CCOs and In-House Counsel Who Got Whacked: SEC and FINRA Disciplinary Actions Against Chief Compliance Officers and In-House Counsel (January–June 2013)

By Brian L. Rubin and Katherine L. Kelly

Introduction

Dr. Jennifer Melfi: What line of work are you in?

Tony Soprano: Waste management consultant.¹

Chief compliance officers (CCOs) and in-house counsel for broker-dealers (BDs) or investment advisers (IAs) generally do not face the same physical and psychological issues as those encountered by professionals in the “waste management” line of work. But being a CCO or in-house counsel does pose very real challenges. While Tony Soprano was (allegedly) in a supervisory position such that he could order compliance by, say, having some kneecaps broken, CCOs and in-house counsel are in the difficult position of advising their colleagues and helping their firms comply with securities rules and regulations, without necessarily having the power to enforce their advice or decisions. Moreover, because of their key functions, their conduct is often carefully scrutinized by the Securities and Exchange Commission (SEC) and Financial Industry Regulatory Authority (FINRA). While there’s no danger of CCOs or in-house counsel “swimming with the fishes” (at least not at the order of regulators), they are potential targets of SEC and FINRA disciplinary actions.

This article, likes its predecessors,² analyzes most of the recent SEC and FINRA actions against CCOs and in-house counsel to examine instances of CCOs or in-house counsel who got “whacked,” without being killed. From January to June 2013, the SEC and FINRA brought disciplinary actions for a range of conduct, including failure to supervise; due diligence failures; aiding and abetting primary violations; anti-money laundering (AML) deficiencies; failure to report customer complaints; advertising violations; registration deficiencies; books and records violations; and suspension from practicing before the SEC.

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Supervisory Systems

Christopher Moltisanti: Maybe one reason things are so [expletive deleted; loose translation: “messed”]-up in the organization these days is guys running off, not listening to middle management.³

Having a good supervisory system, rules that are easily understood, and the ability to enforce those rules is important to any type of organization (including “families”). In the securities business, FINRA requires BDs to establish and maintain supervisory systems “reasonably designed to achieve compliance with applicable securities laws and regulations,” including written procedures to supervise the types of business in which the firms engage.⁴ CCOs may sometimes be responsible for these supervisory systems and, therefore, may be subject to disciplinary actions when the systems come up short.⁵

In some instances, CCOs may be liable where the firm’s written supervisory procedures (WSPs) failed to adequately address one part of the firm’s business. In May 2013, for example, FINRA filed a complaint alleging that a firm, “acting through” its CCO, failed to establish and maintain a supervisory system, including WSPs, reasonably designed to ensure compliance with applicable laws and rules regarding collateralized mortgage obligations (CMOs).⁶ FINRA alleged that the firm, through the CCO, failed to establish procedures “regarding its business in CMOs and with individuals and entities who purportedly sought to obtain possession and control over third party CMOs in order to monetize the securities.” The firm’s procedures did not address how it would approve and supervise CMO transactions and did not require any type of inquiry to be performed before participation in CMO transactions. Based on those failures, FINRA alleged that the CCO violated NASD Rule 3010 (governing supervisory systems) and FINRA Rule 2010 (requiring members to observe high standards of commercial honor and just and equitable principles of trade). The issuance of a complaint means FINRA has initiated a formal proceeding seeking sanctions, but findings as to the allegations in the complaint have not yet been adjudicated. This matter will either be heard by a hearing panel or settled.

CCOs may also be liable where they fail to perform functions delegated to them by their firms. In a March 2013 settlement, FINRA alleged that a CCO failed to maintain and implement an adequate supervisory system for filing and amending Forms U4.⁸ Specifically, the CCO, who was responsible for the firm’s Forms U4 and U5, failed to amend registered representatives’ U4s to reflect customer complaints involving compensatory damages of $5,000 or more. For this and other conduct, the CCO was fined $5,000 and suspended in a principal capacity for 10 business days.

