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## CURTIS BROKER-DEALER CLIENT ALERT

### SEC ADMINISTRATIVE LAW JUDGE IMPOSES CEASE-AND-DESIST ORDER AND \$125,000 FINE ON BROKERAGE FIRM FOR IMPROPER DISCLOSURES OF CLIENT INFORMATION

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Promulgated under Section 504 of the 1999 Gramm-Leach-Bliley Act ("GLB Act") and in effect since 2001, Securities and Exchange Commission ("SEC") Regulation S-P restricts financial institutions from sharing their clients' nonpublic personal information with nonaffiliated third parties without consent. A recent decision by an Administrative Law Judge imposing a \$125,000 civil monetary penalty and a cease-and-desist order on a registered broker-dealer for its violations of Regulation S-P provides considerable guidance as to how financial institutions should handle nonpublic client information when recruiting and hiring representatives in order to avoid SEC enforcement.

In a highly anticipated 55-page Initial Decision in In the Matter of NEXT Financial Group, Inc. (SEC File No. 3-12738), issued on June 18, 2008, Administrative Law Judge James T. Kelly discussed the background of Regulation S-P before proceeding to an analysis of the allegations made by the SEC's Division of Enforcement ("DOE") against respondent NEXT Financial Group, Inc. ("NEXT") and concluding that NEXT had violated various provisions of the regulation.

The DOE asserted allegations of both primary and secondary liability on the part of NEXT. With respect to secondary liability, the DOE alleged that NEXT had repeatedly aided and abetted violations of Regulation S-P by other brokerage firms, by accepting from such firms nonpublic client information. The evidence presented at the hearing revealed that NEXT, a private company with approximately 850 registered representatives nationwide, recruited representatives by offering an

efficient and automated transition process dependent on the quick integration into NEXT's computer system of customer information provided by recruits. Such information, which was provided to NEXT at least two weeks prior to the recruits' proposed start date, included not only basic information about these customers (e.g., names and brokerage account information) but also information such as social security numbers, annual income, employment information, and bank account information. NEXT did not determine whether these clients had consented to the transfer of this information to NEXT by the recruits. Moreover, NEXT had no policies or procedures for purging client information. On several occasions, NEXT retained the client information on its computer system even though recruits did not ultimately join NEXT and the recruits' clients thus did not move their accounts to NEXT.

Judge Kelly noted that, to show that NEXT was secondarily liable for aiding and abetting violations of Regulation S-P, the DOE was required to establish three elements: (1) that a primary wrongdoer unaffiliated with NEXT committed a securities law violation; (2) that NEXT had a general awareness that its actions were part of an overall course of illegal or improper conduct; and (3) that NEXT substantially assisted the conduct constituting the primary violation. Judge Kelly found that several non-party brokerage firms acted negligently in disclosing nonpublic client information to NEXT. Judge Kelly further found that NEXT acted knowingly and recklessly by failing to determine whether these firms had disclosed to their clients that it was sharing nonpublic information with

NEXT and by soliciting and accepting such information from recruits whom NEXT had not approved to join the firm (and, in some cases, from recruits who did not actually join NEXT). Finally, Judge Kelly held that members of NEXT's transition team substantially assisted primary violations of Regulation S-P by helping recruits download and organize the nonpublic information; on several occasions, NEXT employees actually accessed the computer systems of the recruits' current firms after being given user identifications and passwords.

The DOE also asserted that NEXT was primarily liable for violations of the following provisions of Regulation S-P: (1) Rule 4, by failing until 2006 to provide its customers with a clear and conspicuous notice accurately reflecting its privacy policies and practices; (2) Rule 6, by failing to identify to its clients the categories of nonpublic personal information it discloses and the affiliated and nonaffiliated parties to whom such information is disclosed; (3) Rule 10, by disclosing nonpublic information to the new employers of outgoing representatives without giving its clients proper notice and a reasonable opportunity to opt out of the disclosure; and (4) Rule 30, by failing to adopt sufficient policies and procedures aimed at safeguarding client information. The DOE urged Judge Kelly to apply a strict liability standard to these charges, while NEXT argued that Regulation S-P requires a showing of scienter with respect to primary liability. After reviewing the text of Regulation S-P, Judge Kelly found neither party's argument to be correct and held that, to establish a primary violation of Regulation S-P, the DOE was required to show that NEXT acted negligently. On the basis of the evidence presented at the hearing, Judge Kelly found that NEXT did in fact act negligently in connection with each alleged primary violation.

NEXT presented, and Judge Kelly addressed, a number of defenses to the allegations of primary and secondary liability. First, Judge Kelly found no merit to NEXT's argument that Regulation S-P is directed at "wirehouse" brokerage firms with "captive" sales forces, rather than "independent"

brokerage firms such as NEXT. Judge Kelly found there to be no distinction within Regulation S-P between "independent" firms and "wirehouse" firms, and rejected the suggestion that NEXT's registered representatives should be viewed as independent contractors rather than employees and that, accordingly, when these representatives leave NEXT, they do not really "take" client information but rather "keep" information already in their possession. Judge Kelly also addressed NEXT's argument that it followed industry standard as evidenced by the fact that it had joined several larger broker-dealers in an agreement under which the signatories agreed not to sue one another for recruiting each other's registered representatives. Judge Kelly found that NEXT had not demonstrated the existence of an industry standard and that, even if it had done so, this would not be a controlling factor in determining liability. He also rejected the argument that any alleged misconduct was attributable to independent registered representatives who were acting beyond the scope of their agency. He also found that, contrary to NEXT's argument, the GLB Act was designed to prevent not only the sale of nonpublic client information but also the mere dissemination of such information.

Finally, Judge Kelly held that NEXT did not sufficiently demonstrate that the DOE's interpretation of Regulation S-P was likely to impede the timely transfer of customer accounts. NEXT argued that the use of client information by a successor brokerage firm for the limited purpose of pre-populating account transfer documents avoids delay and does not harm clients. Judge Kelly, however, noted that if a brokerage firm's privacy policy discloses to the firm's clients that their nonpublic personal information may be provided to a successor firm, then Regulation S-P does not require the firm to re-notify clients and afford them another opportunity to opt out when the representative actually departs for another firm. Accordingly, Judge Kelly observed, the regulation does not increase the time it takes to complete the transfer of client accounts.

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The DOE sought a cease-and-desist order and a civil penalty of \$325,000. Judge Kelly considered as mitigating factors NEXT's lack of prior violations and the fact that the preamble to Regulation S-P notes that there may be "confusion" and "uncertainty" in the securities industry regarding financial institutions' obligations under the rule. He considered as an aggravating factor NEXT employees' repeated access of the computer systems of recruits' current brokerage firms after being provided with user identifications and passwords.

After weighing these factors along with the other evidence presented at the hearing, Judge Kelly found that a cease-and-desist order was warranted in light of the high likelihood of future violations by NEXT. Judge Kelly held that the requested penalty amount of \$325,000 was too high considering the absence of harm to any investors, but found a civil penalty of \$125,000 would be in the public interest.

Judge Kelly's Initial Decision is available at <http://www.sec.gov/litigation/aljdec/2008/id349jtk.pdf>.

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