



# Securities Industry Alert

## Newsletter for Securities Professionals

Securities Industry Alert

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**Equity Indexed Annuities:**

**The Hot Product That Has The Regulators' Attention!**

Equity indexed annuities are one of the hottest products on the market today. Sales of EIAs in 2004 were approximately \$22 billion, an increase of over 50% from the prior year. EIAs are complex financial instruments issued by insurance companies that guarantee a minimum return and provide an opportunity to earn addi-

tional interest based on the performance of a securities market index. They typically have significant commissions and lengthy surrender periods during which investors face heavy charges for early withdrawals. EIAs are not registered with the SEC and no one is sure whether they are securities.

The recent popularity

of EIAs has attracted significant attention from the regulators, who are not waiting around for the courts to decide whether they are securities. NASD Enforcement head Barry Goldsmith recently expressed concerns about existing EIA sales practices. Recently, the NASD issued a Notice to Members stating, NASD is concerned

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**NASD's 2005 Disciplinary Statistics — "Take Aways" and Trends**

The 2005 NASD statistics show a dramatic increase in the amount of fines levied by the regulator. Disciplinary fines collected by the NASD totaled over \$125 million,

representing an increase of approximately 22% from the prior year. On the other hand, the number of disciplinary actions that were resolved in 2005 decreased slightly and the

number of individuals suspended or barred decreased by over 10%. In trying to reconcile this information, the first thought that comes to mind is the Jerry Maguire line, "show me the

*(Cont. on page 2)*

**Former Senior Regulator Joins FF&S**

Sylvia Scott, formerly a senior attorney at the NASD and SEC, joined the law firm of Freeman, Freeman & Smiley, LLP as a senior litigator and consultant to the securities indus-

try. NASD Enforcement head Barry Goldsmith stated in an announcement, "Without doubt, Sylvia has been one of the finest attorneys and litigators ever in this

[Enforcement] Department. During her 12 years with us, we have come to respect her formidable litigation abilities and to count on those talents in a number of high visibility cases." Mr. Goldsmith

*(Cont. on page 3)*

## NASD 2005 Statistics (Cont.)

money.” Actually, the NASD has intensified its efforts to bring more high profile cases and levy heavy fines in areas that represent “hot button” issues for the regulator. In these cases, the NASD Sanction Guidelines (which provide recommended fine ranges for specified misconduct) are thrown out and the fine amounts can go through the roof.

The “take away” here is to become sensitized to the NASD’s priorities and hot buttons and make sure compliance in those areas have been adequately addressed. This is not always possible, particularly if there is an atmosphere of regulation (or rulemaking) by enforcement. However, the NASD has been known to issue early warnings of enforcement priorities in speeches by officials,

press releases, and other publications. Observing the actions of other regulators (i.e., the Spitzer phenomenon) can also provide insight as to future actions by NASD and others.

In 2005 and for the third year in a row, the NASD has made the mutual fund industry a pri-

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***“In high profile, ‘hot button’ cases, the NASD Sanction Guidelines are thrown out and the fine amounts can go through the roof.”***

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mary focus of its regulatory efforts. In 2005, the NASD brought over 400 enforcement actions in the mutual fund area representing

## California Court Allows Brokerage Firm To Defame Employees on Form U-5

Marco Fontani sued Wells Fargo Investments charging defamation and interference with his prospective business advantage. *Fontani v. Wells Fargo Investments*, 129 Cal. App. 4th 719 (2005). WFI submitted a Form U-5 stating that Fontani had been terminated for “violation of company policies by misrepresenting information in the sale of annuities, not being properly registered and firm procedures

regarding annuity applications.” WFI filed a special motion asking the court to strike Fontani’s claims based on a California statute that protects free speech in connection with a public issue (other states have similar statutes). A California appeals court granted the motion holding that WFI’s U-5 disclosures constituted a communication before an official proceeding and involved a

(Cont. on page 5)

nearly 30% of all new enforcement actions for the year. In 2004, mutual fund cases accounted for about 9% of new enforcement actions and in 2003, they accounted for about 4½ % of such actions. Those who read the NASD “Year in Review” press releases for 2003 and 2004

might have seen it coming as both press releases highlighted NASD enforcement efforts in the mutual fund area. While early identification of the NASD’s interest in this area may not have helped those whose cases were already in the NASD pipeline, for others preventative or corrective

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## NASD Statistics (Note: 2005 stats are preliminary)

Regulatory Event	2005	2004	2003
Formal Actions Resolved	1,296	1,336	1,324
Disciplinary Fines Collected	\$125.4 mil	\$103.9 mil	\$33.3 mil.
New Disciplinary Actions Filed	1,412	1,396	1,410
Firms Suspended	3	4	7
Firms Expelled	14	22	30
Individuals Barred or Suspended	737	833	827
# of Firms	5,144	5,222	5,272
# of Registered Reps	662,938	667,751	653,887
# of Branches	106,449	97,250	92,861

### Securities Industry

*Alert* is a publication of the Securities Practice Group of Freeman, Freeman & Smiley, LLP. Sylvia Scott heads the firm’s Securities Practice Group and is the Editor of the newsletter.