Supervision of Individuals

Paulie “Walnuts” Gualtieri: The Boss of this Family told you you were going to be Santa Claus. You’re Santa Claus, so shut up about it!⁹

When it’s clear who the “Boss” is, it’s clear who supervises whom. Unfortunately, the securities industry does not always follow a rigid supervisory structure like that found in other “professions.” CCOs or in-house counsel (or anyone else) may be considered supervisors, and therefore potentially liable as such, when they have sufficient “responsibility, ability, or authority to affect the conduct of the employee whose behavior is at issue.”¹⁰ Where a CCO is deemed to be a supervisor, he or she may be liable for supervisory failures when a registered representative or others in the firm engage in wrongful conduct. For example, in a March 2013 settlement, FINRA
disciplined a CCO for failing to supervise his firm’s owner (and producing manager), who excessively traded in at least five customer accounts. The FINRA Letter of Acceptance Waiver and Consent (AWC) noted that the CCO had no experience in a supervisory or compliance role prior to becoming CCO and producing manager’s supervisor. It further noted that the firm’s WSPs required the CCO to review the producing manager’s trading activity but that the CCO failed to identify and follow up on red flags indicating excessive trading. For violations of NASD Rule 3010 and FINRA Rule 2010, the CCO was suspended for 30 business days in a principal capacity, but was not fined due to a demonstrated inability to pay.

Another case illustrated the perils of CCOs acting as direct supervisors. In an April 2013 settlement, a CCO was disciplined for failing to supervise a registered representative in connection with the sale of non-exempt unregistered securities. Three customers opened accounts with the firm, deposited unregistered securities in the accounts, and shortly thereafter sold the unregistered securities. The CCO was the direct supervisor of the registered representative who effected the sales of the unregistered securities. For each of the sales, the registered representative submitted a Deposited Securities Request (DSR) form to the CCO for review. The CCO reviewed the forms to ensure they had been completed, but failed to ensure that the information on the DSR forms was consistent and did not raise any red flags. FINRA determined that the CCO relied on the registered representative to determine whether the shares were either registered or properly exempt. Based on this conduct, FINRA concluded that the CCO failed to reasonably supervise the sale of unregistered shares in violation of NASD Rule 3010 and FINRA Rule 2010. The CCO was suspended in any principal capacity for six months, but was not fined due to a demonstrated inability to pay.

**Due Diligence**

*Bobby Baccilieri:* Dick Barone died?

*Sillo Dante:* Lou Gehrig’s disease.

*Christopher Moltisanti:* You ever think what a coincidence it is that Lou Gehrig died of Lou Gehrig’s disease?

Some people might find due diligence necessary to investigate the odd occurrence of someone dying from a disease named after the deceased. BDs, on the other hand, are required to perform due diligence on investments they recommend, which involves a reasonable investigation of the issuers and securities to ensure they have a reasonable basis for recommending them to anyone. As several recent cases concerning the sale of private placement offerings have made clear, adequate product due diligence is a necessary component of a reasonable supervisory system. In several of those recent cases, FINRA disciplined CCOs for violations in connection with the firm’s due diligence failures.

In January 2013, FINRA disciplined a CCO in connection with his firm’s allegedly inadequate due diligence of private placement investments. Under the firm’s WSPs, the CCO was responsible for “the due diligence investigation of private placements, including the acquisition and review of relevant documents, discussions with product sponsors, review of third party due diligence reports, monitoring of the affairs of the issues during the period that a private placement was being offered for sale by the firm’s representatives and, where applicable, establishing conditions upon the offer and sale of private placement securities.” FINRA determined that the CCO failed to respond reasonably to red flags indicating risks associated with a particular private placement offering. In August 2008, the CCO approved a private placement offering despite knowledge that the issuer of that private placement had missed payments of distributions to customers on a prior offering and eventually suspended sales in that offering. Moreover, the CCO approved the offering even though the Private Placement Memorandum (PPM) for the offering falsely claimed that the issuer had never missed any interest payments on its offerings. In addition, after approving the private placement, the CCO created a disclosure form to accompany the private placement, but the disclosure form failed to inform investors that the issuer was delinquent in payments to investors on at least one previous offering. Finally, after at least one prior offering was declared in default, the CCO instructed the firm’s representatives to disclose those delinquencies in payments but did not establish any procedures to monitor compliance with this condition on the sale of the offering. Based on this conduct, the FINRA concluded that the CCO violated NASD Rule 3010 and FINRA Rule 2010. Under the terms of the settlement, the CCO was suspended in any principal capacity for six months. No monetary sanction was imposed because the CCO had filed for bankruptcy.
In a March 2013 settlement, a CCO was disciplined for failing to conduct adequate due diligence of private placement offerings consisting of preferred stock. As president and CCO, he was responsible for approving private placement offerings for sale. (The AWC did not explain whether those responsibilities were when the person was acting as president or when he was “wearing” his CCO hat.) According to FINRA, the CCO received the PPM and “took part in the preparation of pro forma financial statements included in the PPM but did no further due diligence” regarding the investment. Accordingly, FINRA concluded he had not conducted adequate due diligence. In addition, the CCO allowed the firm to continue selling the private placement without any conditions and without requiring the issuer to amend the PPM even after the following material events occurred:

- The issuer had borrowed almost $1.4 million through short-term promissory notes with interest rates of 15% to 20%;
- The president and CEO of the issuer resigned; and
- The issuer experienced cash flow problems significant enough to delay payroll and cause employee layoffs.

FINRA concluded this conduct violated NASD Rule 3010 and FINRA Rule 2010. For this and other conduct, the CCO was suspended in any principal capacity (other than Financial and Operations Principal) for eighteen months, suspended as Financial and Operations Principal for one month, and ordered to re-qualify as a principal.

Another CCO was disciplined in a May 2003 settlement with FINRA for inadequate due diligence of private placement investments. In that case, he failed to take certain steps required by his firm’s WSPs, including reviewing financial statements for the issuer, visiting the issuer’s office, and reviewing the background and qualifications for the issuer’s management team. For this and other conduct, the CCO was fined $5,000 and suspended in any principal capacity for one year.

### Aiding and Abetting

Tony Soprano: There’s an old Italian saying: You [expletive deleted; loose translation: err in your ways] up once, you lose two teeth.

Sometimes you don’t even have to be the one to . . . err in your ways. You can just be standing a little too close to the action. Liability for aiding and abetting requires an underlying violation, substantial assistance in connection with the primary violation and scienter, which is satisfied by recklessness. CCOs may also be found liable for “causing” violations, which similarly involves a primary violation and an act or omission by the respondent that causes the violation. Causing liability, however, in some cases requires only a negligent state of mind.

In an April 2013 settlement, the SEC disciplined a CCO for his firm’s failure to conduct a timely annual review of the firm’s compliance policies and procedures. Section 206(4) of the Advisers Act and Rule 206(4)-7 require that an IA imple-
ment written policies and procedures reasonably designed to prevent violations of the Advisers Act and review at least annually the written policies and procedures for effectiveness. In addition to the firm’s failure to conduct such a review, the firm also allegedly failed to maintain complete and accurate trading records as required by Section 204 of the Advisers Act and Rule 204-2(a)(3). In particular, the SEC found that the firm failed to keep records concerning the reallocations of unallocated shares from client accounts with insufficient funds. For his role in connection with these issues, the CCO was found to have willfully aided and abetted his firm’s violations of the Advisers Act and the relevant rules and was censured and ordered to pay a civil penalty of $25,000.

Anti-Money Laundering Violations

Tony Soprano: (digging with shovel) Halfway ta China... there’s nuthin’ here.

Uncle Junior: Forty thousand I had. My share of the Bohack’s haul from the seventies.

Tony Soprano: Did you wrap [the money] right? It gets moldy...it could’ve disintegrated.23

Some people find ways to hide money other than burying it in the ground. As a result, BDs are required to have specific procedures and systems to enable them to “follow the money.” FINRA Rule 3310 requires BDs to implement an effective AML program designed to achieve compliance with the Bank Secrecy Act, 31 U.S.C. § 5311. In addition, Rule 17a-8 of the Exchange Act also requires BDs to comply with reporting obligations under the Bank Secrecy Act.

In recent months, FINRA has disciplined several AML compliance officers (AMLCOs) in connection with their firms’ deficient AML compliance programs. In many instances where CCOs have been disciplined in connection with AML programs, firms may have had in place adequate procedures but failed to adequately implement or follow their procedures with respect to the detection of red flags.

Three CCOs were disciplined in recent AML settlements. In a May 8, 2013, settlement, FINRA disciplined an AMLCO and his firm for failing to adequately implement its AML compliance program.24 In particular, FINRA faulted the AMLCO for failing to adequately monitor AML red flags, including the following:

- The customer wished to engage in transactions that lacked apparent business sense or apparent investment strategy, or were inconsistent with the customer’s stated business strategy;
- The customer’s account showed an unexplained high level of account activity, such as wire transfers, with very low levels of securities transactions; and
- The customer’s account had wire transfers with no apparent business purpose to or from a country identified as a money laundering risk or bank secrecy haven, such as Nigeria.

