically, the SEC found that from December 2008 through May 17, 2010, NYSE's distribution of the feed at 2:00 pm did not comply with its then-existing rule that stated that such a feed would first be distributed to floor brokers at 3:40 pm.

7. With respect to mid-point passive liquidity orders, the SEC found that ARCA failed to execute certain orders in accordance with the effective exchange rule, and that ARCA accepted certain orders in violation of the effective exchange rules. The SEC found that ARCA's failures were the result of insufficient testing protocols, as

well as inadequate procedures to check that its systems were consistent with its rules and regulations.

8. The NYSE Entities agreed to pay a $4.5 million civil penalty and implement certain remedial measures. Specifically, the NYSE Entities agreed to retain an independent consultant to complete a comprehensive review of their policies and procedures for determining whether (1) a new business practice or a change to an existing business practice requires the filing with the SEC of a proposed rule or rule change; and (2) business practices requiring an exchange rule are conducted pursuant to, and in accordance with, an effective exchange rule.

Net Capital

Last year, the SEC levied its largest sanction in a net capital case.

A. *In the Matter of Latour Trading LLC ("Latour") and Nicolas Niquet, Admin. Proc. File No. 3-16128 (September 17, 2014).*

1. The SEC filed a settled administrative proceeding against Latour and Niquet, Latour's then chief operating officer, for extensive failures to maintain minimum net capital. The alleged failures included: (i) erroneous haircut calculations; (ii) improper treatment of orders to create or redeem ETFs; (iii) operating while out of net capital by millions of dollars; and (iv) failing to make and maintain accurate books and records. According to the SEC, throughout 2010 and 2011, Latour "missed the mark" by amounts ranging from $2 to $28 million. A high-frequency trading firm, Latour's trading at times accounted for 9% of trading volume in equity securities in the U.S. during this period.

2. According to the Order, Latour inaccurately calculated its haircuts by: (i) incorrectly using hypothetical positions to capitalize qualified stock baskets; (ii) using inaccurate index composition data resulting in undercapitalized qualified stock baskets; (iii) failing to calculate minimum capital charges on all futures positions included in its Appendix A calculation; and (iv) failing to take haircuts on some proprietary positions as a result of a computer programming error. The Order alleged that Niquet was inexperienced with net capital calculations and did not seek guidance from an expert.

3. The Order alleged that Latour improperly treated its ETF orders as executed trades without waiting for execution of such orders. Latour did not have a written agreement with its clearing firm, resulting in inconsistent recordkeeping that substantially impacted the firm's intra-day net capital. Latour also improperly treated

after-hours orders as executed before actual execution, which consistently reduced the firm's haircuts.

4. The Order also alleged that the failures described above caused Latour to report inaccurate net capital and to operate while failing to maintain required net capital on 19 of 24 reporting dates. Accordingly, this resulted in Latour's failure to make and maintain accurate books and records. In addition, the Order alleged that Latour failed, in some instances, to maintain electronic communications in non-rewritable, non-erasable format.

5. The Order charged Latour with failing to: (i) maintain minimum net capital; (ii) make and maintain accurate books and records; (iii) make and keep a record of the computation of aggregate indebtedness and net capital; (iv) preserve certain communications; (v) preserve certain records in non-rewritable, non-erasable format; and (vi) file FOCUS Reports.

6. After the SEC began its investigation, Latour and Niquet undertook remedial efforts, agreeing to cooperate fully with the SEC investigation and to produce documents, witnesses, and other information reasonably requested by the SEC. The SEC took these undertakings into consideration when determining whether to accept Latour's and Niquet's settlement offers.

7. The Order required that Latour and Niquet cease-and-desist from engaging in the above violations and censured Latour. The Order also required Latour to pay a $16 million penalty, the largest penalty ever for violations of the net capital rule. The Order also required Niquet to pay a $150,000 penalty.

Regulation M

In 2013, as evidence of its "broken windows" approach to enforcement the SEC announced a large sweep involving compliance with the requirements of Rule 105 of Regulation M. Rule 105 prohibits the purchase of any equity security made available through a covered public offering from an underwriter, broker, or dealer participating in the offering after having sold short the same security during the restricted period. Rule 105 applies regardless of the short seller's intent in effecting the short sale. Last year, the SEC brought additional cases in this area against both firms and individuals.

A. *In the Matter of Worldwide Capital, Inc., and Jeffrey W. Lynn, Admin. Proc. File No. 3-15772 (March 5, 2014).*

1. On March 5, 2014, the SEC instituted a settled administrative proceeding against Worldwide Capital, Inc. ("Worldwide") and Jeffrey W. Lynn ("Lynn") (collectively, "Respondents"), finding that

Lynn, through his alter ego, Worldwide, violated Rule 105 of Regulation M of the Exchange Act.

2. According to the SEC, Worldwide is a proprietary trading firm formed in 1993 for the purpose of investing and trading Lynn's capital. Worldwide's and Lynn's activities were intertwined and their assets commingled.

3. The SEC found that, during the time period October 2007 through February 2012, Respondents violated Rule 105 on sixty (60) occasions by purchasing offered shares from an underwriter, broker or dealer participating in a follow-on public offering after having sold short the same security during the restricted period, resulting in profits of $4,212,797.

4. Worldwide and Lynn were ordered to cease-and-desist from any further violations of Rule 105 of Regulation M of the Exchange Act and to jointly pay disgorgement of $4,212,797, prejudgment interest of $526,358, and a penalty of $2,514,571. In its release announcing the settlement, the SEC stated that this was the largest money sanction to date for Rule 105 shortselling violations.

B. *In the Matters of Derek W. Bakarich, Admin. Proc. File No. 3-15957 (July 2, 2014); Carmela Brocco, Admin. Proc. File No. 3-15958; Tina M. Lizzio, Admin. Proc. File No. 3-15959 (July 2, 2014); Steven J. Niemis, Admin. Proc. File No. 3-15960 (July 2, 2014); William W. Vowell, Admin. Proc. File No. 3-15961 (July 2, 2014).*

1. On July 2, 2014, the SEC instituted settled administrative proceedings against five traders from Worldwide Capital, Inc., for a collective total settlement of nearly $750,000. The SEC charged each trader with selling shares in violation of Rule 105.

2. The SEC found that the traders were selected by Worldwide's owner, Jeffrey W. Lynn, to conduct trades for Worldwide Capital, an entity he created for the purpose of trading his own money. His investment strategy, carried out by the brokers, focused on buying allocations of new shares of public issuers coming to market through secondary and follow-on public offerings that were selling at a discount compared to the company's shares that were already trading publicly. They sold short shares of those issuers in advance of the offerings, hoping to profit on the difference.

3. According to the SEC, the five Worldwide brokers purchased offering shares of the same securities they had shorted through accounts opened in their own names, or in the names of alter-ego

corporate entities at large broker-dealers. They then executed the short sales through a Worldwide account at different, smaller broker-dealers.

4. Earlier Lynn and Worldwide Capital had agreed to pay $7.2 million to settle SEC charges for the same conduct, the largest-ever monetary sanction for Rule 105 violations.

5. Each of the traders agreed to cease-and-desist all violations of Rule 105 without admitting or denying the SEC's findings. They agreed to disgorgement payments in amounts ranging from $16,000 to $200,000, prejudgment interest, and additional penalties equaling 60% of the disgorgement amount.

Regulation SHO

Short selling has been the subject of many SEC actions over the last several years. Below is a litigation involving two individuals.

A. *In the Matter of Thomas Delaney and Charles Yancey, Admin. Proc. File No. 3-15873 (May 19, 2014).*

1. The SEC filed an order instituting administrative proceedings against Delaney and Yancey, officials of Penson Financial Services, Inc. ("Penson"), at the time, one of the largest independent clearing firms in the United States. The Order alleged systematic failures to purchase or borrow sufficient shares to close out "failures to deliver" to a registered clearing agency within certain timeframes. The alleged failures included: (i) Penson's repeated violations of Rules 204T and 204 of Regulation SHO ("Rule 204"); (ii) Delaney's aiding and abetting Penson's Rule 204 violations; and (iii) Yancey's failure to supervise Delaney.

2. According to the Order, from October 2008 through November 2011, Penson violated Rule 204 thousands of times. Rule 204 required Penson to purchase or borrow enough shares to close out the "failures to deliver" within a certain time period. The Order alleged that individuals in Penson's Stock Loan department, which had primary responsibility for complying with Rule 204, willfully ignored the rule's requirements because they did not want the costs of Rule 204 compliance to negatively affect their department's net revenues.

3. The Order alleged that Delaney, Penson's Chief Compliance Officer, was responsible for supervision at Penson, including responsibility for designating supervisors and allocating supervisory responsibilities. According to the Order, Delaney knew of Rule 204's requirements and knew that the Stock Loan department's

procedures did not comply, but refused to implement compliant procedures because he did not want Penson to incur associated costs. The Order further alleged that Delaney intentionally concealed these violations from regulators and Penson's CEO, Yancey. As a result, the Order alleged that Delaney aided and abetted Penson's repeated Rule 204 violations.

4. The Order also alleged that, according to Penson's Written Supervisory Policies and Procedures, Yancey was designated as the direct supervisor of Delaney and Penson's Stock Loan department. According to the Order, Yancey ignored several red flags indicating Delaney was aware of and assisting the Rule 204 violations mentioned above. As a result, the Order alleged Yancey failed to fulfill his supervisory duty.

5. In light of the allegations against Delaney and Yancey, the SEC ordered a public hearing and ordered that Delaney and Yancey file an answer. Penson has since filed for bankruptcy. As of January 28, 2015, the administrative proceedings remained open.

6. At the time these charges were filed, the SEC announced settlements with two other former pension employees involved in securities lending, Michael H. Johnson and Lindsey A. Wetzig. Among other things, Johnson agreed to pay a $125,000 penalty and be barred from the industry for at least five years. Wetzig consented to a censure and a cease-and-desist order.

Sales Practices

The below case involves variable annuity sales practice issues.

