

MEMO# 20850

February 7, 2007

NASD Fines Fund Underwriter and Related Broker-Dealers for Registration, Supervision, and Email Recordkeeping Violations

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TO: SEC RULES MEMBERS No. 15-07
COMPLIANCE MEMBERS No. 7-07
SMALL FUNDS MEMBERS No. 15-07
BROKER/DEALER ADVISORY COMMITTEE No. 9-07
TECHNOLOGY ADVISORY COMMITTEE No. 4-07 RE: NASD FINES FUND UNDERWRITER
AND RELATED BROKER-DEALERS FOR REGISTRATION, SUPERVISION, AND EMAIL
RECORDKEEPING VIOLATIONS

The NASD has sanctioned four related broker-dealers, including a principal underwriter of a family of mutual funds, for various violations of federal law and the NASD's rules relating to registration of representatives, supervision, and recordkeeping.* The sanctions consisted of a censure, fine of \$3.75 million, and a requirement that the Respondents comply with conditions requiring them to undertake various audits, provide reports to the NASD on the audit findings, and provide officer certifications to the NASD. The findings in the AWC, which is attached, are briefly summarized below.

Registration Violations

NASD Rule 1031 requires persons engaged in the securities business of a member who are to function as representatives of the member to be appropriately registered with the NASD. The rule additionally prohibits a member from maintaining ("parking") the registration of

any person who is no longer active in the member's securities business. The rule requires NASD members to review the activities of their registered persons to ensure that registration is appropriate and consistent with the rule.

According to the AWC, from 2002 to 2005, the Respondents violated Rule 1031 by maintaining and renewing the registration of approximately 1100 employees who were neither required nor permitted to be registered with the NASD. They also violated the rule by:

- Failing to make an assessment of what activities these individuals would perform or how they would be supervised;
- Employing Series 7 registered representatives as investment advisor traders and representing that they had registered representative responsibilities when this was not the case;
- The representatives' supervisors and the Respondents' Registration Department failing to assess whether each registered representative was appropriately registered under the NASD's rules; and
- Supervisors making misleading affirmations indicating that individuals were required or permitted to register.

Supervision Violations

A. Failure to Supervise Registered Individuals

NASD Rule 3010(a)(5) requires NASD members to assign a registered supervisor to each registered representative. The NASD found that the Respondents violated this rule by failing to assign a registered supervisor to approximately 1000 employees. Approximately 70 of these 1000 employees were registered at the principal underwriter of the mutual funds, including the improperly registered investment advisor traders. By failing to assign these employees to a supervisor, the Respondents failed to adequately supervise their activities for compliance with NASD rules including, but not limited to, Rule 3030 (Outside Business Activities of an Associated Person), Rule 3040 (Private Securities Transactions of an Associated Person), Rule 3050 (Transactions for or by Associated Persons), Rule 3060 (Gifts and Gratuities), and Rule 3070 (Reporting Requirements).

B. Failure to Supervise for Compliance with the Respondents' Policies

During 2002-2005, the Respondents' employees were subject to the Respondents' gift policies, entertainment policies, and a general policy governing professional conduct and

conflicts of interest. According to the AWC, with respect to the registered investment advisor traders, the mutual fund underwriter Respondent failed to take any action to regulate or supervise their gift and entertainment activity or to enforce the firm's policy. In particular, there was a failure to ensure that these investment advisor traders reimbursed for, or reported, their receipt of hundreds of thousands of dollars worth of gifts and entertainment or that they filled out and filed required Report of Gift Forms. The AWC found that: none of these registered investment advisor traders submitted any gift forms or otherwise reported any gifts; there were no internal communications with the Respondents' Ethics Office regarding the required reporting; and there was no action taken to identify or examine the nature, frequency, extent and expense of the gifts and entertainment received by these persons to determine if such gifts and entertainment were in compliance with applicable policies.

Recordkeeping Violations

Section 17(a) of the Securities Exchange Act of 1934, Rule 17a-4 thereunder, and NASD Rules 3110 (Recordkeeping) and 3010 (Supervision), collectively, require NASD members to establish, maintain, and enforce a supervisory system and procedures that are reasonably designed to capture, retain, and preserve originals of all communications, including electronic communications, relating to their business as broker-dealers in a format, medium, and for the time periods prescribed by law. According to the AWC, from 2001 to August 2004, the Respondents violated these provisions of law through the following conduct:

- From January 2001 to December 2002, the Respondents' back-up tape system, which it used to retain electronic communications, resulted in the systemic deletion and loss of unknown numbers of emails of the Respondents' employees.
- In May 2001, the Respondents implemented a "Mailbox Manager" system that automatically deleted emails older than 60 days and required individual employees to take independent action to retain required email. According to the NASD, the Respondents did not take any steps – nor did they have any process – to determine whether employees were in fact retaining their required emails.
- Respondents had a practice of erasing the hard drives of departed employees to reuse them without taking adequate precautions to ensure that their electronic communications were not destroyed in the process.
- The Respondents failed to maintain the email of approximately 1900 registered representatives (18% of their total number of registrants) whom the Respondents determined were not doing the work of the broker-dealer. This group included registered individuals working for an affiliated investment advisor, such as the investment advisor traders. The Respondents' Enterprise Compliance Group notified the investment advisor traders, among others, in August 2003 that on those occasions when they did engage in the business of the broker-dealer they were individually responsible for retaining their emails. The Respondents, however, failed to take any steps to determine whether such employees were complying with this process.
- Notwithstanding their implementation of a email journaling system in late 2002, the

Respondents failed to retain the emails of those employees described above who were registered representatives of the Respondents but who were not doing the work of the broker-dealer. The emails of these individuals were not journaled by the Respondents until August 2004.

- From 2001 to August 2003, the Respondents did not capture or preserve Instant Message communications, and they did not preserve communications that registered representatives sent via the Bloomberg system until December 2004. While the Respondents had Bloomberg produce emails in response to the NASD's request, these email records were deficient in that they did not include the senders' and recipients' names of employees who no longer worked for the Respondents.
- From 2001 through 2004, Respondents failed to preserve electronic communications in a non-rewritable and non-erasable format, as required by law. Through December 2002, Respondents' retention format was not compliant for any categories of electronic communications for any employees. Thereafter, their system was not compliant for: (i) Instant Message communications until August 2003; (ii) Bloomberg email until after December 2004; and (iii) electronic communications of registered, non-employees of a broker-dealer until August 2004.

Based on the above deficiencies, the NASD found that the Respondents could not ensure that they could produce for the NASD all required records. According to the AWC, the above deficiencies evidenced distinct violations by the Respondents of the recordkeeping requirements under federal law and the NASD's rules.

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[Attachment](#)