In this case, the firm’s AML policies and procedures specifically required the AMLCO to monitor for red flags. For his alleged failures, the AMLCO was fined $25,000 (jointly and severally with the firm) and suspended in any principal capacity for three months.

In a March 2013 settlement, FINRA disciplined an AMLCO for allegedly failing to establish and maintain a system reasonably designed to monitor for, detect, and investigate suspicious activity, and for failing to determine if the firm was required to file a Suspicious Activity Report.25 In particular, FINRA faulted the AMLCO for failing to identify and investigate red flags such as a customer’s large positions in thinly traded, little-known securities and the deposit of a security with an immediate request for liquidation. For this and other conduct, FINRA fined the AMLCO $40,000 and suspended him in any capacity for nine months.

In another March 2013 settlement, a CCO was disciplined for his firm’s failure to develop and implement an adequate AML compliance program.26 Specifically, the firm failed to review information requests it received from the Financial Crimes Enforcement Network as required by the firm’s procedures. In addition, while he tested the firm’s AML compliance program during the years in question, FINRA characterized those tests as, “at best, cursory in nature” and not independent because the AMLCO essentially performed the tests himself. The AMLCO was fined $5,000; he was also suspended for 20 business days in a Financial Operations Principal capacity for other violations.

FINRA also filed two complaints regarding AML systems. The allegations in those complaints have not been adjudicated. In an April 2013 complaint, FINRA’s Department of Enforcement alleged that an AMLCO failed to enforce his firm’s AML procedures by failing to respond to red flags of suspicious AML activity. In particular, the complaint alleged
that he “permitted his role as [the firm’s] AMLCO to become compromised by his role as the registered representative handling accounts engaging in large volumes of transactions through which low priced stocks were received into and sold in accounts at [the firm].” Consequently, FINRA alleged,

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when a clearing firm contacted the AMLCO regarding the suspicious activity, he ignored the red flags identified by the clearing firm, which included large trades in an unregistered security, the fact that the client and the issuer appeared to be same entity, and a history of complaints against the issuer.27

Then, in a May 2013 complaint, FINRA’s Department of Enforcement alleged that an AMLCO violated AML rules by failing to identify and follow up on red flags, including the following ones, each of which was identified in the firm’s AML procedures:

- The customer had a questionable background or was the subject of news reports indicating possible criminal, civil or regulatory violations;
- The customer provided false, misleading or substantially incorrect information about its source of funds; and
- The customer engaged in excessive journal entries between unrelated accounts without any apparent business purpose.28 These allegations have not yet been adjudicated.

**Failure to Report Complaints**

*Matthew Bevilaqua: To kick upstairs to Tony Soprano would be an honor.*

*Sean Gismonte: He the man.*

*Christopher Moltisanti: I thought you said I was the man. He the man, I the man, who the man?*29

In the securities world, it’s clear who The Man is (or better yet, it’s clear who The Regulators are—the SEC, FINRA and the states). And FINRA requires “kicking upstairs,” or reporting customer complaints. In April 2013, FINRA’s Department of Enforcement filed a complaint alleging that a CCO, who was also a founder and the president of a firm, failed to report six customer complaints received by the firm in violation of NASD Rules 3070 and 2110 and FINRA Rule 2010. The complaint noted that the respondent was also the registered representative for the customers.30 These allegations have not yet been adjudicated.

In a June 2013 complaint, FINRA’s Department of Enforcement alleged that another CCO failed to properly report two customer complaints. Among other inaccuracies, the CCO entered zero in the “disputed amount” field, when he should have entered “$5,000 or more/Cannot determine.”31 A hearing will be held to adjudicate these allegations.

**Communications with the Public**

*Christopher Moltisanti: (about Furio Giunta) He’s with us now?*  
*Tony Soprano: Uh huh.*  
*Christopher Moltisanti: Guess I didn’t get the memo.*  
*Tony Soprano: Would you have read it if you got one?*32

FINRA assumes that, unlike certain younger mobsters, customers do read the materials provided to them by their BDs. Accordingly, BDs are subject to FINRA Rule 2210, which imposes obligations on BDs regarding the review, approval and content of their communications with the public.

