

NEW YORK STOCK EXCHANGE, INC.

EXCHANGE HEARING PANEL DECISION 04-154

September 30, 2004

SOUTHWEST SECURITIES, INC.
MEMBER ORGANIZATION

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Violated Exchange Rule 342 by failing to reasonably supervise its business activities, and to establish and maintain appropriate procedures for supervision and control with respect to its business activities involving the trading of mutual funds; violated Section 17(a) of the Exchange Act, SEC Rules 17a-3 and 17a-4 and Exchange Rule 440 in that it failed to make and preserve accurate books and records reflecting orders for mutual fund transactions by its hedge fund customers; violated Section 17(a) of the Exchange Act and SEC Rule 17a-4 and Exchange Rule 440 by failing to preserve certain of the required records of electronic communications relating to the business of the Firm; engaged in conduct inconsistent with just and equitable principles of trade in that the Firm, through certain of its brokers with respect to certain mutual fund transactions (a) purchased, sold or redeemed shares of mutual funds at a price which was not based on the current net asset value of such security in violation of applicable regulatory requirements of Rule 22(c)1 promulgated under the Investment Company Act of 1940, and (b) improperly purchased, sold or redeemed shares of mutual funds after the close of the market, at the share price prior to close, rather than at the next day's share price, to the detriment of the mutual fund companies and their shareholders – Consent to censure, a total payment of \$10,000,000 and an undertaking.

EXCHANGE HEARING PANEL DECISION 04-155

DONALD ROGER LELAND
ALLIED MEMBER AND CHIEF EXECUTIVE OFFICER

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Violated Exchange Rule 342 by failing to reasonably discharge his duties and obligations in connection with the supervision and control of the mutual fund trading activities of certain employees of his member firm employer subject to his control – Consent to censure, a one year supervisory suspension and a total payment of \$200,001.

EXCHANGE HEARING PANEL DECISION 04-156

KERRY MARK RIGDON
SUPERVISOR OF BRANCH OPERATIONS

* * *

Violated Exchange Rule 342 by failing to reasonably discharge his duties and obligations in connection with the supervision and control of the mutual fund trading activities of certain employees of his member firm employer subject to his control – Consent to censure, a one year supervisory suspension and a total payment of \$50,001.

EXCHANGE HEARING PANEL DECISION 04-157

KEVIN JAMES MARSH
FORMER BRANCH OFFICE MANAGER

* * *

Violated Exchange Rule 342 by failing to reasonably discharge his duties and obligations in connection with the supervision and control of the mutual fund trading activities of certain employees of his member firm employer subject to his control – Consent to censure, a one year supervisory bar and a total payment of \$25,001.

Appearances:

For the Division of Enforcement
Susan L. Merrill, Esq.
Rex W. Mixon, Jr., Esq.
Steven F. Korostoff, Esq.
Richard Chin, Esq.

For the Respondents
Michael D. Wolk, Esq.
(For Southwest Securities, Inc.)
William E. White, Esq.
(For Daniel Roger Leland)
Thomas J. McGonigle, Esq.
(For Kerry Mark Rigdon)
Ralph Janvey, Esq.
(For Kevin James Marsh)

* * *

An Exchange Hearing Panel met to consider a Stipulation of Facts and Consent¹ to Penalty entered into between the Exchange's Division of Enforcement and Southwest Securities, Inc. ("Southwest" or the "Firm"), Daniel Roger Leland ("Leland"), Kerry Mark Rigdon ("Rigdon") and Kevin James Marsh ("Marsh"). For the sole purpose of settling this disciplinary proceeding, without admitting or denying guilt, the Firm consents to findings by the Hearing Panel that it:

¹ This document is a "Stipulation and Consent" as the term is used in Exchange Rule 476(g), which authorizes an Exchange Hearing Panel to accept findings of fact to which the Parties consent without the presentation of evidence or testimony. The findings herein are made pursuant to the Firm, Leland, Rigdon or Marsh's offers of settlement and are not binding on any other person or entity in this or any other proceeding.

