

FINANCIAL INDUSTRY REGULATORY AUTHORITY

OFFICE OF HEARING OFFICERS

Department of Enforcement,

Complainant,

v.

Lombard Securities Incorporated
(BD No. 27954),

Respondent.

DISCIPLINARY PROCEEDING
No. 2014038911101

COMPLAINT

The Department of Enforcement alleges:

SUMMARY

1. Over the course of several years, Respondent Lombard Securities Incorporated (“Lombard” or the “Firm”) failed to meet its supervisory responsibilities in several areas. First, between August 2009 and March 2012 (the “2012 Examination Period”), Lombard failed to establish, maintain, and enforce a supervisory system and written supervisory procedures (“WSPs”) that were reasonably designed to ensure the retention, preservation, and review of email and failed to retain and review certain emails. Second, also during the 2012 Examination Period, Lombard failed to establish, maintain, and enforce a supervisory system and WSPs reasonably designed to (1) prevent unsuitable mutual fund switching, and (2) supervise the sale of leveraged, inverse, and inverse-leveraged exchange traded funds. Finally, throughout

the 2012 Examination Period, and continuing from April 2012 to December 2013 (the “2014 Examination Period”), Lombard failed to apply sales charge discounts to customer’s eligible purchases of unit investment trusts (“UITs”) and failed to establish, maintain, and enforce a supervisory system and WSPs reasonably designed to ensure that customers received sales charge discounts on all eligible UIT purchases.

2. This conduct violated NASD Conduct Rules 3010 and 3110 (for conduct before December 5, 2011); FINRA Rules 4511 (for conduct after December 4, 2011) and 2010; and willfully violated Section 17(a) of the Securities Exchange Act of 1934 (“Exchange Act”) and Rule 17a-4(b)(4) thereunder.

RESPONDENT AND JURISDICTION

3. Lombard has been a FINRA member since 1991. The Firm’s main office is in Baltimore, Maryland. As of the date of this filing, the Firm employed 53 registered persons and maintained 40 branch offices.
4. Under Article IV of the FINRA By-Laws, FINRA possesses jurisdiction over Lombard because: (a) it currently is a FINRA member; and (b) the Complaint charges it with securities-related misconduct committed while it was a FINRA member.

FIRST CAUSE OF ACTION

Failure to Review and Retain Emails and Related Supervisory Failures (Section 17(a) of the Exchange Act and Rule 17a-4 thereunder, NASD Conduct Rules 3110 and 3010, FINRA Rules 4511 and 2010)

5. Enforcement realleges and incorporates by reference paragraphs 1 through 4 above.
6. NASD Conduct Rule 3010(a) requires each member to establish and maintain a system to supervise the activities of its registered and associated persons that is

reasonably designed to achieve compliance with applicable securities laws and regulations and NASD and FINRA Rules.

7. NASD Conduct Rule 3010(b) requires each member to “establish, maintain, and enforce written procedures to supervise the types of business in which it engages” and to supervise the activities of its registered and associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations and NASD and FINRA Rules.
8. Rule 17a-4(b)(4), promulgated under Section 17(a) of the Exchange Act, requires member firms to maintain and preserve, for a period of not less than three years (the first two years in an easily accessible place), originals of all communications received and copies of all communications sent relating to the firm’s business. FINRA Rule 4511 (previously NASD Rule 3110) requires member firms to preserve records, including correspondence, in conformity with all applicable laws, rules and regulations including Rule 17a-4. Finally, NASD Conduct Rule 3010(d)(3) requires each member to retain correspondence of registered representatives relating to its investment banking or securities business in accordance with NASD Conduct Rule 3110.
9. During the 2012 Examination Period, Lombard’s WSPs required all of its registered representatives “to use the golombard.com email system to send and receive email to customers or prospects or for any other securities business related email message.”
10. During the 2012 Examination Period, at least two representatives of Lombard, CN and CF, the Firm’s Chief Compliance Officer, used non-Lombard email addresses for

business-related communications, including securities and investment banking related communications to the public, customers and prospective customers.