In April 2013, FINRA disciplined a CCO in connection with institutional sales materials that FINRA alleged violated content standards.33 FINRA alleged that the firm’s procedures for review and approval of hedge fund institutional sales materials were not adequate, that the firm distributed institutional sales materials that did not fairly represent the investments being marketed, and that the firm failed to maintain a file of institutional sales materials. The CCO was responsible for review and approval of institutional sales materials and, according to FINRA, did not engage in adequate supervision to achieve compliance with FINRA’s content standards. The AWC specifically noted that many of the materials in question
were prepared by the hedge funds themselves and failed to contain adequate risk disclosures. For this conduct, FINRA censured the CCO and fined him $10,000.

**Proper Registration**

*Christopher Moltisanti: The wife of a made guy doesn’t hostess.*

Getting “made” presumably involves new responsibilities (and apparently job upgrades for spouses and significant others as well). Registration can similarly provide firms and individuals with opportunities to engage in certain types of business and perform certain functions (although registration involves only taking exams, not taking, or rubbing, somebody out).

In a March 2013 default decision, a CCO was disciplined for violations related to municipal securities. His firm effected transaction in 529 plans (which are classified as municipal securities) even though it was not qualified to engage in municipal securities business and it did not have a principal at the firm properly qualified for municipal securities, each of which violated Municipal Securities Rulemaking Board (MSRB) Rule G-2. The firm also did not have WSPs regarding its municipal securities business, in violation of MSRB Rule G-27. For these violations, the CCO was fined $10,000 and suspended for six months.

In a March 2013 settlement, FINRA disciplined a CCO because he allowed an unpaid and unregistered intern to perform due diligence on a firm offering, in violation of NASD Rule 3010 and FINRA Rule 2010. For this and other conduct, the CCO was fined $5,000 and suspended in a principal capacity for 10 business days.

**Books and Records**

*Meadow Soprano: Boot your computer, the cops are coming.*

*Anthony Junior: So?*

*Meadow Soprano: You want them to see all that porno you downloaded?*

*Anthony Junior: [expletive deleted; loose translation: My dear sister, you are, of course, correct].*

Sometimes, the SEC and FINRA want to see everything on firms’ and registered representatives’ computers. Their authority to make such requests comes from the requirement that BDs and IAs maintain accurate books and records under Securities Exchange Act Rules 17a-3 and 17a-4, Advisers Act Rules 204-2 and related FINRA Rules, including NASD Rule 3110.

In a March 2013 default decision, a CCO was disciplined for, among other things, his firm’s failure to retain, preserve, and review incoming and outgoing correspondence in conformity with NASD Rule 3110. In particular, FINRA found that the firm failed to retain all incoming and outgoing correspondence from 2009 through July 2010 and most incoming and outgoing correspondence for the following year and a half. For this and other conduct, the CCO was fined $10,000.

In June 2013, the SEC affirmed FINRA’s imposition of a bar against a CCO who had ordered that records be destroyed prior to his termination. In that case, FINRA had found that the CCO (who was also president of the firm) had violated NASD Conduct Rule 2110 when, in anticipation of being fired, he resigned from his firm and invited others to help him remove books and records, erase electronic files and remove backup tapes, which they did. FINRA also found that the CCO violated FINRA Rules 8210 and 2010 by failing to respond to the staff’s information requests. The CCO said that he engaged in this conduct because he believed that the firm was engaged in fraud and was going to file false claims with SIPC (the Securities Investor Protection Corporation), and he believed that removing the records would thwart that scheme. After removing the files, the CCO contacted an SEC examiner to report the removal of the files. When FINRA opened an investigation, the CCO failed to respond initially to requests for information and failed ultimately to turn over all the files he had removed. A FINRA Hearing Panel concluded that the CCO had violated NASD Rule 2110 and FINRA Rules 8210 and 2010 and fined the CCO a total of $25,000, with a two-year suspension. The National Adjudicatory Council increased the penalties, barring the CCO for each offense. On review, the SEC affirmed all the violations and upheld the bar for the erasure and removal of books and records. However, the SEC determined that the bar for the failure to respond to 8210 requests was excessive, reasoning that a bar was appropriate when a respondent fails to respond in any manner, not where a respondent fails to respond in full.
Suspension from Practicing Before the Commission