A. *In the Matter of Michael A. Horowitz and Moshe Marc Cohen, Admin. Proc. File No. 3-15790 (March 13, 2014).*

1. On March 13, 2014, the SEC instituted an enforcement action against two brokers, Michael A. Horowitz ("Horowitz") and Moshe Marc Cohen ("Cohen") (collectively, "Respondents") for allegedly violating Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, Sections 17(a)(1) and (2) of the Securities Act, and aiding and abetting and causing violations of Section 17(a) of the Exchange Act and Rule 17a-3 thereunder. Horowitz was also charged with violating Section 15(a) of the Exchange Act.

2. The SEC alleged that Horowitz developed a strategy in 2007 to exploit death benefits arising from variable annuities. Horowitz and others fraudulently obtained personal health and identifying information to profit from the imminent deaths of terminally ill hospice and nursing home patients in California and Chicago.

Unbeknownst to the terminally ill patients, they were designated as annuitants whose death would trigger a benefit payout to investors.

3. Respondents allegedly falsified broker-dealer trade tickets, customers' account forms and/or point-of-sale-forms to obtain supervisory approval of the annuities sold as part of the scheme. The stranger-owned annuities investment strategy was marketed as an opportunity for investors to reap short-term investment gains with a hedge against investment losses. When the annuitants died, the investors collected death benefit payments. The scheme continued into 2008.

4. The scheme allegedly generated more than $1 million in sales commissions on more than $80 million in stranger-owned annuity contracts sold.

5. On July 31, 2014, Horowitz settled with the SEC for over $850,000 in disgorgement, prejudgment interest, and civil penalties, as well as an admission of wrongdoing. On January 7, 2015, an administrative law judge ordered Cohen to disgorge $768,000 in ill-gotten gains.

6. Six other individuals and an investment advisory firm based in New York, who were also allegedly involved in the scheme, agreed to settle the SEC's charges.

Supervision

Supervision cases are a regular staple of the SEC's enforcement docket.

A. *In the Matter of Jefferies LLC, Admin. Proc. File No. 3-15785 (March 12, 2014).*

1. On March 12, 2014, the SEC filed a settled administrative proceeding against Jefferies LLC ("Jefferies") for failure to reasonably supervise Jesse C. Litvak ("Litvak") and other representatives on its mortgage-backed securities ("MBS") desk, as required by Section 15(b)(4)(E) of the Exchange Act.

2. The SEC found that, during the time period 2009 to 2011, Litvak and other representatives lied to, or misled, customers about the price at which Jefferies had purchased residential MBS ("RMBS") and thus, the amount of Jefferies' profit on the RMBS trades. The SEC further found that Jefferies failed to adequately implement its policy regarding supervisory review of its MBS desk representatives' electronic communications in a manner that would reasonably be expected to prevent and detect violations.

3. Litvak was a managing director and senior trader of RMBS at Jefferies. On January 25, 2013, he was indicted and charged in the U.S. District Court for the District of Connecticut with securities fraud, fraud against the U.S., and making false statements to the U.S. government. On January 28, 2013, the SEC charged Litvak in the U.S. District Court for the District of Connecticut with violating Section 17(a) of the Securities Act by engaging in fraud in the offer or sale of securities and with violating Exchange Act Section 10(b) by engaging in fraud in connection with the purchase or sale of securities.

4. The SEC found that Jefferies failed to reasonably implement its policy regarding supervisory review of MBS desk representatives' electronic communications, including Mr. Litvak's communications, because Jefferies failed, among other things, to: (a) include communications with customers that took place in Bloomberg group chats in the electronic communications selected for supervisors' review; (b) provide direction and/or tools to its supervisors to meaningfully review desk representatives' communications; and (c) check traders' communications against actual pricing information.

5. Jefferies was censured and agreed to make payments to customers totaling more than $11 million, which represents the full amount of Jefferies' profits earned on the trades at issue, as well as to pay a $4,200,402 penalty and prejudgment interest. Jefferies was also ordered to retain a compliance consultant to evaluate and recommend improvements to its policies and procedures related to preventing and detecting fraud on the MBS desk, as well as any other fixed income desk potentially susceptible to the same conduct and to take all necessary steps to adopt and implement the consultant's recommendations. The firm also agreed to pay an additional $9.8 million as part of a non-prosecution agreement with federal prosecutors.

6. In settling this matter, the SEC specifically considered Jefferies' remedial efforts and cooperation with the investigation.

7. On March 7, 2014, a jury found Litvak guilty on 15 criminal counts, of which 10 related to securities laws. On July 23, 2014, Litvak was sentenced to two years in prison and a $175 million fine. Litvak appealed the conviction, and the case is still pending. Based upon his conviction, on September 2, 2014, the SEC Enforcement Division instituted administrative proceedings against Litvak to determine what remedial action is appropriate. In January 2015, an ALJ granted a motion to permanently bar Litvak from the securities industry.

8. The SEC's civil complaint is still pending, and has been stayed pending the outcome in the criminal proceedings.

Enforcement Statistics

Although FINRA instituted fewer disciplinary cases in 2014 than in the prior year, its fines doubled over the prior year. Moreover, the amount of restitution FINRA ordered in 2014 more than tripled the amount that had been returned to investors in 2013.

In 2014, FINRA brought 1,397 new disciplinary actions, a noticeable decline from the 1,535 cases initiated in 2013. FINRA resolved 1,110 formal actions last year; 197 fewer cases than it had in the prior year. Last year, FINRA expelled 18 firms from its membership (compared to 24 in the prior year), barred 481 people (versus 429 in 2013), and suspended 705 individuals (an increase over the 670 such actions in the prior year).[90]

With respect to penalties and restitution, last year FINRA levied $134 million in fines (versus $60 million in 2013) and ordered $32.3 million (versus $9.5 million in 2013) to be paid in restitution to harmed investors.[91]

Targeted Examination Letters and Sweeps

In 2014, FINRA posted only two Targeted Examination letters on its website, versus three in 2013. In 2012, FINRA posted five Targeted Examination letters.

- In January 2014, FINRA posted a letter announcing that it was conducting an assessment of firms' approaches to managing cybersecurity threats. This assessment comes in light of the increasing threats posed to firms, as well as the potential harm to investors, due to the critical role of IT in the securities industry. The letter stated four expansive goals for the assessment: (i) to better understand the threats to firms; (ii) to better understand firms' risk appetite, and to expose areas of vulnerability within firms' IT systems; (iii) to better understand the approaches that firms take to manage threats; and (iv) to share observations and findings with firms, as appropriate.

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90 *See* the 2014 Regulatory Actions data on the FINRA website at the FINRA Statistics and Data page available at: http://www.finra.org/Newsroom/Statistics/.

91 *See* the current About FINRA page on the FINRA website available at: http://www.finra.org/AboutFINRA/.

- In July 2014, the Trading Examinations Unit within the Trading and Financial Compliance Examinations group of the Marketing Regulation Department at FINRA posted a letter regarding order routing and execution quality of customer orders. The letter outlined a review of the processes and procedures used by firms that covers the period from January 1, 2014 through July 2014. The FINRA staff requested, among other things, copies of written supervisory procedures, and information regarding order-routing decisions, maker/taker fees, and best execution. The specific list of requests for the review can be found on FINRA's website.

Enforcement Developments

There were two noteworthy enforcement developments last year.

First, in mid-2014, FINRA was criticized by SEC Commissioner Stein and the *Wall Street Journal* for its alleged failure to impose significant sanctions on brokerage firms and their executives. FINRA rejected those views.[92] Interestingly, as described above, FINRA's fine levels doubled last year and it returned more than three times the amount of money than it had in 2013.

At the time of the criticism regarding its enforcement program, FINRA announced that it would review its Sanction Guidelines. According to FINRA, the agency will focus particularly on repeat offenders and the largest broker-dealers. No timetable was set for the completion of the review.[93]

Second, last year, FINRA announced two new regulatory service and market surveillance arrangements. On February 6, 2014, FINRA announced that it had entered a regulatory service agreement with BATS Global Markets. Under this agreement, FINRA will provide cross-market surveillance services to BATS' four stock exchanges-BZX, BYX, EDGX, and EDGA, along with certain other regulatory services. This expands FINRA's cross-market surveillance program to 99 percent of all U.S. stock market trading. FINRA had previously been selected by Direct Edge to provide market surveillance services on behalf of Direct Edge's two licensed stock exchanges (EDGA and EDGX). Direct Edge and BATS Global Markets merged on January 31, 2014.

On December 22, 2014, FINRA announced that it had signed an agreement with the Chicago Board Options Exchange (CBOE) and C2 Options Exchange (C2) to provide market surveillance, financial surveillance, examinations, investigations, and disciplinary services to CBOE and C2, in addition to other regulatory services. FINRA began performing these services as of January 1, 2015. Under this agreement, FINRA stated that it will be uniquely positioned to detect

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[92] *See* "FINRA Weighs Tougher Stance," by Jean Eaglesham, Wall Street Journal, June 19, 2014.

[93] *Id. See also* "Wall Street Watchdog to Review Sanction Guidelines," by Suzanne Barlyn, Reuters, June 16, 2014.

cross-product (equity and options) manipulation. Additionally, FINRA will be assuming responsibility for the Options Regulatory Surveillance Authority (ORSA) industry options insider trading program. FINRA intends to integrate the options insider trading program with the current equity insider trading program, thereby allowing FINRA to conduct surveillance for insider trading for all equities and options trading in the United States.

Current FINRA Enforcement Priorities

The following list reflects some of FINRA's top enforcement priorities.[94]

- Fraud and Misrepresentations
- Conversion and Misuse of Customer Funds
- AML and Suspicious Trading
- Foreign Finders
- Complex Products and Alternative Investments
  - Reasonable Basis Suitability
  - Supervision
- Research Reports and Material Nonpublic Information
- Trade Execution and Pricing
- Regulation SHO
- Supervisory Systems
  - Supervision of Discounts and Waivers
  - Consolidated Reporting Systems
  - E-Mail Retention and Review
  - Customer Protection
- Other Technology Failures
  - Inaccurate Blue Sheet Data
- Cybersecurity/Regulation S-P

[94] This list is based on an outline prepared by FINRA.