- I. Violated Exchange Rule 342 by failing to reasonably supervise its business activities, and to establish and maintain appropriate procedures for supervision and control with respect to its business activities involving the trading of mutual funds.
- II. Violated Section 17(a) of the Exchange Act, SEC Rules 17a-3 and 17a-4 and Exchange Rule 440 in that it failed to make and preserve accurate books and records reflecting orders for mutual fund transactions by its hedge fund customers.
- III. Violated Section 17(a) of the Exchange Act and SEC Rule 17a-4 and Exchange Rule 440 by failing to preserve for a period of three years and/or preserve in an easily accessible place for two years, records of electronic communications relating to the business of the firm.
- IV. Engaged in conduct inconsistent with just and equitable principles of trade in that the Firm, through certain of its brokers with respect to certain mutual fund transactions:
 - A. Purchased, sold or redeemed shares of mutual funds at a price which was not based on the current net asset value of such security next computed after receipt of a tender of such security for redemption or of an order to purchase or sell such security, in violation of applicable regulatory requirements of Rule 22(c)1 promulgated under the Investment Company Act of 1940; and
 - B. Improperly purchased, sold or redeemed shares of mutual funds after the close of the market, at the share price prior to close, rather than at the next day's share price, to the detriment of the mutual fund companies and their shareholders.

For the sole purpose of settling this disciplinary proceeding, without admitting or denying guilt, Mr. Leland consents to a finding that he violated Exchange Rule 342 by failing to reasonably discharge his duties and obligations in connection with the supervision and control of the mutual fund trading activities of certain employees of his member firm employer subject to his control.

For the sole purpose of settling this disciplinary proceeding, without admitting or denying guilt, Mr. Rigdon consents to a finding that he violated Exchange Rule 342 by failing to reasonably discharge his duties and obligations in connection with the supervision and control of the mutual fund trading activities of certain employees of his member firm employer subject to his control.

For the sole purpose of settling this disciplinary proceeding, without admitting or denying guilt, Mr. Marsh consents to a finding that he violated Exchange Rule 342 by failing to reasonably discharge his duties and obligations in connection with the supervision and control of the mutual fund trading activities of certain employees of his member firm employer subject to his control.

For the sole purpose of settling this disciplinary proceeding, without admitting or denying any of the facts or matters referred to in the Stipulation of Facts and Consent to Penalty, the Firm, Leland, Rigdon and Marsh each consent to findings by the Hearing Panel, the substance of which are as follows:

Background and Jurisdiction

Southwest Securities, Inc.

1. Southwest became an Exchange member organization in 1972. Southwest is a wholly owned subsidiary of SWS Group, Inc, which is a listed company on the Exchange under the ticker symbol SWS. Southwest is headquartered in Dallas, Texas and has 31 branch offices. Southwest provides securities clearing services and conducts a full service brokerage business (Private Client Group), including stock and bond trading, market making, securities lending, and public finance activities.
2. By letter dated April 19, 2004, which Southwest received, Enforcement notified Southwest of its investigation into possible violative conduct involving the market timing and late trading of mutual funds by certain of the Firm's registered representatives ("RRs") and of the Firm's supervision of its mutual fund trading business.

Daniel Roger Leland

3. Leland was born in January 1961. He entered the securities industry in June 1983 with Firm A and became a registered representative in February of 1986. In 1995, Southwest acquired Firm A and Leland was appointed an executive vice president at Southwest. In 1999, Leland became an executive vice president of SWS Group, Inc. and in August 2002, Leland was promoted to president and chief executive officer of Southwest and retained his position as executive vice president of SWS Group, Inc. Leland served as president and chief executive officer of Southwest and as executive vice president of SWS Group, Inc. from August 2002 until September 7, 2004. As president and chief executive officer of Southwest, Leland supervised the Firm's full service brokerage operation, but not the clearing operations. Leland is currently employed as a senior vice president, institutional sales, with the Firm.
4. By letter dated May 12, 2004, which Leland received, Enforcement notified Leland of its investigation into his supervision of the Southwest RRs and of his supervision of certain activities involving the Firm's mutual fund trading business.

Kerry Mark Rigdon

5. Rigdon was born in September 1959. He entered the securities industry in 1988 and was employed in a registered capacity by Firm B and Firm C from approximately February 1988 to July 1993 and from July 1993 to October 1996, respectively. In October 1996, Rigdon joined Southwest as a branch office manager and in February 2000, was promoted to director and senior vice president of Southwest's Private Client Group. Rigdon served as director and senior vice president until March 2004 and reported to Leland. As a director of the Private Client Group, Rigdon was responsible for supervising Southwest's branch operations. In March 2004, Rigdon was reassigned and is currently employed as a registered representative at Southwest.

6. By letter dated May 14, 2004, which Rigdon received, Enforcement notified Rigdon of its investigation into his supervision of the Southwest RRs and of his supervision of certain activities involving the Firm's mutual fund trading business.