**If you have any questions concerning any of the articles in this newsletter, please contact Sylvia at 310.255-6161 or email at [sms@ffslaw.com](mailto:sms@ffslaw.com).**

## Statistics (cont.) Equity Indexed Annuities (cont.)

measures might have helped deter or mitigate possible enforcement action by the regulator.

Looking forward to 2006, the NASD's 2005 "Year in Review" press release offers some clues as to other areas that are likely to receive intensified scrutiny in the coming year. For example, variable annuities are explicitly referenced as a "continued focus" of the NASD. In 2005, NASD brought 88 enforcement actions involving variable annuities and imposed a \$16 million dollar monetary sanction against a firm for unsuitable switching activity.

PIPES (private investment in public equity) and fee-based accounts are also on the NASD's radar. Additionally, the research analyst rules and 529 college savings plans are receiving continuing attention by the regulator. In 2006, industry members should consider adding to their New Year's resolutions the task of revisiting their sales practices and compliance procedures in these areas to ensure a Happy New Year! (See also, article on Equity Indexed Annuities.)

about the manner in which associated persons are marketing and selling unregistered EIAs, and the absence of adequate supervision of these sales practices. In the Notice, the NASD pointed to misleading advertisements that had phrases like, "A Win/Win Investment Vehicle" and "Growth Potential Without Market Risk." In fact, investors *can* lose a substantial amount of money if for any reason they have to cancel their annuity early. Investors pay substantial early withdrawal charges and high upfront commissions.

One of the first EIA

enforcement actions was recently filed by the Massachusetts securities regulator. The complaint accuses a brokerage firm of failing to supervise hundreds of its brokers who allegedly engaged in unethical and unsuitable EIA sales. (*In re Investors Capital Corp., Docket No. E-2005-0190.*) The complaint alleges that brokers improperly switched customers out of existing investments and into EIAs. Brokers allegedly gave investors the false impression that because a minimum return was guaranteed by the EIAs there was no risk of loss to the investors.

Not to be outdone by the Massachusetts regulators (think Spitzer), you can bet that the NASD is ramping up its investigations in this area. Therefore, firms would be wise to carefully consider whether they need to adopt compliance procedures described in the NASD Notice. First, provide training to brokers selling EIAs to ensure they understand the product's features and suitability considerations. Second, consider maintaining an approved product list for EIAs and prohibit brokers from selling unapproved EIAs. Third, consider requiring all EIAs to be processed through the firm.

## Scott Joins FFS (cont.)

added, "[i]n addition to her enforcement work ... Sylvia also contributed greatly to the Enforcement Department and NASD in a wide variety of other ways. Since the inception of the Regulatory Expertise Program, Sylvia has been a member of the Underwritings/Private Placements/Hedge Funds Team. In that capacity, she has spent countless hours providing her expertise to her NASD colleagues through, among other things, training and individual case consults. ..."

During Sylvia's 6-year career at the SEC, she be-

came an Assistant Regional Director at the SEC's Pacific Regional Office where she assisted in planning and shaping the overall objectives of the office's enforcement program. Sylvia also had ongoing responsibilities for supervising and litigating numerous complex enforcement actions involving a wide variety of the federal securities laws.

Ms. Scott leads the FFS's Securities Practice Group, which is part of the Litigation Department. The Group provides clients with highly specialized legal and consulting services

to enable them to deal effectively with the complexities of the regulatory landscape. The Group consults with clients to assist them in complying with securities rules and regulations, implementing preventative or corrective measures as appropriate, and responding to regulatory inquiries by the SEC, NASD, NYSE and other regulators. To root out problems and prevent or mitigate regulatory action, the Group conducts forensic investigations to determine whether violations of securities rules or regulations have been violated *before* the regulators arrive.