FINRA Enforcement Actions[95]

Alternative Trading Systems

Like the SEC, FINRA appears focused on Alternative Trading Systems. Below are two cases in this area from last year.

A. *ConvergEx Execution Solutions, LLC ("ConvergEx") (April 8, 2014).*

1. FINRA alleged that ConvergEx, which owns and operates two ATSs, VortEx ATS and ConvergEx Cross ATS, made inaccurate reports of trades executed within those ATSs and failed to disclose certain order handling practices within VortEx ATS.

2. According to FINRA, from approximately February 2007 through June 2012, ConvergEx submitted 64 inaccurate Rule 605 reports because of two separate programming errors in violation of Rule 605 of Regulation NMS. In addition, from approximately January 2008 through April 2010, ConvergEx submitted 14 inaccurate Rule 606 reports in violation of Rule 606 of Regulation NMS.

3. FINRA also alleged that, from approximately July 2009 through April 2010, ConvergEx, in violation of FINRA Rule 7230A and B, incorrectly reported approximately 1,536,788 long sales to the Trade Reporting Facility ("TRF") with a "short sale" indicator, and that from approximately July 13, 2009 through approximately May 2010, ConvergEx, in violation of FINRA Rule 6380A and B, over-reported approximately 401,000 trades to the TRF as a result of a programming error.

4. FINRA also alleged that, from July 2008 through December 2010, ConvergEx failed to maintain records that it had provided oral or written disclosure of how indications of interest were used on VortEx ATS to every subscriber prior to using indications of interest. According to FINRA, not all subscribers were aware of the practice, or ConvergEx could not confirm that they were aware of it. In addition, FINRA alleged that ConvergEx failed to maintain adequate policies and procedures regarding the violations discussed above.

5. ConvergEx consented to a censure and a fine of $425,000 (consisting of $75,000 for violations of Rule 605 of Regulation NMS; $50,000 for violations of Rule 606 of Regulation NMS; $25,000 for violations of FINRA Rule 6380A; $50,000 for violations of FINRA Rule 7230A; $100,000 for violations of NASD Rule 2110

[95] The cases described herein are settlements in which respondents neither admitted nor denied the allegations against them, unless the description explicitly states otherwise.

and FINRA Rule 2010; and $125,000 for the supervisory violations).

B. *Goldman Sachs Execution & Clearing, L.P. ("GSE&C") (July 1, 2014).*

1. FINRA settled a matter with Goldman Sachs, in which FINRA alleged that GSE&C failed to have reasonably designed written policies and procedures in place to prevent transactions on SIGMA-X, an alternative trading system ("ATS") owned and operated by the firm, from trading through a protected quotation at a price inferior to the National Best Bid and Offer ("NBBO").

2. FINRA alleged that GSE&C failed to regularly surveil to determine the effectiveness of the firm's policies and procedures designed to prevent trade-throughs of protected quotations in NMS stocks. According to FINRA, the firm was unaware that, from July 29, 2011 through August 9, 2011, approximately 395,119 transactions on SIGMA-X traded through a protected quotation at a price inferior to the NBBO. The firm failed to detect the trade-throughs, which were caused by market data latencies on SIGMA-X, in a timely manner.

3. FINRA alleged that, from at least November 1, 2008, through August 31, 2011, GSE&C failed to establish, maintain, and enforce written policies and procedures reasonably designed to prevent trade-throughs, and identified three methods used by the firm that were inadequate to detect trade-throughs.

4. First, one report used, which compared a sampling of SIGMA-X's market data with an independent data source at the time of an order event, was inadequate given its limited scope—a review of 20 orders per week when SIGMA-X executed millions of transactions each week.

5. Second, firm-wide capacity monitoring used by the firm was ineffective to identify market data latencies or potential trade-throughs.

6. Third, a trade-through report GSE&C used to confirm that all trades on SIGMA-X occurred at or within the NBBO at the time of execution was inadequate because it did not detect trade-throughs that occurred as a result of market data latencies.

7. GSE&C consented to a censure, a fine of $800,000, and an undertaking to revise its supervisory policies and procedures to address the deficiencies identified.

8. In settling the case, FINRA staff considered that the firm voluntarily paid approximately $1.67 million in restitution.

Anti-Money Laundering

FINRA continues to emphasis anti-money laundering issues in its enforcement and examination programs.

A. *The Vertical Trading Group, LLC ("Vertical Trading") (January 10, 2014).*

1. FINRA settled a matter with Vertical Trading in which FINRA alleged that Vertical Trading and its agents violated Section 5 of the Securities Act of 1933 ("Section 5") by failing to determine whether certain securities were freely tradable, and failing to ascertain whether the stocks could be sold pursuant to the brokers' exemption, as claimed by the customer. FINRA alleged that the Firm and its Chief Compliance Officer did not establish and maintain adequate supervisory systems and procedures reasonably designed to comply with Section 5, particularly in light of the nature of the Firm's business, which involved liquidating large volumes of speculative, thinly-traded stock on behalf of its customers.

2. FINRA alleged that, between March and September 2010, a Vertical Trading customer deposited, and then promptly sold, $10 million worth of thinly traded, speculative securities. FINRA alleged that Vertical Trading knew, or should have known, that the customer utilized a strategy of converting debt to equity in small increments to evade compliance with Section 5. The Firm failed to implement its written supervisory procedures concerning unregistered distribution of securities and failed to identify and address red flags indicative of an unregistered distribution of securities.

3. FINRA alleged that Vertical Trading's AML program was not reasonably designed to monitor for, detect, and cause the reporting of suspicious activity. The Firm's AML systems and procedures did not adequately address risks inherent in liquidations by customers of multiple thinly-traded speculative securities or high volumes of stock liquidations in low-priced securities.

4. FINRA also alleged that Vertical Trading and its CCO failed to recognize red flags regarding high-volume sales of low-priced and thinly-traded securities conducted in correspondent accounts maintained for foreign institutional clients—despite knowing that regulators had disciplined two authorized persons from those foreign institutions for liquidating such securities without conducting due diligence. Vertical Trading lacked an appropriate due diligence program for correspondent accounts of foreign financial institutions.

5. Vertical Trading consented to a censure, a fine of $400,000, and an undertaking to review and revise its AML and Section 5 policies, procedures, and internal controls.

6. The CCO was fined $15,000 and suspended from association for two months.

7. A registered representative who participated in the distribution of unregistered securities was fined $50,000 and suspended from association for two months.

B. *Banorte-Ixe Securities International, Ltd. (“Banorte Securities”) (January 28, 2014).*

1. Banorte Securities is a New York-based securities firm that services Mexican clients investing in U.S. and global securities. In this settlement, FINRA alleged that Banorte Securities had inadequate anti-money laundering (AML) systems and procedures and failed to register approximately 200 to 400 foreign finders who interacted with the firm’s Mexican clients.

2. FINRA alleged that Banorte Securities’ AML program failed in the following three respects:

   (a) First, the firm did not properly investigate certain suspicious activities required to be reported under the Bank Secrecy Act. Banorte Securities lacked an adequate system to identify and investigate suspicious activity, and therefore failed to adequately investigate and, if necessary, report activity in three customer accounts.

   (b) Second, Banorte Securities did not adopt AML procedures adequately tailored to its business, relying instead on off-the-shelf procedures that were not customized to identify the unique risks posed by opening accounts, transferring funds, and effecting securities transactions for customers located in Mexico, a high-risk jurisdiction for money laundering, or the risks that arose from the firm’s reliance on foreign finders.

   (c) Third, Banorte Securities did not fully enforce its AML program as written.

3. From January 1, 2008, to May 9, 2013, Banorte Securities failed to register 200 to 400 foreign finders, who were employed by the firm’s Mexican affiliates and who both referred customers to Banorte Securities and performed various activities requiring registration as an associated person, such as discussing

investments, placing orders, responding to inquiries, and, in some instances, obtaining limited trading authority over customer accounts.

4. FINRA alleged that Banorte Securities, and its former Chief Compliance Officer, violated NASD Rules 3011 (a) and (b) and 2110, and FINRA Rules 3110 (a) and (b) and 2010.

5. Banorte Securities consented to a censure and a fine in the amount of $475,000, and to certain undertakings concerning its AML and registration obligations.

6. The former Chief Compliance Officer consented to a 30-day suspension.

C. *Brown Brothers Harriman & Co. ("BBH") (February 5, 2014).*

1. FINRA settled a matter with BBH, in which it alleged deficiencies in the firm's AML program, specifically with respect to penny stock transactions in bank secrecy havens, and activity in foreign financial institution (FFI) accounts.

2. Between January 1, 2009 and June 30, 2013, BBH executed transactions or delivered securities involving at least six billion shares of penny stocks (generating approximately $850 million in proceeds to the sellers of the securities) many on behalf of undisclosed customers of foreign banks in known bank secrecy havens. BBH executed these transactions despite the fact that it was unable to obtain information essential to verify that the stocks were free trading. In many instances, BBH lacked information such as the identity of the stock's beneficial owner, the circumstances under which the stock was obtained, and the seller's relationship to the issuer.

3. FINRA alleged that BBH lacked an adequate surveillance system to review penny stock transactions (including Delivery versus Payment transactions), and that the firm's AML procedures were inadequate to detect, investigate, and report suspicious penny stock activity. FINRA's allegations concerned both trading and custodial activity.

4. FINRA alleged that BBH did not record necessary information concerning the expected business activity of certain FFI customers, and failed to periodically review the activity in the FFI accounts, which would have revealed that the accounts were being utilized for higher-risk activity than the customer had outlined.

5. FINRA alleged that BBH did not conduct adequate AML testing, in that its testing did not uncover shortcomings in trade monitoring and asset movement with respect to penny stocks. FINRA also alleged that BBH failed to conduct adequate AML training specific to the risks and red flags associated with penny stock activity.

6. FINRA further alleged that BBH lacked a supervisory system to achieve compliance with Section 5 of the Securities Act, to identify penny stock shares deposited or sold through the firm that were not registered or subject to an exemption.