Tony Soprano: I'm in the waste management business. Everybody immediately assumes you're mobbed up. It's a stereotype, and it's offensive.40

If a court finds you've violated federal securities laws, the SEC may engage in some of its own stereotyping and assume you're not fit to practice before the Commission. One recent example involves a general counsel of an IA, who was also a CCO.41 A federal court found she had violated the federal securities laws by engaging in insider trading. For this conduct, an administrative law judge (ALJ) temporarily suspended her from practicing before the Commission as an attorney. The general counsel appealed the suspension to the SEC on a number of grounds, including that the suspension was a “penalty” and that the federal district court had declined to assess a penalty against her. The SEC ordered a hearing before the ALJ to determine whether to lift the temporary suspension.42 After the hearing, the ALJ, who issued her rulings based on motions for summary disposition, reasoned that a sanction was appropriate, but that the “seven-month suspension that [the general counsel] has already served is appropriate under the circumstances.” Accordingly, she lifted the temporary suspension in an April 2013 order.

Conclusion

Tony Soprano: What do ya wanna do, Carmela? You wanna move to Utah? Be Mr. and Mrs. Mike Smith? We...we can sell some Indian relics by the road. Maybe start a rattlesnake ranch.

Carmela Soprano: This is our chance to get out, Tony. We could start a whole new life.

Tony Soprano: Eat some tomatoes that have no taste.43

Being a CCO or in-house counsel is a “dangerous-ish” job, but it is rare that such folks will have to take on new identities (even following a disciplinary proceeding). Nonetheless, to make the job just a little bit safer, it may make sense to review disciplinary actions concerning other CCOs and in-house counsel who have gotten the attention of regulators in the past. Hopefully, consideration of these cases can help CCOs and in-house counsel avoid getting "whacked" in the future.

ENDNOTES

4 NASD Rule 3010. For other relevant supervisory statutes, see Section 15(b)(4)(E) of the Securities Exchange Act of 1934 (Exchange Act) and Section 203(e)(6) of the Investment Advisers Act of 1940 (the Advisers Act).
5 CCOs may liable when they are performing true (or arguably true) “compliance” functions, such as in their role as drafters of written supervisory procedures as discussed in this section. They may also be liable where they have been delegated a function within the supervisory system, even if the function is not traditionally a compliance function, such as the examples discussed in the section entitled Due Diligence below. Finally, both of these circumstances should be distinguished from circumstances when a CCO has been deemed to be a supervisor, discussed in greater detail below in the section entitled Supervision of Individuals.
7 Michael A. Zurita, FINRA AWC No. 2009019534203 (April 4, 2013).
8 Richard Borgner, FINRA AWC No. 20120328624 (March 13, 2013).
11 Brady Castille, FINRA AWC No. 2011025843302 (March 15, 2013).
12 Michael A. Zurita, FINRA AWC No. 2009019534203 (April 4, 2013).
14 NASD Conduct Rule 2310; FINRA Rule 2111; FINRA Regulatory Notice 10-22, Obligations of Broker- Dealers to Conduct Reasonable Investigations in Regulation D Offerings (April 2010).
15 Enforcement v. Marc Holzberg, Order Accepting
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Offer of Settlement, Disciplinary Proceeding No. 2009018956001 (January 24, 2013).


GlobalLink Securities, Inc. and Junhua Lia, FINRA AWC No. 2009018818901 (May 14, 2013).

Gary Mitchell Spitz, FINRA AWC No. 2012030787301 (May 14, 2013).


Section 15 of the Securities Act of 1933 (Securities Act), Section 20(e) of the Exchange Act, and Section 209(f) of the Advisers Act provide for aiding and abetting liability for reckless, as well as knowing, conduct.


World Trade Financial Corp. et al., FINRA AWC No. 2010022543701 (March 8, 2013).


Enforcement v. Richard Lee Reno, Sr., Disciplinary Proceeding No. 2011025604002 (March 5, 2013).

Richard Borgner, FINRA AWC No. 20120328624 (March 13, 2013).


Enforcement v. Richard Lee Reno, Sr., Disciplinary Proceeding No. 2011025604002 (March 5, 2013).


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