## *Victory For Brokerage Defendants In Mutual Fund Disclosure Cases... With A Few Hidden Landmines*

An SEC and a shareholder lawsuit were both dismissed in connection with allegations that the brokerage defendants omitted material facts relating to class B mutual fund shares. In the SEC case, three brokers allegedly committed fraud when they failed to disclose to customers that A shares outperformed B shares, and that they received higher commissions for selling B shares. See, *In re IFG Network Securities, Inc., et al.*, SEC Rel. No. 273, 2005 SEC LEXIS 335. The customers had invested \$250,000 or more in B shares. The administrative law judge found that the SEC had not proved that A shares always outperform B shares at the \$250,000 level. Therefore, the brokers' alleged omissions relating to performance were not material.

In finding for the brokers, the ALJ also pointed to the fact that the SEC had considered, but had yet to adopt, rule changes that would mandate transparency of marketing charges applicable to A

shares and B shares. The ALJ similarly found that because the SEC was in the process of rulemaking as to commission disclosures, the brokers were not liable for related omissions. As a result, the supervision charges levied against the brokers' supervisors were also dismissed.

The shareholder lawsuit had similar flaws in its charges that a distributor of mutual funds and affiliated entities committed fraud. See, *Benzon v. Morgan Stanley Distributors, et al.*, No. 04-5230, 2005 WL 1000927 (6<sup>th</sup> Cir. Aug. 11, 2005). Plaintiffs claimed that: 1) defendants failed to make disclosures regarding the varying characteristics of share classes, 2) it was a fraud in and of itself to offer B shares because they are inferior to other class shares, and 3) defendants failed to disclose that the broker compensation structure favored B shares over other share classes. All claims were dismissed.

First, the court found that all of the information necessary to compare the different class shares was in

the prospectuses and the prospectuses were in compliance with specific SEC disclosure rules. Second, defendants had no duty to disclose that the broker compensation structure favored sales of B shares because SEC rules covering this area imposed no such requirement. Third, the fact that defendants offered securities to investors

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***“Brokers might be liable for making unsuitable recommendations of inferior products, while the entities that put them on the market get off scot-free!”***

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that were more valuable than others it offered did not constitute fraud, particularly given that the prospectuses disclosed all pertinent information under the law.

While the court's rulings might sound like a victory for brokers, it is one with plenty of landmines. **The court said that its rulings did not mean that plaintiffs had no right**

**to sue brokers who “inappropriately” invested their money in B shares when other class shares were obviously preferable.** The court is apparently saying that it's okay for mutual funds to offer inherently inferior products, but that brokers who offer them do so at their own peril! In other words, brokers (and those who fail to supervise them) might be liable for making unsuitable recommendations of inherently inferior products, while the entities that put them on the market get off scot-free and make money in the process!

Brokers and their supervisors should also be aware that giving clients a prospectus is usually *not* a defense to sales practice charges by regulators and plaintiffs. For example, courts have repeatedly held that delivery of a prospectus does not cure an otherwise materially misleading sales presentation that fails to disclose investment risks. Brokers who are confused by all of this should not hesitate to contact their compliance departments.

## U-5 (cont.)

matter of public interest.

This ruling means that whatever is written in an employee's Form U-5 is *absolutely privileged* under California law and cannot provide the basis for a defamation action, regardless of malicious intent. Additionally, based on this absolute privilege, intentionally false statements on a U-5 cannot be the basis for any other tort claim, such as interference with prospective business advantage.

For example, suppose a

broker gets an email from his supervisor stating, "I'm going to get you on your Form U-5 for being disloyal to the firm and joining our despicable competitor!" The broker replies back, "You can't do that, I've never broken any rules and have always followed company policy." The supervisor replies, "Just watch me" and reports on the broker's U-5, "Rep terminated for not following NASD rules and the firm's compliance procedures."

Under Fontani, the

broker has no recourse against his supervisor even though the U-5 was intentionally falsified and there are emails to prove it. Unfortunately, the court's decision was not appealed to challenge this troublesome outcome. Other state courts might have different outcomes. However, a new rule clarifying that intentionally falsified U-5s are prohibited by the NASD might change subsequent court rulings. NASD Conduct Rule 2110 already requires associated persons to "observe high standards of commercial conduct and just and equitable principles of trade."

The Group, together

with the Litigation Department, also handles all securities enforcement matters before federal, state and administrative tribunals such as the SEC, NASD and NYSE. The Group and the Department handle all aspects of dispute resolution, including the defense and prosecution of clients' claims in arbitration proceedings and in state and federal court. They also represent securities industry professionals, including financial consultants, branch/regional managers and investment bankers in employment disputes required to be litigated before various tribunals, including the NASD and NYSE.

### Securities Industry Trivia

#### **What is the oldest stock exchange in the US?**

The Philadelphia Stock Exchange was founded in 1790, about two years before the New York Stock Exchange.

#### **Where does the term "bull" and "bear" market come from?**

While there are several theories, the most plausible is that a bull knocks you up in the air (rising market) and a bear knocks you down (falling market).