7. BBH consented to a censure, a fine of $8 million and its former Global AML Compliance Officer was fined $25,000 and suspended for one month.

D. *Wells Fargo Advisors ("WFA") and Wells Fargo Advisors Financial Network ("WFAFN") (collectively, "Wells Fargo") (December 18, 2014).*

1. FINRA alleged that Wells Fargo failed to comply with broker-dealer AML requirements for a customer identity verification process ("CIP").

2. According to FINRA, from 2003 to 2012, the electronic systems supporting the firms' CIP system contained a design flaw, such that the transaction-processing system recycled customer identifiers from old accounts that had been closed and assigned them to new customer securities accounts. When the recycled identifiers were transmitted to the firms' CIP system, the system did not recognize them as new customers, and did not subject those new customers to CIP.

3. FINRA found that, as a result of the system flaw, the firms failed to conduct CIP for nearly 220,000 new accounts, approximately 3% of the accounts opened by the firms during that time period.

4. Further, approximately 120,000 accounts that had never been subjected to CIP were already closed when the problem came to light.

5. The firms, through their compliance self-testing of the CIP process in 2012, detected the issue, corrected the design flaw, and performed CIP on approximately 100,000 of the affected accounts that remained open.

6. In determining the sanctions, FINRA considered the fact that the firms discovered the violations, performed remediation, and self-reported. WFA and WFAFN consented to a censure and joint fine of $1.5 million.

Best Execution

Best execution appears to continue to be a top FINRA priority.

A. *Citigroup Global Markets Inc. ("Citigroup") (August 26, 2014).*

1. FINRA alleged that Citigroup had best execution and supervisory deficiencies involving non-convertible preferred securities.

2. According to FINRA, Citigroup failed to provide best execution in approximately 22,000 customer transactions involving non-convertible preferred securities, and for related supervisory deficiencies during more than three years' time.

3. FINRA alleged that one of Citigroup's trading desks employed a manual pricing methodology for non-convertible preferred securities that did not appropriately incorporate the National Best Bid and Offer (NBBO) for those securities.

4. FINRA also alleged that Citigroup failed to perform any review of customer transactions in non-convertible preferred securities executed on BondsDirect or manually by the trading desk to ensure compliance with the firm's best execution obligations. The firm failed to conduct these supervisory reviews even though it had received several inquiry letters from FINRA staff.

5. Citigroup consented to a censure, a fine of $1.85 million, and an undertaking to pay more than $638,000 in restitution, plus interest, to affected customers.

Blue Sheets

The "Blue sheets," as they are commonly called, are responses to information requests from regulators that are intended to provide the requesting regulator with specific information about transactions, such as the name of the account holder effecting the transaction, the nature of the transaction (e.g., buy, sale, short) and the price at which the transaction occurred. In June 2014, FINRA settled blue sheet cases involving three firms with the imposition of fines of $1 million and filed a complaint against a fourth firm.

A. *Barclays Capital Inc. ("Barclays") (June 4, 2014).*

1. FINRA alleged that, between August 2012 and April 2013, Barclays submitted 229 inaccurate blue sheets to the SEC, and 253 inaccurate blue sheets to FINRA. The blue sheets associated trade data with the wrong customer names and addresses. In addition, FINRA alleged that Barclays lacked an adequate audit system to provide for accountability of blue sheet submissions. FINRA alleged violations of Section 17(a) of the Exchange Act and Rules

17a-4(j), 17a-4(f)(3)(v), and 17a-25 thereunder; and FINRA Rules 8211, 8213, and 2010.

2. According to FINRA, Barclays' submission of inaccurate blue sheet data was the result of an inherited practice of recycling customer account numbers after 18 months of inactivity. Purged accounts were given an end date of "31-Dec-9999." When a new account was created and assigned the purged account number, the end date on the purged account was changed to the day before the new account was created.

3. In or around August 2012, Barclays migrated to a new system and, according to FINRA, the addition of new fields to that system prevented it from updating the end date on purged accounts, leaving the infinite end date and resulting in two accounts with the same account number. The system generated trade information for the new customer but retrieved the name and address from the prior customer's purged account. As a result, when Barclays submitted blue sheet information, the trade information submitted did not correspond to the appropriate customer information.

4. FINRA also alleged that Barclays did not have in place an adequate audit system for accountability of its blue sheet submissions.

5. Barclays consented to a censure and a fine of $1 million and agreed to conduct a review of its policies, systems and procedures, relating to the deficiencies described in the AWC.

B. *Goldman, Sachs & Co. ("GS&Co.") (June 4, 2014).*

1. FINRA alleged that, (1) between 2004 and 2012, GS&Co. submitted to the SEC, FINRA and other regulators blue sheets that inaccurately reported certain short-sale transactions as long-sale transactions; (2) between November 2012 and January 2013, GS&Co. omitted certain transactions in its blue sheet submissions to FINRA; and (3) between 2004 and 2013, GS&Co. lacked an adequate audit system to provide for accountability of blue sheet submissions. FINRA alleged violations of Section 17(a) of the Exchange Act and Rules 17a-4(j), 17a-4(f)(3)(v), and 17a-25 thereunder; and NASD Rules 8211, 8213, and 2110; and FINRA Rules 8210, 8213, and 2010.

2. According to FINRA, when GS&Co. trading desks facilitated customer orders, they used a "control account" to process "street side" activity (execution against the market or GS&Co. trading accounts) and "customer side" activity (allocations to customer accounts). In certain instances, transactions in the same GS&Co. account involving the same security were aggregated and

"batched" for trade booking purposes. The transactions were transmitted in a bulk file to GS&Co.'s blue sheet reporting system.

3. Between 2004 and 2012, GS&Co. reported short sales as long sales on its blue sheet submissions when transactions processed through a control account were batched by a particular middle office system for blue sheet reporting. As a result, FINRA identified at least 692 inaccurate blue sheets that GS&Co. submitted to the SEC and FINRA between November 2010 and June 2012, and an undetermined amount of inaccurate blue sheets between 2004 and October 2010.

4. FINRA also alleged that GS&Co. blue sheets omitted certain street side transactions executed for customers. GS&Co.'s blue sheet reporting infrastructure misread certain transactions as bookkeeping entries, and did not include them in blue sheet reporting. As a result, FINRA alleged that, between November 2012 and January 2013, GS&Co. submitted at least 53 inaccurate blue sheets to FINRA.

5. FINRA alleged that GS&Co. lacked an adequate audit system for accountability of blue sheet submissions.

6. GS&Co. consented to a censure, a fine of $1 million and agreed to conduct a review of its policies, systems and procedures, relating to the deficiencies described in the AWC.

C. *Merrill Lynch, Pierce, Fenner & Smith Inc. ("Merrill Lynch") (June 4 2014).*

1. FINRA alleged that, from March 2006 to January 2014, Merrill Lynch submitted at least 5,323 inaccurate blue sheets to FINRA, the SEC, and other securities regulators. FINRA alleged that Merrill Lynch's blue sheet submissions omitted customer names and addresses from trades made the day the customer opened a Merrill Lynch account. FINRA also alleged that Merrill Lynch lacked an adequate audit system for accountability of blue sheet submissions. FINRA alleged violations of Section 17(a) of the Exchange Act and Rules 17a-4(j), 17a-4(f)(3)(v), and 17a-25 thereunder; and FINRA Rules 8211, 8213, and 2010.

2. Between 2008 and January 2014, when trades occurred in a new customer's account before the customer's data was fully populated across all of Merrill Lynch's databases, Merrill Lynch's systems did not append the customer data to the trade, resulting in blue sheets with "no name" associated with the trade.

3. FINRA alleged that Merrill Lynch submitted at least 2,980 inaccurate blue sheets to the SEC; 1,538 inaccurate blue sheets to

FINRA; 733 inaccurate blue sheets to the NYSE; and 72 inaccurate blue sheets to other regulators.

4. FINRA also alleged that Merrill Lynch lacked an adequate audit system for accountability of blue sheet submissions.

5. Merrill Lynch consented to a censure and a fine of $1 million and agreed to conduct a review of its policies, systems and procedures, relating to the deficiencies described in the AWC.

D. *Wedbush Securities Inc. (“Wedbush) (June 4, 2014)*

1. FINRA alleged that, in 2012 and 2013, Wedbush failed to provide blue sheets to FINRA and the SEC for 160,000 trades executed on behalf of correspondent firms. FINRA also alleged that Wedbush failed to properly provide blue sheets for 5.6 million trades, as requested by FINRA and the SEC. FINRA alleged violations of Section 17(a) of the Exchange Act and Rules 17a-4(j), 17a-4(f), and 17a-25 thereunder; and FINRA Rules 8211, 8213, and 2010; and NASD Rule 3010.

2. FINRA’s complaint alleges that these failures can be attributed to the fact that Wedbush lacked an adequate audit system for accountability of blue sheet submissions, as well as a supervisory system and procedures to achieve compliance with relevant securities laws, regulations and regulatory rules.

3. The Wedbush complaint is not yet adjudicated.

Confirmations and Account Statements

Below is a case involving disclosures on confirmations and account statements.

A. Morgan Stanley Smith Barney LLC *(“MSSB”) (December 2014).*

1. FINRA alleged that, from June 2009 through at least November 2013, MSSB failed to disclose certain required information on transaction confirmations in the Global Stock Plan Services Group (“GSPS”) and option transactions.

2. According to FINRA, for a period of four and a half years, when the firm issued GSPS account statements and confirmations, it failed to disclose required information including whether the firm acted in an agency or principal capacity, the market value of the securities, and the dollar amount of the opening and closing account balances.

3. FINRA also alleged that the firm failed to indicate whether certain option transactions, which were processed through

one of the firm's programs and two of the firm's exception trade processing systems, were opening or closing transactions.

4. Additionally, FINRA alleged that MSSB failed to establish a reasonable supervisory system and written procedures for compliance with customer account statement and transaction confirmation rules. FINRA alleged that the firm's supervisory failures caused the firm's violations to continue unchecked for four and a half years.