Kevin James Marsh

7. Marsh was born in December 1964. He entered the securities industry in 1989 and has been employed in a registered capacity by Firm B and Firm C from September 1989 to July 1993 and from July 1993 to October 1996, respectively.
8. In October 1996, Marsh joined Southwest as a registered representative and in 1998 was promoted to an assistant branch office manager. In 2000, Marsh was promoted to vice president and branch office manager of the downtown Dallas branch of Southwest. Marsh served as the branch office manager of the Firm's downtown Dallas branch office until October 29, 2003, when he resigned from Southwest.
9. Marsh was the direct supervisor of the RRs whose activities are discussed in this Stipulation and Consent. Marsh is not currently employed in the securities industry.
10. By letter dated April 19, 2004, which Marsh received, Enforcement notified Marsh of its investigation into his supervision of the Southwest RRs and their mutual fund trading activities.

Summary

11. This matter arises from Southwest's failure to reasonably supervise the trading activities of two registered representatives at the Firm's downtown Dallas branch office who engaged in an illegal market timing scheme,² and a third who engaged in both a market timing scheme and late trading³ on behalf of two Southwest hedge fund customers, and also from Southwest's failure to make and keep required books and records. Between October 2002 and September 2003 (the "Relevant Period"), certain RRs employed by the Firm – X, Y and Z (collectively, the "Brokers") – defrauded hundreds of mutual funds and their shareholders by engaging in a series of surreptitious, or "masking," activities designed to circumvent restrictions that the mutual funds imposed on market timing. One of the RRs, X, also defrauded many of the same mutual funds and their shareholders by systematically late trading the

² Market timing includes: (i) frequent buying and selling of shares of the same mutual fund or (ii) buying or selling mutual fund shares in order to exploit inefficiencies in mutual fund pricing. Market timing, while not illegal per se, can harm other mutual fund shareholders because it can dilute the value of their shares, if the market timer is exploiting pricing inefficiencies, or disrupt the management of the mutual fund's investment portfolio and can cause the targeted mutual fund to incur costs borne by other shareholders to accommodate frequent buying and selling of shares by the market timer.

³ Late Trading refers to trades in a mutual fund's shares after the mutual fund has calculated its daily net asset value ("NAV"), with the intent to receive that day's net asset value per share, rather than the next day's net asset value per share. Most mutual funds calculate their daily net asset value at the close of the major United States securities exchanges and markets (normally 4:00 p.m. Eastern Time).

- mutual funds' shares. Through these activities, the Brokers violated the antifraud provisions of the federal securities laws and Exchange Rules.
12. During the Relevant Period, Southwest collected approximately \$1.8 million in fees from the hedge funds as a result of the market timing and late trading transactions.
 13. During the Relevant Period, Southwest and Leland failed to reasonably supervise X with a view to preventing his fraudulent late trading scheme, in that Southwest had no policies and procedures to detect and prevent late trading (*i.e.*, policies and procedures to monitor mutual fund trading by its registered representatives to ensure that shares purchased or sold after the close of the U.S. equity markets received a price based on the next day's NAV). Leland, in his capacity as president and chief executive officer, was responsible for ensuring that Southwest had policies and procedures to detect and prevent late trading.
 14. Southwest and three of its supervisors – Marsh, Rigdon and Leland (collectively, the "Managers") – failed to reasonably supervise the Brokers with a view to preventing their fraudulent market timing schemes. The Managers had direct supervisory authority over the Brokers, and they were aware of the Brokers' market timing activities. The Managers failed to reasonably supervise the Brokers, by failing to respond adequately to indications of irregularities, or "red flags". The red flags included indicia of masking activities, which the Managers failed to adequately follow up.
 15. Southwest, by and through the Brokers, also failed to make and keep order tickets for the Brokers' market timing transactions, or to record on order tickets the time when Brokers' received mutual fund orders from its customers. Further, the Firm failed to preserve required email communications that related to its business as a broker-dealer.

The Firm's Employees Committed Misconduct and Engaged in Conduct Inconsistent with Just and Equitable Principles of Trade

16. During the Relevant Period, the Brokers engaged in a fraudulent scheme to circumvent restrictions imposed by the mutual funds on market timing, and X engaged in a fraudulent late trading scheme. By virtue of their participation in these fraudulent schemes, the Brokers violated Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b-5 thereunder.

Fraudulent Market Timing Practices by Firm Employee

17. In the fall of 2002, the Managers recruited and hired X to be a broker in Southwest's downtown Dallas branch. Prior to joining Southwest, X was employed by Mutuals.com, where he placed market timing trades and late trades on behalf of

several hedge fund clients, including ABC Capital Management (“ABC”).⁴ Upon joining Southwest, X opened five accounts for two ABC affiliated entities and began placing market timing trades for ABC on October 1, 2002.