#### **Interesting Stock Symbols (past & present):**

BLUD:	Immucor, Inc.
BOOM:	Dynamic Material Corp.
CHIK:	Golden Poultry Co., Inc.
COOL:	Majesco Entertainment Co.
EARS:	Hearx Ltd.
FAXM:	Hotelcopy, Inc.
OUCH:	Occupational-Urgent Care

### Recent Enforcement Actions

#### **Research Analyst Issues Misleading Reports**

Jury found research analyst liable for not disclosing in research reports significant personal financial interests in pending mergers of covered companies. The analyst allegedly made private, unfavorable comments about one stock he covered while simultaneously reporting "buy" recommendations. (*SEC v. Johnson, S.D.N.Y. Civ. Act. No. 03-0177, 11/11/05.*)

#### **Firm Fined for Directed Brokerage Violations**

NASD fined Ameriprise Financial Services \$12.3 million for allegedly providing preferential treatment to certain mutual funds who received special access to the firm's sales force and promotional spots on its website. In return, funds directed portfolio trades to the trading desks of clearing firms designated by Ameriprise. (*NASD press release dated 12/1/05.*)

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## Recent Enforcement Actions (cont.)

### **Hedge Fund Charged With Fraud**

SEC filed a complaint against a hedge fund alleging that investors were told the fund had \$43 million in assets when it actually had only \$14 million. The fund manager allegedly created a fictitious auditor and audit reports. *SEC v. Mark R. Conway and Groundswell Partners, No. 05-12209-RWZ (D. Mass. filed 11/4/05).*

### **Firm Fined \$1.4 Million For Trade Reporting**

NASD fined State Street Global Markets \$1.4 million for MSRB trade reporting violations where more than 80% of its self-cleared corporate bond transaction went unreported. (NASD press release dated 11/22/05.)

### **Stock Manipulation By Brokerage Firm Charges**

SEC filed a complaint against Kirlin Securities and two principals for their alleged roles in a fraudulent scheme to avoid Nasdaq delisting of parent company by manipulating its stock price. (NASD press release dated 11/29/05.)

### **Three Firms Fined A Total of \$19.4 Million For Improper Mutual Fund Sales**

The NASD fined Merrill Lynch, Wells Fargo and Linsco/Private Ledger a total of \$19.4 million for suitability and supervisory violations relating to sales of class B mutual funds shares. (NASD press release dated 12/19/05.)

## Industry Quotes

*"The additional administrative burden of SEC registration may result in a distraction to senior management with no discernible benefit to our investors. Accordingly, we have decided not to register with the SEC at this time."*

Hedge fund manager's response to a new SEC rule requiring investment adviser registration of hedge funds managing more than \$25 million. The hedge fund and others plan to impose a 2-year lockup which provides an exemption from registration (at least for now).

*"All of this diversity highlights the fact that "one size fits all" is not going to work when it comes to compliance. No two advisory firms are exactly alike. You all have different client bases, different advisory services, different areas of investment expertise and different organizational structures. In fact, that is why we need on-the-ground compliance professionals in the first place."*

SEC Chairman Cox in opening remarks before a seminar for chief compliance officers of investment advisers and broker-dealers. Recently, the SEC said it plans to randomly audit investment advisers each year to prevent alleged complacency in the compliance arena.

*"I follow about 1,000 stocks closely... And there's about another 500 or 1,000 I keep an eye on."*

Jim Cramer of CNBC's Mad Money whose show features a "Lightning Round Segment" where Cramer gives a thumbs-up or thumbs-down to stocks you ask him about. He wears a post-it note on his forehead if he picks a bad stock. *Editor's Note: The regulators would pounce on any broker who tried this with his or her clients.*

### **About Freeman, Freeman & Smiley, LLP**

The firm, founded in 1976, offers legal services to local, national and international clients from its Los Angeles and Irvine offices. The practice of FFS emphasizes the areas of securities and litigation, business and tax planning, estate and charitable gift planning, probate and trust administration, and real estate. Each legal matter is unique and our talented attorneys work with clients to identify, evaluate and prioritize each situation. FFS serves a diverse client base that ranges from brokerage clients to investment advisers, and individuals to public and private companies.

For FFS, honesty, integrity and loyalty are more than just slogans. The firm believes that you are entitled to prompt responses and returned phone calls, accurate and thorough advice and work product, not to mention fair fees. Each of our staff is dedicated to providing you with the highest quality of personal service in a courteous and professional manner. For more information about the individual practice areas, please visit the firm's website at [www.ffslaw.com](http://www.ffslaw.com).