5. MSSB consented to a censure and a fine of $800,000.

Consolidated Statement Reporting

FINRA brought the two cases below regarding consolidated statement reporting on the same day last March.

A. *Triad Advisors, Inc. ("Triad") and Securities America, Inc. ("Securities America") (March 12, 2014).*

1. FINRA separately settled with two firms, Triad and Securities America, for failing to supervise the use of consolidated reporting systems, which resulted in statements with inaccurate valuations being sent to customers, and for failing to retain copies of consolidated reports. A consolidated report is a summary document containing information on most or all of a customer's financial holdings, including assets held away.

2. FINRA alleged that Triad and Securities America failed to establish, maintain, and enforce a reasonable supervisory system regarding the use of consolidated reports by their registered representatives. Both firms made a consolidated reporting system available to their registered representatives which allowed the representatives to enter customized values for assets and accounts held away from the Firms. However, both Firms lacked a satisfactory system to supervise the accuracy of the valuations provided to their customers. For example, from April 2010 to June 2012, Triad's supervisory procedures did not specifically address the use of the consolidated reports by its representatives.

3. FINRA further alleged that the Firms failed to adequately supervise the accuracy of valuations provided to customers. This resulted in inaccurate statements being sent to the customers. For example, at Securities America, a review of the consolidated reports issued during the fourth quarter of 2011 revealed numerous instances where the representatives had input inaccurate values for certain investments. Further, the supervisory system at Triad failed to

detect consolidated reports provided by two former representatives that contained false assets that were manually entered.

4. FINRA further alleged that Securities America failed to retain some of the consolidated reports. Both Firms lacked records for certain consolidated reports that had been sent to customers.

5. FINRA also alleged that Triad failed to establish, maintain, and enforce a reasonably designed supervisory system and written procedures regarding its examinations of branch offices. FINRA found that some auditors lacked adequate training. Additionally, in some instances, the audits were not reviewed by a compliance principal, as required by Triad's procedures.

6. FINRA also alleged that Triad conducted a securities business while failing to maintain its required net capital on 10 business days in 2009. This resulted in inaccurate books and records as Triad failed to maintain accurate net capital computations.

7. Finally, FINRA alleged that Triad failed to send its 2009 privacy policy notice to a group of customers and failed to enforce its procedures regarding the encryption of electronic messages containing personal confidential information.

8. Triad and Securities America consented to the entry of FINRA's findings, and were fined $650,000 and $625,000, respectively. Additionally, Triad was ordered to pay $375,000 in restitution.

Continuing Commission Payments to Retired Brokers

Below is a case regarding policies and procedures relating to the payment of continuing commissions to retired financial advisors.

A. *Morgan Stanley Smith Barney LLC ("MSSB") (July 3, 2014).*

1. FINRA settled a matter with MSSB related to its failure to establish, maintain, and enforce written procedures to supervise the payment of continuing commissions to retired representatives.

2. FINRA alleged that MSSB paid more than $100 million in commissions to approximately 780 former registered representatives who had retired from MSSB. When the payments were made, these representatives were not registered or associated with a registered firm.

3. The payments were made under a program that allowed payments to unregistered, retired representatives in compliance with a No-Action Letter issued by the Securities and Exchange Commission in November 2008.

4. In order to comply with the letter, MSSB implemented procedures that required the creation and maintenance of documents that were specified in the letter. For example, these documents included written acknowledgements by the retired representatives upon enrolling in the program that they could not solicit securities transactions, as well as annual certifications from the representatives attesting to the fact they had not contacted any customers for the any securities-related purpose.

5. FINRA alleged that MSSB failed to comply with its own procedures and failed to create or maintain the necessary documentation as required by the No-Action Letter for a significant number of retired representatives.

6. MSSB consented to a censure and fine $1 million. In addition, MSSB was required to conduct a review of its systems and written procedures used to supervise its Former Financial Advisor Program (FFAP) or similar program involving the payment of commissions to retired representatives.

Customer Arbitration Agreements

FINRA and Charles Schwab litigated a matter relating to certain language in the firm's customer arbitration agreement. Last year, this case was resolved.

A. *Charles Schwab & Co. ("Charles Schwab") (April 24, 2014).*

1. In a decision before FINRA's Board of Governors, the Board found that Charles Schwab prevented customers from bringing or participating in judicial class actions and FINRA arbitrators from consolidating more than one party's claims in a FINRA arbitration.

2. The Board affirmed the lower Hearing Panel's determination that Charles Schwab first violated FINRA rules when the firm attempted to keep investors from participating in judicial class actions by adding waiver language to customer account agreements in October 2011, requiring that customers agree that any claims against Schwab be arbitrated solely on an individual basis and that arbitrators had no authority to consolidate more than one party's claims.

3. The Board also determined that the the Federal Arbitration Act does not preclude FINRA's enforcement of its own rules that limit the language that firms may place in predispute arbitration agreements.

4. In lieu of pursuing the matter further (e.g., appealing the matter to the SEC), Charles Schwab entered into a settlement, consenting to

pay a fine of $500,000 and to notify all of its customers that the Class Action Waiver requirement has been withdrawn from its customer account agreements and is no longer in effect.

Customer Fees

Last year FINRA again returned to the area of customer fees with the case below.

A. *Banesto Securities, Inc. now known as Santander International Securities, Inc. ("Banesto") (January 6, 2014).*

1. FINRA settled a matter in which it alleged that Banesto provided clients with a misleading and inaccurate fee schedule. The fee schedule included a "Custody Fee," even though Banesto did not act as custodian for client assets. Banesto did not provide clients with a description of the purpose of the fee, instead providing them with only the method by which it calculated the fee.

2. Over a seven year period, from 2005 to 2011, Banesto generated a substantial percentage of its revenue from the mislabeled "Custody Fees."

3. Banesto account statements referred to the quarterly "Custody Fee" as a "Fee Based Brokerage Charge." FINRA alleged that the use of two different terms for the same fee, neither of which was accurate, created potential for confusion. The "Fee Based Brokerage Charge" description was also inaccurate because Banesto was not registered as an investment advisor and did not collect the fee as compensation for investment advice. According to FINRA, the term "Fee Based Brokerage Charge" is normally associated with accounts that have an all-inclusive wrap fee for transactions and investment advice.

4. FINRA alleged that Banesto lacked a supervisory system to review the reasonableness of its fees, and failed to perform reasonableness tests concerning the fees charged on individual accounts.

5. FINRA further alleged that Banesto increased the fee without adequate notice to clients. Banesto advised clients in 2007 of the fee's increase, but only provided 11-day advanced notice. Notice to Members 92-11 calls for notification of at least 30 days prior to the implementation or change of any service charge. In 2008 and 2009, some customers were subjected to increased fees, but did not receive notice. Those clients were reimbursed.

6. Banesto consented to a censure and a fine of $650,000.

Delivery of Prospectuses

FINRA has brought numerous cases regarding firms' failure to deliver prospectuses. One such case is summarized below.

A. *Chase Investment Services Corp. ("CISC") (December 18, 2013).*

1. FINRA settled a matter with CISC in which it alleged that CISC failed to deliver prospectuses to its customers for certain mutual funds and ETF transactions in contravention of Section 5(b)(2) of the Securities Act of 1933.

2. FINRA alleged that from May 2008 through October 2010, CISC contracted with a third-party service provider to deliver mutual fund and ETF prospectuses.

3. According to FINRA, due to a configuration error in an automated system, CISC directed its service provider to deliver prospectuses for mutual fund and ETF fund transactions in certain fee-based, discretionary accounts to CISC's affiliated investment adviser instead of to customers. FINRA alleged that this resulted in CISC failing to deliver 1,101,271 prospectuses to customers.

4. FINRA alleged that CISC failed to maintain a supervisory system reasonably designed to achieve compliance with federal rules regarding prospectus delivery requirements.

5. CISC consented to a censure and a fine of $825,000.

Failure to Prevent the Transmission of Erroneous Orders

The case below involves procedures regarding erroneous orders and relates to several exchanges.

A. *Citadel Securities LLC ("CDRG") (June 16, 2014).*

1. NASDAQ settled a matter with CDRG in which it alleged that the firm failed to reasonably prevent the transmission of erroneous orders to various exchanges by failing to establish, maintain, and enforce a supervisory system reasonably designed to check various aspects of orders.

2. NASDAQ alleged that CDRG failed to reasonably prevent the transmission of erroneous orders—both customer orders and proprietary orders—to NASDAQ, BATS Exchange, Inc., BATS Y-Exchange, Inc., and NYSE Arca, Inc. (the "Exchanges") from March 18, 2010 through February 28, 2014 (the "review period").

3. According to NASDAQ, CDRG failed to prevent the transmission of 24 erroneous customer orders to the Exchanges during the review period, which orders affected the price of each security, in some cases, dramatically.

4. NASDAQ alleged that CDRG added a pre-trade risk control that compared the size of a customer order to the average daily trading volume in the security. But according to NASDAQ, the control was inadequate because it did not identify certain erroneous customer orders.

5. NASDAQ also alleged that an update to part of CDRG's trading system caused CDRG to erroneously sell short 2.75 million shares of PC Group, Inc., causing its share price to fall by 77% in an eleven-minute period.

6. NASDAQ additionally alleged that an improperly configured wait timer in CDRG's software caused it to sent multiple, periodic bursts or order messages, at 10,000 per second, to the Exchanges.

7. According to NASDAQ, a flawed CDRG data server transposed NYSE Arca market data and NYSE Stock Exchange LLC market data, causing CDRG's proprietary trading desk to send erroneous hyper-marketable limit orders to the Exchanges, resulting in a loss of approximately $1.4 million to CDRG.

8. NASDAQ alleged that the errors described above were the result of CDRG's failure to establish, maintain, and enforce a supervisory system reasonably designed to: (i) check for order accuracy, (ii) reject orders that exceeded appropriate price and/or size parameters, (iii) reject duplicative orders, and (iv) monitor appropriate message level activity.