11. Neither CN nor CF took any action to preserve the emails sent or received through their non-Lombard email accounts, *e.g.*, by forwarding the emails at issue to a Firm email address, printing and retaining hard copies, or otherwise providing those emails to Lombard.
12. Lombard principals, including CF, were aware that he and CN used outside email accounts for business-related communications, even though this was contrary to Lombard's supervisory procedures. Indeed, the Firm's principals received emails from, and sent emails to, those email accounts.
13. In addition, Lombard failed to retain the complete content of certain emails for the month of December 2011. Specifically, Lombard's email system retained email header information (to, from, date, subject, etc.) but not the message content for 2,603 out of a total of 3,488 emails sent from the Firm that month.
14. By reason of the foregoing, Lombard violated NASD Conduct Rules 3110 (for conduct on or before December 4, 2011) and 3010; FINRA Rules 4511 (for conduct after December 4, 2011) and 2010; and willfully violated Section 17(a) of the Securities Exchange Act and Rule 17a-4 thereunder.

SECOND CAUSE OF ACTION

**Failure to Establish, Maintain and Enforce a Supervisory System and WSPs in connection with Mutual Fund Switches
(NASD Conduct Rule 3010 and FINRA Rule 2010)**

15. The Department realleges and incorporates by reference paragraphs 1 through 14 above.

16. In Notice to Members 95-80, *NASD Further Explains Members Obligations And Responsibilities Regarding Mutual Funds Sales Practices* (“NtM 95-80”), FINRA advised member firms of their obligation to ensure “that any recommendation to switch mutual funds is evaluated with regard to the net investment advantage to the investor” and “that their supervisory and compliance procedures are adequate to monitor switching of customers among funds.”
17. Throughout the 2012 Examination Period, Lombard’s WSPs – consistent with FINRA guidance – indicated that mutual fund switches were disfavored and required written notice to the Firm’s compliance personnel prior to any such switch:
- Sales agents should never recommend that a client switch out of one fund family into another family of funds unless it can be clearly demonstrated that the switch is in the client’s best interest. Any switch of this type requires the representative [to] provide notification to the Compliance Department. A ‘switch letter’ (Form 552) may be sent by the Compliance Department, and the customer may be requested to acknowledge in writing to the firm that the client is aware that sales charges could be incurred with the switch.
18. Notwithstanding Lombard’s policy and FINRA guidance, there were 92 mutual fund switches in 86 customer accounts during the 2012 Examination Period where no switch letter was sent and no written notice was provided to the Firm’s compliance personnel, as required.
19. In addition, Lombard did not have any electronic surveillance reports or exception reports to detect mutual fund switches during the 2012 Examination Period, but instead relied on a manual blotter review.
20. The Firm’s manual monitoring system was unreasonable, and resulted in the Firm’s failure to detect most, if not all, of the mutual fund switches.

21. As a result of the Firm's failure to establish and maintain a supervisory system, including WSPs, reasonably designed to detect and prevent unsuitable mutual fund switching, the Firm failed to adequately supervise, and failed to reject, any of the mutual fund switches effected during the 2012 Examination Period, despite the presence of red flags, such as:

- Many of the mutual fund switches involved switches from Class A shares of one mutual fund to Class A shares of another mutual fund;
- The buy and sell sides of the switches occurred in close proximity, with many taking place on the same date;
- The bulk of the mutual fund switching activity was confined to a handful of representatives; and
- More than 80% of the mutual fund switches were marked as unsolicited.

22. By reason of the foregoing, Lombard violated NASD Conduct Rule 3010 and FINRA Rule 2010.

THIRD CAUSE OF ACTION

Failure to Establish, Maintain and Enforce a Supervisory System and WSPs in connection with Non-Traditional ETFs (NASD Conduct Rule 3010 and FINRA Rule 2010)

23. Enforcement realleges and incorporates by reference paragraphs 1 through 22 above.

24. Leveraged, inverse and inverse-leveraged exchange traded funds (collectively, "non-traditional ETFs") are designed to return a multiple of an underlying index or benchmark, the inverse of that benchmark, or both, over only the course of one trading session – usually a single day. As a result, the performance of non-traditional ETFs over periods of time longer than a single trading session can differ significantly

from the performance of their underlying index or benchmark during the same period of time.