18. During X’s 11 month tenure at Southwest, ABC was his only customer, and ABC’s sole trading strategy was market timing. X executed for ABC approximately 3,000 market timing trades, with an aggregate value of about \$1.7 billion, in at least 132 mutual fund families (490 total mutual funds). Southwest earned \$1,515,981 in fees from ABC’s accounts, of which X received \$704,235.⁵ Soon after joining Southwest, X became one of the Firm’s top producing retail brokers, and regularly appeared on the Firm’s “Top Ten Producers” list.
19. Many of the mutual funds in which X placed ABC’s market timing trades either prohibited market timing, or strictly limited the frequency of trades in order to prevent market timing. During the Relevant Period, at least 35 mutual fund families, consisting of hundreds of individual mutual funds, detected X’s timing activity. Those fund families either complained to Southwest, in writing, that the customer account (one of the ABC accounts managed by X) was engaging in market timing; or they blocked the account from future trades in the fund (“Block Notices”); or both. By policing X’s market timing activity in this manner, the mutual funds hampered his continuing execution of ABC’s market timing trades and thereby, jeopardized his status as one of the Firm’s top producers. X therefore had a significant incentive to evade the policing activities of the mutual funds, and he devised a number of deceptive practices, or masking activities, to conceal his market timing.
20. During the Relevant Period, X regularly used multiple accounts and multiple customer-affiliated entities as account holders, in an effort to evade trading restrictions that the mutual funds imposed. At Southwest, X opened 10 accounts for four ABC related entities. By rotating trades in these accounts, X disguised ABC’s identity and gained access to funds that had previously restricted ABC’s market timing trading. X also used the multiple ABC accounts to divide the timing trades into dollar amounts that would more likely evade detection by the mutual fund companies.

Late Trading by Firm Employee

21. During the Relevant Period, Southwest did not have procedures to detect and prevent late trading in mutual fund shares. Southwest’s back-office systems permitted

⁴ The Securities and Exchange Commission (the “SEC” or “Commission”) filed suit against Mutuals.com on December 4, 2003 alleging violations of the federal securities laws relating to its market timing and late trading activities. Lit Release No. 18489 (December 4, 2003). The United States Attorney’s Office for the Southern District of New York filed a criminal complaint against Mutuals.com on March 12, 2004. A federal grand jury indicted the Mutuals.com executives on August 13, 2004.

⁵ The ABC accounts were “fee based” accounts. Southwest charged ABC a 1.75% fee on total assets under management. Because the Firm’s profitability affected the bonuses that each of the Managers received, the Managers profited, in an undetermined amount, as a result of the fees that timing customers paid to the Firm.

brokers to enter trades until 6:30 p.m. EST, and all trades entered by that time, including trades received after the close of the U.S. equity markets (typically 4:00 p.m. EST), were processed at that day's NAV. The Firm, therefore, did not have procedures to ensure that trades received after the close of the U.S. equity markets would be processed at the next day's NAV, as required by Rule 22c-1 promulgated under the Investment Company Act.

22. X exploited and took advantage of Southwest's lack of procedures by regularly executing late (after 4:00 p.m. EST) trades on ABC's behalf. Southwest received as many as 90% (over 2500 trades) of all ABC's orders after 4:00 p.m. EST, yet ABC received that day's NAV for the trades because X entered them into the system before 6:30 p.m. EST. Neither the Managers, who were unaware of X's late trading, nor X ever informed the mutual funds that Southwest received the orders after 4:00 p.m. EST and executed the trades as if they had been received prior to 4:00 p.m. EST.