9. CDRG consented to a censure and a fine of $800,000, of which $420,000 was paid to NASDAQ, $160,000 to NYSE Arca, $100,000 to BATS Exchange, Inc., $70,000 to BATS Y-Exchange, Inc., and $50,000 to FINRA. CDRG additionally consented to an undertaking to revise its written supervisory procedures and risk management controls to address the deficiencies described above.

Fair Pricing

Fair pricing remains a priority of FINRA. Below is a summary of a case involving certain securities that had been de-listed and the supervision of pricing provided to retail customers.

A. *Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch") (December 16, 2014).*

1. FINRA's Market Regulation Department settled a matter with Merrill Lynch, involving alleged fair pricing and supervisory violations in connection with distressed securities transactions.

2. FINRA alleged that, over a two-year time period between July 1, 2009 through June 30, 2011, Merrill Lynch's Global Banking & Markets Credit Trading Desk ("Credit Desk") purchased certain senior notes that had been de-listed after the issuer had filed for bankruptcy. The Credit Desk purchased the notes from retail customers at prices 5.3 percent to 61.5 percent below the prevailing market price. After accumulating smaller lots of the notes through retail customer transactions, the Credit Desk sold the notes to other broker-dealers at the prevailing market price.

3. FINRA identified 716 instances in which the Credit Desk's purchases of the notes were at prices that were not fair to its retail customers, as they had purchased the notes at markdowns of more than 10 percent.

4. FINRA also alleged that Merrill Lynch did not have an adequate supervisory system in place to detect whether the retail transactions executed by the firm's Credit Desk were at prices consistent with prevailing market prices. Specifically, the firm allegedly failed to conduct any post-trade best execution or fair pricing reviews for transactions executed by the Credit Desk.

5. Merrill Lynch consented to a censure and a fine of $1.9 million (consisting of $1.4 million for fair pricing violations and $500,000 for supervision violations). The firm also agreed to pay restitution of over $540,000, plus interest, to affected customers. Under the settlement, Merrill Lynch is also required to undertake to provide certain reports on the effectiveness of the firm's supervisory system with respect to the pricing of retail customer transactions.

Initial Public Offerings

With the re-emergence of initial public offerings over the last several years, FINRA has apparently turned its attention to firms' procedures for handling such transactions. Below is one such case.

A. *Morgan Stanley Smith Barney LLC ("MSSB") (June 6, 2014)*

1. FINRA settled a matter with MSSB, alleging that MSSB failed to establish and maintain adequate systems and procedures for supervising solicitation of retail interest in 83 equity IPOs from

February 16, 2012 to May 1, 2013, with over 68,000 customers investing in the largest offering.

2. Contracts for the purchase or sale of a security are prohibited prior to the effectiveness of the registration statement. However, solicitation that does not result in a contract prior to registration is permissible under certain circumstances. For example, an "indication of interest" may be a permissible solicitation, but must be confirmed after effectiveness of the registration statement in order to form a contract. A "conditional offer" becomes a contract when a firm accepts the offer after the effectiveness of the registration statement, as long as the customer has been given a meaningful opportunity to withdraw the offer after the registration statement became effective.

3. MSSB began operations in June 2009 though the merger of Morgan Stanley and Smith Barney's retail business. Thereafter, certain offices operated under legacy Morgan Stanley policies, which directed financial advisors to use indications of interest, while others operated under Smith Barney legacy policies, which directed financial advisors to use conditional offers.

4. According to FINRA, MSSB issued a compliance notice on February 16, 2012 to reconcile the policies, but the notice did not properly distinguish between indications of interest and conditional offers. Financial advisors were directed to ascertain customer interest in IPO shares at a specified price range. Customers were informed that shares were not guaranteed, but there was no reconfirmation unless the final price was outside of the indicated range. MSSB's policy also did not expressly state that investors would have an opportunity to withdraw their offers before acceptance, post-registration.

5. FINRA alleged that MSSB did not offer training or other materials to financial advisors to clarify its policy and, as a result, sales staff and customers may not have properly understood what type of interest was being solicited.

6. MSSB changed its practice on May 1, 2013 such that all customer orders were reconfirmed after final pricing terms became available.

7. MSSB consented to a censure and a fine of $5 million.

Large Option Position Reporting

In 2013, FINRA brought three significant actions in the large options position reporting area. It returned to the space in 2014 with the below action.

A. *Barclays Capital, Inc. ("Barclays") (January 7, 2014).*

1. FINRA settled a matter in which it alleged that Barclays erred in reporting certain positions to the Large Options Position Reporting (LOPR) system. Barclays failed in reporting an Options Contract Equivalent of the Net Delta (OCEND) position to the Options Clearing Corporation (OCC). FINRA also cited Barclays for violating certain position limits and for an inadequate review system to achieve compliance with LOPR requirements.

2. Specifically, FINRA alleged that Barclays:

   (a) Incorrectly reported large conventional non-index option positions as index options to LOPR) from January 1, 2010 to April 15, 2011;

   (b) Exceeded the applicable position limit in four options for 86 business days in 2010;

   (c) Failed to report its OCEND position to the OCC in one symbol for 23 business days in late 2010;

   (d) Failed to report or submitted inaccurate reports to the LOPR system in an estimated 223,760 instances during 2011 and 2012;

   (e) Failed to report positions to the LOPR system when contra-parties were non-U.S. affiliates of U.S. broker-dealers, in an estimated 1.466 million instances from 2010 through mid-2012;

   (f) Inaccurately reported positions to the LOPR system in 1,148 instances from mid-2012 through mid-2013); and

   (g) Had an inadequate supervisory system to achieve compliance with LOPR requirements.

3. Barclays consented to a censure and a fine of $750,000.

Mutual Fund Sales Charge Waivers

Mutual fund sales practices are an important of FINRA's enforcement program. Below is a case relating to sales charge waivers.

A. *Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch") (June 16, 2014).*

1. FINRA settled a matter with Merrill Lynch in which it alleged that the firm failed to apply certain sales charge waivers in selling mutual fund shares to certain small business retirement plans and charitable organizations and failed to establish an adequate supervisory system and procedures for such waivers.

2. According to FINRA, from at least January 2006 through December 2011, Merrill Lynch accounts that were eligible to purchase Class A mutual fund shares with waived front-end sales charges, instead received Class A shares without such waivers or Class B or C shares with sales charges and higher fees. The issue affected retirement plan accounts and accounts of charitable organizations that were eligible for Class A shares and fee waivers.

3. FINRA cited Merrill Lynch for lacking adequate policies and procedures to train its representatives to identify and manually apply waivers.

4. The firm learned of this issue in 2006 but allegedly did not notify its brokers or customers and did not report its findings to FINRA until November 2011. At that time, Merrill Lynch developed a remediation plan with FINRA and paid approximately $58 million (including interest) to the approximately 28,000 customer accounts.

5. FINRA also alleged that Merrill Lynch sold certain mutual fund shares during the same time period to approximately 3,200 403(b) retirement accounts as if they were non-retirement accounts for purposes of determining share class eligibility, and likewise failed to apply sales charge waivers. According to FINRA, Merrill Lynch unreasonably relied on financial advisors to make eligibility determinations and did not have controls to detect instances in which waivers should have been applied.

6. FINRA also alleged that, from January 2004 through August 2011, Merrill Lynch sold Class A shares with a sales charge to certain charitable organizations, or Class B or Class C shares with higher expenses, despite such accounts being eligible for sales charge waivers.

7. Merrill Lynch's supervisory procedures did not require a determination of whether Class A pricing should be provided to eligible charitable organizations. Procedures did not exist to monitor whether financial advisors were informing customers of eligibility or ensuring that customers received waivers.

8. Merrill Lynch became aware of this issue in or around April 2010 and self-reported to FINRA in January 2011.

9. Procedures for manually applying waivers were not adequately distributed to representatives until October 2010 or incorporated into the firm's compliance manual until May 2012.

10. In March 2012, Merrill Lynch remediated more than $2.7 million to 1,505 charitable organization accounts and an additional $4.1 million in March 2014 to 2,119 charitable organization accounts.

11. Merrill Lynch consented to a censure and a fine of $8 million.

12. In addition to the approximately $64.8 million in restitution already voluntarily provided, Merrill Lynch agreed to provide an estimated additional $21.2 million to approximately 13,000 small business retirement accounts and $3.2 million to approximately 3,178 403(b) retirement accounts.

Net Capital, Customer Reserve, and Possession or Control

Summarized below are two actions relating to firms' financial reporting.

A. *RBS Securities Inc.("RBS"), Case No. 2011027246701, CRD No. 11707 (March 2014 (AWC dated December 18, 2013)).*

1. FINRA alleged that RBS failed to make accurate net capital and customer reserve computations, comply with the possession or control requirements of the customer protection rule, comply with the requirements of Regulation SHO of the Securities Exchange Act of 1934, maintain accurate books and records, and establish and maintain reasonable supervisory systems and procedures.

2. According to FINRA, RBS's security position allocation system for its fixed income business ensured that all customer receipt versus payment/delivery versus payment (RVP/DVP) fails were included in the customer reserve formula computation, but incorrectly represented the underlying security positions, which resulted in incorrect representations in the reserve formula computation and mismatches between the securities positions on RBS' stock record and the quantities in RBS' allocation system.

3. With respect to possession or control, RBS lacked an adequate process to identify customers that had accounts on its two back office platforms and to issue segregation instructions for customer positions, which caused potential inaccuracies in RBS' excess

margin and deficit position listings because they did not consider the customer positions on both platforms.

4. In addition, FINRA alleged that RBS did not receive information necessary to determine capital charges related to reconciling items and used an incorrect methodology to compute capital charges related to repurchase and reverse repurchase agreements. It claimed that RBS failed to take net capital charges related to variable non-convertible debt securities and repurchase and reverse repurchase transactions or improperly treated these transactions for net capital purposes, resulting in miscalculations of required net capital, which reduced the firm's excess net capital, but did not result in a deficiency.