25. Because of the inherent risks and complexity associated with non-traditional ETFs, FINRA issued FINRA Regulatory Notice 09-31, *Non-Traditional ETFs* (“Notice 09-31”), in which FINRA warned member firms that “inverse and leveraged ETFs that are reset daily typically are unsuitable for retail investors who plan to hold them for longer than one trading session, particularly in volatile markets,” and reminded firms that they should “establish an appropriate supervisory system to ensure that their associated persons comply with all applicable FINRA and SEC rules when recommending any product, including leveraged and inverse ETFs.”
26. Notice 09-31 further stated that an appropriate supervisory system for non-traditional ETFs includes WSPs which, among other things, provide for a reasonable basis and customer specific suitability analysis.
27. During the 2012 Examination Period, Lombard had no WSPs governing non-traditional ETFs.
28. In addition, the Firm did not employ any sort of exception report or other automated surveillance to monitor holding periods for non-traditional ETFs.
29. Instead, during the 2012 Examination Period, Lombard, through CF, monitored transactions in non-traditional ETFs through a daily trade blotter. The trade blotter, however, did not differentiate between traditional and non-traditional ETFs and did not specify the holding periods for either.
30. During the 2012 Examination Period, there were at least 18 transactions in non-traditional ETFs, none of which were detected by the Firm due to its inadequate

supervisory system and procedures. Many of these transactions in non-traditional ETFs involved extended holding periods, excessive concentration levels, and/or resulted in customer losses.

31. By reason of the foregoing, Lombard violated NASD Conduct Rule 3010 and FINRA Rule 2010.

FOURTH CAUSE OF ACTION
Failure to Provide Eligible Customers with UIT Discounts
(FINRA Rule 2010)

32. Enforcement realleges and incorporates by reference paragraphs 1 through 31 above.
33. On March 31, 2004, FINRA issued Notice to Members 04-26, *Unit Investment Trust Sales* (“NtM 04-26”), to remind broker-dealers that they should develop and implement procedures to ensure customers receive appropriate sales charge discounts for UITs. NtM 04-26 further stated that, “It is the responsibility of firms to take appropriate steps to ensure that they and their employees understand, inform customers about, and apply correctly any applicable price breaks available to customers in connection with UITs.”
34. Notwithstanding this guidance, Lombard failed to apply sales charge discounts to eligible UIT transactions. During the 2012 Examination Period and continuing into the 2014 Examination Period, the Firm failed to provide applicable sales charge discounts for 74 UIT trades in approximately 50 customer accounts, resulting in approximately \$25,037.23 in total missed discounts.
35. By reason of the foregoing, Lombard violated FINRA Rule 2010.

FIFTH CAUSE OF ACTION

**Failure to Establish, Maintain and Enforce a Supervisory System and WSPs in connection
with UIT Discounts
(NASD Conduct Rule 3010 and FINRA Rule 2010)**

36. Enforcement realleges and incorporates by reference paragraphs 1 through 35, above.
37. During the 2012 Examination Period and 2014 Examination Period, Lombard failed to adequately supervise UIT transactions to ensure that sales charge discounts were correctly applied on eligible UIT transactions.
38. During the 2012 Examination Period and 2014 Examination Period, Lombard also had no WSPs in place to address UIT discounts and no procedures to ensure that discounts were given on eligible transactions.
39. Due to these supervisory deficiencies, during the 2012 Examination Period and 2014 Examination Period, Lombard failed to apply sales charge discounts to virtually every eligible UIT transaction, resulting in lost discounts to customers in the amount of approximately \$25,037.23.
40. By reason of the foregoing, Lombard violated NASD Conduct Rule 3010 and FINRA Rule 2010.

RELIEF REQUESTED


WHEREFORE, the Department respectfully requests that the Panel:

- A. make findings of fact and conclusions of law that Respondent committed the violations charged and alleged herein;
- B. order that one or more of the sanctions provided under FINRA Rule 8310(a) be imposed, including that Respondent be required to disgorge fully any and all ill-gotten gains and/or make full and complete restitution, together with interest;

- C. make specific findings that Respondent willfully violated Section 17(a) of the Exchange Act and Exchange Act Rule 17a-4.
- C. order that Respondent bear such costs of proceeding as are deemed fair and appropriate under the circumstances in accordance with FINRA Rule 8330.

FINRA DEPARTMENT OF ENFORCEMENT

Date: September 22, 2015



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