Fraudulent Market Timing Practices by Other Firm Employees

23. In early February 2003, at the request of Y and Z, the Managers agreed to take on another market timing client – DEF Capital Management (“DEF”), a hedge fund based in New York. All three of the Managers discussed DEF's business with Y and Z. By September 2003, Y and Z had executed for DEF approximately 2,000 market timing trades, with an aggregate value of at least \$650 million, in at least 56 mutual fund families (165 total mutual funds). Southwest earned \$257,349 in fees from the DEF accounts, of which Y and Z received approximately \$112,871.⁶
24. Like X, Y and Z executed trades in mutual funds that prohibited market timing, or had strict limitations on the frequency of trades. During the Relevant Period, at least 32 mutual fund families, representing hundreds of individual mutual funds, detected Y and Z's timing activity and sent Block Notices to Southwest. By policing market timing activity in this manner, the mutual funds hampered Y and Z's continued execution of market timing trades for DEF. To preserve their income from fees paid by DEF, Y and Z devised masking activities to circumvent the mutual funds' policing efforts.
25. Y and Z's masking activities included multiple account numbers, multiple DEF entities, multiple registered representative numbers, and dual office identification numbers. Using these tactics, Y and Z placed trades in mutual funds that had either blocked DEF's market timing trading or restricted all trading by Southwest due to X's market timing reputation. By September 2003, Y and Z had opened 21 DEF accounts, held by nine different DEF affiliated entities. By rotating the trades in these accounts, Y and Z disguised DEF's identity and gained access to mutual funds that attempted to prevent DEF's market timing trading.

⁶ Like the ABC accounts, the DEF accounts were “fee based” accounts. Thus, Southwest charged DEF a 1.5% fee on total assets under management.

26. In addition, Y and Z used multiple registered representative numbers to conceal their identities from the mutual fund companies. In setting up the DEF accounts, Y and Z requested three registered representative numbers – one for Y, one for Z and a joint registered representative number – and they used all three to make trades for DEF.⁷ In doing so, Y and Z disguised their identities and, thereby, gained access to mutual funds that had previously restricted their market timing activities. Finally, Y and Z also used the multiple DEF affiliated accounts and entities to divide the trades into dollar amounts that would more likely evade detection by the mutual fund companies.

Southwest and the Managers Failed to Reasonably Supervise the Brokers

27. Southwest and the Managers failed reasonably to supervise the Brokers with a view to detect and prevent their fraudulent conduct. In particular, the Managers ignored numerous red flags relating to the Brokers' market timing activities. Moreover, while Leland, as President and Chief Executive Officer, was responsible for Southwest's policies and procedures, Southwest failed to adopt, implement or follow adequate supervisory and compliance policies and procedures to detect and prevent X's fraudulent late trading scheme.

The Managers Were Aware of Red Flags Relating to Market Timing

28. Each of the Managers was involved in hiring X for Southwest's Downtown Dallas branch. At the time of his hiring, and throughout the 11 months that X was associated with Southwest, the Managers were aware that his book of business consisted entirely of market timing on behalf of ABC. Similarly, each of the Managers later approved taking DEF as a customer, and they were all aware that the business Y and Z conducted for DEF consisted exclusively of market timing in mutual funds.
29. Shortly after Southwest opened accounts for ABC and DEF, red flags related to the Brokers' fraudulent market timing practices began appearing, and red flags continued to appear throughout the time those accounts were open. The Managers were aware that numerous mutual fund companies sought to curtail the Brokers' market timing trading. Specifically, as noted above, Southwest received hundreds of Block Notices, relating to the Brokers' market timing, from dozens of mutual fund companies. Many of these communications came to the attention of at least one of the Managers, but the Managers failed to take appropriate action in response to indicia that the Brokers were continuing to execute market timing trades in the same funds that sought to block their market timing.
30. For example, Marsh received at least 93 Block Notices. At least 21 of the mutual fund companies that issued the Block Notices had previously complained to Southwest regarding the Brokers' market timing. Rigdon received at least 65 Block

⁷ There was no legitimate purpose for Y and Z's use of multiple registered representative numbers to execute DEF's trades. Brokers sometimes use joint representative numbers to divide commissions on trades that a shared customer places, but Southwest did not charge commissions on DEF's trades. The DEF account was a "fee based" account, and Y and Z received fees based on a percentage of assets under management.

Notices from mutual funds, and at least 11 of them came from mutual funds that had issued Block Notices to Southwest already. Leland received at least 50 Block Notices from mutual funds. Those Block Notices referenced trading in numerous Southwest accounts belonging to ABC and DEF, and at least 16 of the Block Notices were from mutual funds that had previously complained to Southwest about the Brokers' timing activities. At least six of the Block Notices that Leland received asked for a halt to all trading by one or more of the Brokers.