5. FINRA also alleged that RBS did not comply with the requirements of Regulation SHO by failing to properly mark sell orders in a customer account as long or short due to the improper use of the aggregation unit order marking method and obtain and document required locates prior to accepting or effecting short sales. According to FINRA, RBS also did not establish systems and procedures that were reasonably designed to achieve compliance with Regulation SHO in that it did not have adequate procedures regarding the fail to deliver, close-out, and penalty box requirements.

6. FINRA also alleged RBS failed to maintain accurate books and records by failing to: (1) maintain the required notations and disclosures in connection with a securities loan transaction, (2) keep required books and records in connection with its fixed income business, (3) record on its stock record to be announced (TBA) transactions that had passed settlement date, (4) maintain a stock record that was consistent with its allocation system, and (5) accurately record the customer positions of the affiliate account.

7. Finally, FINRA also found RBS failed to establish and maintain an adequate system to supervise, and written procedures related to, the computation of its customer reserve and net capital calculations, compliance with books and records requirements, and the order marking, locate, close out of fails to deliver and penalty box requirements of Regulation SHO.

8. RBS consented to a censure, a fine of $475,000, and an entry of certain findings.

B. *Pershing LLC ("Pershing") (December 29, 2014).*

1. FINRA alleged that, between July 2010 and September 2011, Pershing failed to adhere to the customer protection rule

concerning weekly customer reserve formula calculations, and possession or control requirements. FINRA also alleged certain deficiencies in Pershing's Financial and Operational Combined Uniform Single (FOCUS) Reports.

2. FINRA alleged that, in November 2010, Pershing personnel misinterpreted certain guidance regarding the customer protection rule and, as a result, incorrectly computed its weekly reserve formula by improperly including additional debits for Securities Borrowed and Fail to Deliver. This error in the calculation reduced the amount of funds that Pershing was required to maintain.

3. Pershing learned of these issues during a routine annual FINRA examination in 2011, promptly conducted an historical review of its weekly reserve formula computations calculated between November 30, 2010, and August 5, 2011, and determined that the misinterpretations resulted in hindsight deficiencies during most of that period, ranging from $4,000,000 to $220,000,000.

4. FINRA also alleged that Pershing had failed to promptly maintain physical possession or control of customers' fully paid and excess margin securities in three of Pershing's clearance accounts during the period from late July 2010 to September 2011.

5. Specifically, Pershing maintained three clearance accounts to facilitate the settlement of cross-border securities transactions by a customer. Intending to make the cross-border settlement trade process more efficient, in July 2010, Pershing personnel changed the possession or control coding of the three clearance accounts from non-control locations to good control locations. FINRA alleged that the three clearance accounts in fact were not good control locations, and the coding changes thus caused Pershing's excess/deficit reports to overstate securities that were in the Firm's possession or control whenever there were securities on deposit in those three accounts.

6. Additionally, unrelated to Pershing's actions, incorrect coding on two of the three clearance accounts permitted the turnaround of shares in those accounts to clean up Continuous Net Settlement fails, when securities in those accounts were fully paid for and thus should have been segregated. According to FINRA, Pershing should have maintained all three accounts as non-control locations and ensured that the securities in the two miscoded accounts were properly segregated.

7. Pershing learned of these issues during the 2011 routine FINRA examination, promptly conducted an historical review, and identified that it had incorrectly created 47 new possession or control deficits,

and in a significant number of other instances, had created and/or increased intraday possession or control deficits.

8. FINRA also alleged that Pershing did not have an adequate supervisory system and procedures in place to review and approve procedural changes to the reserve formula computation and required possession or control requirements. Pershing's procedures allegedly did not include a process whereby the personnel who implemented coding changes would communicate the changes to those responsible for the daily review of delivery deficits.

9. Finally, FINRA cited Pershing for alleged inaccuracies reported in "Part II" of its FOCUS Reports for the period from July 2010 through September 2011.

10. Pershing consented to a censure and a fine of $3 million.

Penny Stock Transactions

Below is a summary of a case involving penny stock transactions, including issues concerning suitability and supervision.

A. *Feltl & Company ("Feltl") (November 2014).*

1. FINRA alleged that the firm: (i) did not meet suitability, disclosure and record keeping requirements with respect to thousands of penny stock transactions; (ii) failed to establish, maintain and test supervise systems for its penny stock business; and (iii) failed to produce certain trade blotters.

2. According to FINRA, between January 2008 and February 2012, Feltl was a market maker in 17 penny stocks, solicited at least 2450 penny stock purchases and received over $2.1 million in revenue from the transaction markups, markdowns, and commissions.

3. During that period, Feltl allegedly failed to:

   (i) document customer's suitability, send customers suitability determination two days prior to the transaction or obtain written customer agreement;

   (ii) provide customers with risk disclosure documents;

   (iii) disclose inside bid and ask market quotations or the amount of compensation to the firm; and

(iv) send to customers monthly account statements with value of each penny stock owned and penny stock risk language.

4. FINRA also alleged that, during the relevant period, Feltl's written procedures did not include certain required information, such as directions on required waiting periods, customer agreements, contact information for follow-up questions, disclosures regarding compensation for penny stocks, disclosures for suitability, and information regarding what documents need to be maintained to meet suitability requirements.

5. In addition, although exception reports flagged penny stock transactions, the firm did not have a reasonable system to follow-up on the exceptions. The firm also failed to submit required reports and test results during the Relevant Period.

6. Further, FINRA alleged that Feltl was unable to produce daily blotters signed off by a designated supervisor for one branch and produced blotters from another branch ten months after FINRA staff's request.

7. Feltl consented to a censure and a fine of $1 million.

Regulation M

Like the SEC, FINRA appears to remain focused on Regulation M matters. Here is an example of that emphasis.

A. *Citigroup Global Markets Inc. ("SBSH") (March 18, 2014).*

1. FINRA settled a matter with SBSH in which it alleged that certain trading activity violated of Rule 105 of Regulation M under the Securities Exchange Act of 1934.

2. FINRA alleged that, between May 2009 and September 2010, SBSH sold short the securities of five issuers in the five business days before the pricing of follow-on offerings by those issuers, and then purchased shares in the follow-on offerings at lower prices.

3. According to FINRA, the firm's Equity Principal Strategies Desk (EPSD) engaged in short selling of certain securities and did not qualify in any of the transactions for any exemption from the trading restrictions of Rule 105 of Reg. M. In each instance, EPSD sold short, then purchased the issuer's securities at a lower price in a follow-on offering. EPSD earned profits of approximately $538,626 from the transactions.

4. FINRA additionally alleged that SBSH's supervisory system was deficient with respect to Rule 105 of Reg. M. FINRA cited SBSH for lacking written supervisory procedures for: (1) identification of those responsible for supervision with respect to applicable rules; (2) required supervisory steps; (3) how often such supervisory steps should be taken; and (4) documentation of completion of those steps.

5. SBSH consented to a settlement totaling $1,097,939.06 (consisting of disgorgement of $538,626.04 in profits, $269,313.02 for the underlying violations of Rule 105, and $290,000 for the supervisory findings). SBSH separately resolved a case with the BATS Exchange, and the above amount was to be paid jointly to BATS and FINRA.

6. SBSH additionally consented to an undertaking to revise its written supervisory procedures.

Regulation SHO

Much like the SEC, FINRA has brought many cases involving short selling. Below is another example in this trend.

A. *Merrill Lynch Professional Clearing Corp. ("Merrill Lynch PRO") and Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch") CRD Nos. 16139 and 7691 (October 27, 2014)*

1. FINRA's Departments of Enforcement and Market Regulation alleged that Merrill Lynch PRO violated Regulation SHO, and that its affiliated broker-dealer, Merrill Lynch, failed to establish, maintain and enforce supervisory systems and procedures related to Regulation SHO and other areas.

2. FINRA alleged that, from September 2008 through July 2012, Merrill Lynch PRO did not take any action to close out certain fail-to-deliver positions, and did not have systems and procedures in place to address the close-out requirements of Regulation SHO for the majority of that period.

3. FINRA also alleged that, from September 2008 through March 2011, Merrill Lynch's supervisory systems and procedures were inadequate and improperly permitted the firm to allocate fail-to-deliver positions to the firm's broker-dealer clients based solely on each client's short position without regard to which clients caused or contributed to Merrill Lynch's fail-to-deliver position.

4. In addition, FINRA alleged that Merrill Lynch Pro failed to maintain and/or preserve for a period of at least three years records of

orders for trades placed by its naked access and sponsored access clients during at least the September Order Period.

5. FINRA also alleged that Merrill Lynch PRO lacked adequate systems and procedures to ensure that the electronic trading of its naked access and sponsored access clients was properly reviewed and reasonably supervised.

6. According to FINRA, Merrill Lynch also violated Section 15(c) of the Exchange Act and Rule 15c3-3(e), Section 17(a) of the Exchange Act and Rule 17a-5, and FINRA Rule 2010 by submitting six inaccurate FOCUS Reports that contained inaccurate reserve formula computations in 2009.

7. Furthermore, FINRA alleged that both Merrill Lynch Pro and Merrill Lynch's programs for suspicious activity monitoring failed to capture certain trading data necessary to monitor for suspicious activity, and they failed to implement and establish anti-money laundering procedures and internal controls reasonably designed to detect and cause the reporting of suspicious transactions.

8. Merrill Lynch PRO consented to a censure and a fine of $5 million.

9. Merrill Lynch consented to a censure, a fine of $2.5 million, and an undertaking requiring Merrill Lynch to within 120 days adopt and implement supervisory systems and written procedures reasonably designed to achieve compliance with the current requirements of Rule 204 of Reg SHO.

Research Conflicts

While FINRA regularly brings enforcement actions related to disclosure deficiencies in research reports, it does not often bring enforcement actions regarding the involvement of research analysts in their firms' efforts to win investment banking business. Below is a summary of the actions FINRA brought against 10 firms for using research analysts in their investment banking pitches to a potential IPO candidate.