The Managers Failed to Investigate Red Flags and Respond Adequately

31. Notwithstanding these red flags, the Managers did not investigate why, or how, the Brokers continued to place trades in mutual funds that had previously blocked their market timing. In fact, on several occasions, the Managers approved modifications in the way the Brokers conducted business, which had the effect of facilitating the Brokers' masking activities.
32. In November 2002, only one month after the Managers had hired X, Southwest's director of operations threatened to suspend X's trading privileges because of complaints from the mutual funds, and Leland intervened on X's behalf. Specifically, Leland held a meeting with the director of operations, Rigdon and others, after which X was permitted to continue trading in mutual funds.
33. Also in November 2002, Marsh received a document in which DEF explained its strategy for circumventing Block Notices. The document was a questionnaire from Southwest, and DEF's responses identified strategies such as use of "more than one [registered representative] number . . . [r]otating accounts and [use of] more than one [registered representative] number with multiple accounts." Despite his receipt of the DEF questionnaire, Marsh approved Y and Z's request to open 21 DEF accounts for nine DEF affiliated entities, and their use of three registered representative numbers to execute trades for DEF. At no time did Marsh investigate why Y and Z were requesting so many accounts or why they were executing trades using three registered representative numbers. Moreover, Marsh did not bring the DEF questionnaire to the attention of Leland or Rigdon.
34. On February 26, 2003, Z requested a "new" branch office identification number for the DEF trades, because, in light of X's market timing reputation, various mutual funds had restricted DEF's trades. Leland, Rigdon and Marsh all received this request, which stated that "[t]hree funds found us and canceled our trades solely by [their] search of the office codes . . . [t]he office rep and [X's] number." Upon receiving approval for the new office identification number, Z updated Leland saying "[a]s of yesterday, each broker group or groups now have their own office id. Before this time, our group was bumping into the reputation of the [downtown Dallas] office. The [downtown Dallas] office had a timing reputation." Y and Z used the new office identification number to circumvent restrictions that the mutual funds had imposed on Southwest. The Managers failed to follow up and investigate Y and Z's request for

the new office identification number and, in so doing, failed to detect or prevent their fraudulent market timing scheme.

35. Z's February 2003 email (requesting the new office identification number) also stated that "[X] lied to [the mutual funds] three times about timing and did what he said [he] would not do." The Managers did not follow up with X or the mutual funds regarding Z's accusations.
36. During the Relevant Period, the Managers were in the Brokers' direct line of supervision, and were directly involved in the management and supervision of the Brokers' market timing business. The Managers allowed the Brokers to engage in market timing on behalf of their hedge fund customers, despite numerous red flags, by failing to follow up and investigate potential problems with the Brokers' market timing activities. As a result, X, Y and Z continued to engage in market timing on behalf of their Southwest customers in the same deceptive fashion (e.g., through multiple accounts, customer entities, registered representative numbers, and office identification numbers) long after the red flags came to the Managers' attention. The Managers thus failed reasonably to supervise the Brokers with a view toward preventing violations of the federal securities laws and Exchange Rules.

Southwest Failed to Adopt Procedures to Detect and Prevent Late Trading

37. Leland, as Southwest's President and CEO, was responsible for ensuring that Southwest developed procedures that would prevent and detect late trading. As noted above, Southwest did not have procedures to detect and prevent late trading during the Relevant Period. In fact, the Firm's back-office systems permitted brokers to enter mutual fund trades until 6:30 p.m. EST, and all trades entered by that time, including trades received after the close of the U.S. equity markets (typically 4:00 p.m. EST), were processed at that day's NAV. The Firm, therefore, did not have procedures to ensure that trades received after the close of the U.S. equity markets would be processed at the next day's NAV, as required by Rule 22c-1 promulgated under the Investment Company Act.
38. X exploited and took advantage of Southwest's lack of procedures by regularly executing late trades (after 4:00 p.m.) on ABC's behalf. By failing to ensure that Southwest developed procedures to detect and prevent late trading, Leland, and Southwest failed reasonably to supervise with a view toward preventing violations of the federal securities laws and Exchange Rules.

Southwest Failed to Make and Keep Certain Required Books and Records

Order Tickets

39. Section 17(a) of the Exchange Act and SEC Rules 17a-3 and 17a-4 require, in pertinent part, that firms make and keep books and records relating to the receipt and execution of customer orders. Exchange Rule 440 requires that member

organizations make and keep books and records as prescribed by the Exchange and by SEC Rules 17a-3 and 17a-4.

40. Southwest was required to make and keep all order tickets for orders placed by the Firm's customers, but Southwest could not produce the majority of tickets from a representative sample of trades that ABC and DEF executed during the Relevant Period. In addition, from May 2003 to September 2003, Southwest failed to record the time it received mutual fund orders from its customers on order tickets that the Firm did make and keep.