A. *Barclays Capital Inc. ("Barclays"), Citigroup Global Markets Inc. ("CGMI"), Credit Suisse Securities (USA), LLC ("Credit Suisse"), Goldman, Sachs & Co. ("Goldman"), JP Morgan Securities LLC ("JP Morgan"), Deutsche Bank Securities Inc. ("Deutsche Bank"), Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch"), Morgan Stanley & Co., LLC ("Morgan Stanley"), Wells Fargo Securities, LLC ("Wells Fargo"), and Needham & Company LLC ("Needham") (collectively, the "firms") (December 11, 2014).*

1. In connection with the planned initial public offering of Toys “R” Us (“TOYS”), FINRA alleged that each of the firms allowed a research analyst to solicit investment banking business and that the firms offered favorable research coverage in exchange for a role in the IPO.

2. According to FINRA, each of the firms allowed an equity research analyst to make a presentation to TOYS management and the company’s sponsors during the solicitation period (i.e., the period of time after which a company has said it intends to initiate a transaction, but before it has selected an investment banking firm).

3. FINRA alleged that the firms understood that TOYS sought the meetings in order to vet the views of the research analyst and compare whether those views were aligned with the valuations given by the firms’ investment bankers. At the presentations, TOYS asked the firms to complete a valuation form that the firm, and its analysts, would be expected to support, in an effort by TOYS to prevent analysts from adopting a negative view of the company after it had awarded the investment banking business to that firm.

4. While there was a wide range of conduct at issue, FINRA alleged that, either explicitly or implicitly at the meetings or in follow-up communications, each of the firms offered favorable research coverage to TOYS in exchange for a role in the IPO.

5. FINRA alleged that TOYS sought the combined view of the firms’ research and investment banking teams on valuation, and that all of the firms, except for Needham, provided a valuation to TOYS.

6. FINRA also alleged that six firms had inadequate supervisory procedures related to research analyst participation in each firm’s solicitation efforts and offers of favorable research coverage. The six firms were Barclays, CGMI, Credit Suisse, Goldman, JP Morgan, and Needham.

7. Barclays, CGMI, Credit Suisse, Goldman, and JP Morgan each consented to a censure and a fine of $5,000,000.

8. Deutsche Bank, Merrill Lynch, Morgan Stanley, and Wells Fargo each consented to a censure and a fine of $4,000,000.

9. Needham consented to a censure and a fine of $2,500,000.

Supervision of Research Analysts

The actions and oversight of research analysts has long been a priority for securities regulators. Below is a recent case in this area.

A. *Citigroup Global Markets, Inc ("CGMI") (November 24, 2014).*

1. FINRA alleged that CGMI (i) failed to supervise and enforce its policies and procedures related to equity research analysts' communications with clients and the firm's sales and trading staff; and (ii) allowed one analyst to indirectly participate in two IPO road shows.

2. According to FINRA, between January 2005 and February 2014, CGMI encouraged its research analysts to communicate with clients and sales and trading staff by creating a compensation structure for research analysts in which voting by clients and sales personnel was a significant factor.

3. FINRA alleged that the compensation structure created an inherent conflict of interest in that analysts were incentivized to share nonpublic research with clients. In these circumstances, CGMI failed to take adequate supervisory steps to deter selective dissemination of nonpublic research and to supervise analysts' communications with clients, as well as sales and trading personnel.

4. For example, between October 2010 and October 2013, CGMI allegedly failed to supervise at least 36 analysts who hosted or attended over 40 "idea dinners" with institutional clients, and sales and trading staff where the analysts provided stock picks which were sometimes inconsistent with their published research reports. CGMI did not specifically address these dinners in its policies and procedures.

5. FINRA also alleged that, in December 2012, an equity research analyst in a CGMI Taiwanese affiliate disseminated to approximately 40 clients of CGMI nonpublic information about Apple iPhone orders that was not contained in his published research.

6. Further, FINRA alleged, that while between January 2005 and February 2014 CGMI had issued approximately 100 internal warnings to research analysts, when CGMI detected violations of its policies regarding dissemination of nonpublic research, it failed to consistently and timely enforce the policies and deter future violations.

7. Finally, FINRA alleged that, in May and July 2011, a senior equity research analyst indirectly participated in two investment banking road show presentations by providing guidance to two companies preparing presentation materials. CGMI did not expressly prohibit equity research analysts from assisting in preparation of investment banking road show materials.

8. CGMI consented to a censure and a fine of $15,000,000, and to review, report, and implement necessary changes to the firm's policies and procedures related to certain equity research communications.

Supervision of Sales of Alternative Investments

FINRA remains focused on the supervision of complex products. These cases demonstrate that emphasis.

A. *Stifel, Nicolaus & Company, Incorporated ("Stifel") and Century Securities Associates, Inc. ("Century ") (January 9, 2014).*

1. FINRA alleged that, between January 2009 and June 2013, Stifel and Century made unsuitable recommendations of leveraged and inverse exchange-traded funds ("nontraditional ETFs") to certain retail customers. FINRA also alleged that Stifel and Century did not have reasonable supervisory systems in place, including written procedures, specific to sales of nontraditional ETFs.

2. Stifel and Century are affiliates and are both owned by Stifel Financial Corporation.

3. According to FINRA, nontraditional ETFs are generally designed to meet their stated objectives over the course of one trading session, and generally rebalance the fund's holdings on a daily basis (known as the "daily reset"). Nontraditional ETFs typically have at least a small difference between the performance of the fund and its underlying index or benchmark, which may compound over longer periods of time. FINRA has advised members that, in its view, because of these risks, and their inherent complexity, nontraditional ETFs are not typically suitable for retail investors who plan to hold them for more than one trading session.

4. According to FINRA, Stifel and Century did not require registered representatives and supervisory personnel to have training specific to the products before recommending them to customers. As a result, some representatives allegedly did not fully understand the unique features and specific risks associated with nontraditional ETFs.

5. FINRA alleged that Stifel and Century registered representatives recommended nontraditional ETFs to customers with conservative investment objectives. Customers held those investments for long periods of time.

6. From 2009 through the second quarter of 2013, Stifel retail customers purchased approximately $641 million worth of nontraditional ETFs, and Century retail customers purchased approximately $31 million. FINRA alleged that customers who held the investments for longer periods of time experienced losses.

7. Stifel and Century consented to censures and fines of $450,000 for Stifel and $100,000 for Century. The firms also paid restitution to 65 customers. Stifel paid restitution of approximately $338,000 and Century paid restitution of approximately $136,000.

B. *Berthel Fisher & Company Financial Services, Inc. ("Berthel Fisher") and Securities Management & Research, Inc. ("Securities Management") (February 24, 2014).*

1. FINRA settled a matter with Berthel Fisher and its affiliate, Securities Management, in which FINRA alleged that Berthel Fisher had inadequate supervisory systems and written procedures, including systems and procedures regarding its suitability review, concerning the sale of non-traded real estate investment trusts (REITs), and leveraged and inverse ETFs.

2. According to FINRA, between January 2008 and December 2012, Berthel Fisher allegedly did not comply with its own concentration limits concerning alternative investments. The Firm's method of calculating concentration limits for suitability did not accurately record all of the alternative investments (such as futures, oil and gas programs, equipment leasing, business development companies, and non-traded REITs). The Firm also failed to train its supervisory staff to properly analyze suitability of certain alternative investments, and did not have controls to ensure that current subscription agreements were used in the purchase paperwork for an alternative investment transaction. FINRA also alleged that Berthel Fisher's supervisory system was deficient in monitoring for alternative investment concentration levels, did not consider prospectus or state suitability standards in states with heightened concentration standards, and in some instances used outdated subscription agreements to assess suitability.

3. Between April 2009 and April 2012, Berthel Fisher allegedly did not fully assess the features and risks of nontraditional ETFs that were being recommended to customers by the Firm's registered representatives, and failed to provide training regarding the

products. Berthel Fisher also failed to monitor and detect certain unsuitable buy-and-hold strategies of ETFs in customer accounts. The Firm's exception reports and other supervisory tools did not distinguish nontraditional ETFs from other exchange-traded securities.

4. From September 2008 to November 2010, Berthel Fisher had an inadequate supervision of a remote branch office, due to a lack of periodic unannounced audits of the branch office, and insufficient review of some branch communications and e-mails.

5. From August 2007 to February 2012, Berthel Fisher and Securities Management failed to retain e-mails for certain e-mail domains.

6. Berthel Fisher consented to a fine of $675,000, and restitution to certain customers totaling approximately $13,000. Securities Management consented to a fine of $100,000. Berthel Fisher agreed to retain an independent consultant to improve its supervisory procedures relating to its sale of alternative investments.

C. *LPL Financial LLC ("LPL") (March 24, 2014).*

1. FINRA settled a matter with LPL in which it alleged that LPL inadequately supervised the sale of alternative investment products, resulting in violations of suitability standards.

2. FINRA alleged that: (1) LPL's supervisory systems and procedures were inadequate to identify and determine whether customer holdings of alternative investments exceeded concentration limits set forth in LPL, prospectus, or state suitability standards; (2) LPL's supervisory personnel lacked information to identify alternative investment transactions that fell outside the firm's suitability guidelines, or prospectus or state suitability standards; and (3) LPL failed to adequately train supervisors in how to analyze state suitability standards for alternative investment transactions.

3. FINRA identified deficiencies in the alternative investment paperwork utilized by LPL to compare customer profiles to alternative investment concentration limits. Supervisory review of alternative investment profiles did not consider fluctuations in customers' liquid net worth or net worth over time.

4. FINRA alleged that LPL lacked policies or procedures requiring verification of a customer's financial information on the firm's alternative investment form and that LPL also failed to adequately review prospectuses and subscription agreements to determine concentration limits.

5. FINRA also alleged deficiencies in manual and automated systems used by LPL operations personnel to assess suitability when processing alternative investment transactions.

6. LPL consented to a censure and a fine of $950,000 and agreed to undertake a comprehensive review of the firm's policies and procedures relating to the supervision of compliance with suitability standards. In connection with the AWC, LPL submitted a corrective action statement, which described the firm's improvements relating to supervision of alternative investment transactions and the process for identifying transactions triggering further review.

Securities Enforcement and Litigation Practice

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