Records of Electronic Mail Communications

41. The Firm violated Section 17(a) of the Exchange Act, SEC Regulation 17a-4 and Exchange Rule 440 by failing to preserve for a period of three years, and/or preserve in an easily accessible place for a period of two years, certain electronic mail communications ("emails") relating to the business of the firm. The Firm also lacked adequate systems or procedures to ensure the preservation of certain electronic mail communications.
42. Finally, Southwest also failed to preserve required business-related correspondence during the Relevant Period. Specifically, prior to September 26, 2003, Southwest failed to preserve an undetermined number of business related emails. In early May 2003, Southwest's chief information officer and representatives of the compliance department realized that Southwest was deleting emails from its system every 31 days. Although the company took action to stop its systems from automatically deleting emails from users' systems in May 2003, it did not terminate users' ability to delete emails manually until September 26, 2003. Southwest's failure to preserve emails is a violation of its obligations under the federal securities laws and Exchange Rules.

Applicable Law

43. Rule 22c-1 promulgated under the Investment Company Act of 1940 states that "no registered investment company issuing any redeemable security, no person designated in such issuer's prospectus as authorized to consummate transactions in any such security, and no principal underwriter of, or dealer in, any such security shall sell, redeem, or repurchase any such security except at a price based on the current net asset value of such security which is next computed after receipt of a tender of such security for redemption or of an order to purchase or sell such security..."
44. Exchange Rule 342 provides that "[e]ach office, department or business activity of a member or member organization ... shall be under the supervision and control of the member or member organization establishing it and of the personnel delegated such authority and responsibility."

45. Exchange Rule 476(a) provides that member firms and their employees may be subject to disciplinary sanctions by the Exchange for, inter alia, engaging in “conduct inconsistent with just and equitable principles of trade.”

Violations of the Federal Securities Laws and Exchange Rules

46. As a result of the conduct described above, Southwest violated Section 17(a)(1) of the Exchange Act and Rules 17a-3 and 17a-4 thereunder, violated Rule 22c-1 under the Investment Company Act and Exchange Rules 342, 440 and engaged in conduct inconsistent with just and equitable principles of trade. The Brokers engaged in a fraudulent scheme to circumvent restrictions imposed by the mutual funds on market timing, and X engaged in a fraudulent late trading scheme. By virtue of their participation in these fraudulent schemes, the Brokers violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. As a result of the Brokers’ fraudulent conduct and the conduct of the Managers described above, Southwest and the Managers failed to reasonably supervise the Brokers in violation of Exchange Rule 342.

DECISION

The Hearing Panel, in accepting the Stipulation of Facts and Consent to Penalty, found the Firm, Mr. Leland, Mr. Rigdon and Mr. Marsh guilty as set forth above by unanimous vote.

PENALTY

In view of the above findings, the Hearing Panel, by unanimous vote, imposed the penalty consented to by the Firm of a censure and total payment of \$10,000,000, as follows:⁸

1. \$8,000,000 as a penalty; and
2. \$2,000,000 as disgorgement and prejudgment interest.

The requirement by the Exchange that the Firm shall comply with an undertaking as follows:

1. The Firm shall cooperate with the staff of the Exchange in any litigation or ongoing investigation in this matter and related matters;
2. Southwest has undertaken to bear its pro rata share of the reasonable cost of compensation and expenses of an Independent Distribution Consultant, who will be named by order of the Commission, and who will be responsible for any distribution of any Fair Fund established pursuant to such Order and Section 308(a) of the Sarbanes-Oxley Act of 2002; and

⁸ Payment of this amount pursuant to an order issued in a related Commission proceeding (the “Commission’s Order”) shall be deemed payment in satisfaction of this Stipulation and Consent. The terms of the payment and the distribution of the penalty and disgorgement amounts are set forth in the Commission’s Order.

3. Southwest shall retain an Independent Consultant as follows:
 - a. Southwest shall retain, within 30 days of the date of this Order, at its expense, an Independent Consultant not unacceptable to the Commission's staff and the Exchange, to conduct a review of Southwest's supervisory, compliance, and other policies and procedures designed to prevent and detect federal securities law violations and violations of Exchange Rules related to mutual fund late trading, mutual fund market timing, and making, keeping and preserving required books and records. Southwest shall cooperate fully with the Independent Consultant and shall provide the Independent Consultant with access to its files, books, records, and personnel as reasonably requested for the review;
 - b. Southwest shall require that, at the conclusion of that review, which in no event will be more than 150 days after the date of the Independent Consultant's retention, the Independent Consultant will submit to Southwest, the Commission and the Exchange an Initial Report. The Initial Report will address the adequacy of Southwest's policies and procedures to detect and prevent federal securities law violations and violations of Exchange Rules related to mutual fund late trading, mutual fund market timing, and making, keeping and preserving required books and records, and will include the Independent Consultant's recommendations thereon;
 - c. Within 30 days of transmittal of the Independent Consultant's Initial Report, Southwest shall in writing advise the Independent Consultant of the recommendations that it has determined to accept and the recommendations that it considers to be unduly burdensome. With respect to any recommendation that Southwest deems unduly burdensome, Southwest may propose an alternative policy or procedure designed to achieve the same objective or purpose;
 - d. With respect to any recommendation or proposal as to which Southwest and the Independent Consultant do not agree, Southwest shall attempt in good faith to reach an agreement with the Independent Consultant. In the event the Independent Consultant and Southwest are unable to agree on an alternative proposal acceptable to the staff of the Commission and the Exchange, Southwest shall abide by the recommendation of the Independent Consultant;
 - e. Within 90 days of transmittal of the Independent Consultant's Initial Report, Southwest shall in writing advise the Independent Consultant, the Commission and the Exchange of the recommendations and proposals that it is adopting;
 - f. Southwest shall require that the Independent Consultant complete the aforementioned review and submit a written Final Report thereon to Southwest, to the Commission's staff and the Exchange within 330 days after the date of this Order. The Final Report will recite the efforts the Independent Consultant undertook to review Southwest's supervisory functions, compliance mechanisms, and other policies and procedures, set forth the Independent Consultant's

recommendations and Southwest's proposals, and describe how Southwest is implementing those recommendations and proposals;

- g. Southwest shall take all necessary and appropriate steps to adopt and implement all recommendations contained in the Independent Consultant's Final Report;
- h. No later than one year after the date of this Stipulation and Consent, unless extended pursuant to Subsection "i" below, Southwest shall submit to the Commission's staff and the Exchange an Affidavit setting forth the details of its efforts to implement the recommendations and proposals contained in the Independent Consultant's Final Report and stating whether it has achieved compliance;
- i. For good cause shown, and upon receipt of a timely application from the Independent Consultant or Southwest, the Commission's staff and the Exchange may extend any of the procedural dates set forth above;
- j. To ensure the independence of the Independent Consultant, Southwest: (i) shall not have the authority to terminate the Independent Consultant, without the prior written approval of the Commission's staff and the Exchange; (ii) shall compensate the Independent Consultant, and persons engaged to assist the Independent Consultant, for services rendered pursuant to this Order at their reasonable and customary rates; (iii) shall not be in and shall not have an attorney-client relationship with the Independent Consultant and shall not seek to invoke the attorney-client or any other doctrine or privilege to prevent the Independent Consultant from transmitting any information, reports, or documents to the Commission or its staff and the Exchange; and
- k. Southwest shall require the Independent Consultant to enter into an agreement that provides that for the period of engagement and for a period of two years from completion of the engagement, the Independent Consultant shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with Southwest, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such. The agreement will also provide that the Independent Consultant will require that any firm with which he/she is affiliated or of which he/she is a member, and any person engaged to assist the Independent Consultant in performance of his/her duties under this Order shall not, without prior written consent of the Fort Worth District Office of the Commission and the Exchange, enter into any employment, consultant, attorney-client, auditing or other professional relationship with Southwest, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such for the period of the engagement and for a period of two years after the engagement.

In view of the above findings, the Hearing Panel, by unanimous vote, imposed the penalty consented to by Mr. Leland of a censure, a fine of \$200,000, a payment of \$1 as disgorgement

and prejudgment interest,⁹ and a suspension for a period of one year from employment or association in any supervisory capacity with any member or member organization.

In view of the above findings, the Hearing Panel, by unanimous vote, imposed the penalty consented to by Mr. Rigdon of a censure, a fine of \$50,000, a payment of \$1 as disgorgement and prejudgment interest,⁹ and a suspension for a period of one year from employment or association in any supervisory capacity with any member or member organization.

In view of the above findings, the Hearing Panel, by unanimous vote, imposed the penalty consented to by Mr. Marsh of a censure, a fine of \$25,000, a payment of \$1 as disgorgement and prejudgment interest,⁹ and a bar for a period of one year from employment or association in any supervisory capacity with any member or member organization.

For the Hearing Panel

Vincent F. Murphy
Hearing Officer

⁹ Payment of these amounts pursuant to an order issued in a related Commission proceeding (the “Commission’s Order”) shall be deemed payment in satisfaction of this Stipulation and Consent. The terms of the payment of the fine are set forth in the Commission’s Order.