INITIAL DECISION RELEASE NO. 349
ADMINISTRATIVE PROCEEDING
FILE NO. 3-12738

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of	:	
	:	INITIAL DECISION
NEXT FINANCIAL GROUP, INC.	:	June 18, 2008
	:	
	:	

APPEARANCES: Paul N. Feindt, Karen L. Martinez, and Thomas M. Melton for the Division of Enforcement, Securities and Exchange Commission.

Peter J. Anderson, Shane B. Hansen, and Brian L. Rubin for NEXT Financial Group, Inc.

BEFORE: James T. Kelly, Administrative Law Judge.

The Securities and Exchange Commission (SEC or Commission) issued its Order Instituting Proceedings (OIP) on August 24, 2007, pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 (Exchange Act). Respondent NEXT Financial Group, Inc. (NEXT or Respondent), received the OIP on August 29, 2007, and filed a timely Answer.

The OIP alleges that NEXT, a registered broker and dealer, willfully violated Regulation S-P, 17 C.F.R. Part 248, by disclosing nonpublic personal information about its customers to nonaffiliated third parties without notice or a reasonable opportunity to opt out of such disclosure, by allowing registered representatives to disseminate customer nonpublic personal information to other brokerage firms when leaving NEXT, and by failing to safeguard customer records and information. The OIP also alleges that NEXT willfully aided and abetted and caused violations of Regulation S-P by other, non-party brokers and dealers. According to the OIP, NEXT did so by encouraging and, in many cases, helping registered representatives from other brokerage firms (recruits) to disclose their customers' nonpublic personal information to NEXT without proper notice to the customers and without affording the customers a reasonable opportunity to opt out of such disclosure. As relief for the alleged violations, the Division of Enforcement (Division) seeks a cease-and-desist order and a civil monetary penalty.

I held a four-day public hearing in Houston, Texas, during December 2007. The Division and NEXT have filed proposed findings of fact, proposed conclusions of law, and supporting briefs, and the matter is ready for decision. I base my findings and conclusions on the entire

record and on the demeanor of the witnesses who testified at the hearing.[1] I applied "preponderance of the evidence" as the standard of proof. See Steadman v. SEC, 450 U.S. 91, 97-104 (1981). I have considered and rejected all arguments, proposed findings, and proposed conclusions that are not discussed in this decision.

STATUTORY AND REGULATORY BACKGROUND

November 1999: Congress Enacts the Gramm-Leach-Bliley Act

Congress enacted the Financial Services Modernization Act of 1999, also known as the Gramm-Leach-Bliley Act (GLB Act), Pub. L. No. 106-102, 113 Stat. 1338, in November 1999. Subtitle A of Title V of the GLB Act, captioned Disclosure of Nonpublic Personal Information, contains privacy protections and related safeguarding measures for consumer financial information. These protections are codified at 15 U.S.C. §§ 6801-6809.

The GLB Act declared it to be "the policy of the Congress that each financial institution has an affirmative and continuing obligation to respect the privacy of its customers and to protect the security and confidentiality of those customers' nonpublic personal information." 15 U.S.C. § 6801(a). Section 509(4)(A) of the GLB Act defines "nonpublic personal information" as "personally identifiable financial information (i) provided by a consumer to a financial institution; (ii) resulting from any transaction with the consumer or any service performed for the consumer; or (iii) otherwise obtained by the financial institution." 15 U.S.C. § 6809(4)(A). The statutory definition excludes publicly available information (unless provided as part of a list, description, or other grouping), as well as any list, description, or other grouping of consumers (and publicly available information pertaining to them) that is derived without using nonpublic personal information. 15 U.S.C. §§ 6809(4)(B)-(C). The GLB Act does not define either "personally identifiable financial information" or "publicly available information."

Privacy Protections. Sections 502(a) and 503(a) of the GLB Act limit the instances in which a financial institution may disclose nonpublic personal information about consumers who are customers to nonaffiliated third parties, and require a financial institution to disclose to all of

---

[1] References in this Initial Decision to the hearing transcript, as amended by my Order of January 15, 2008, are noted as "Tr. ___." References to the Division's Exhibits and Respondent's Exhibits are noted as "DX ___" and "RX ___," respectively. The parties submitted three sets of stipulated facts. Pursuant to Rule 324 of the Commission's Rules of Practice, I now receive these sets of stipulated facts into evidence, in their entirety. These sets of stipulated facts are identified as "First Stip. ___," "Second Stip. ___," and "Third Stip. ___," respectively.

References to the Division's Proposed Findings of Fact, Proposed Conclusions of Law, and Post Trial Brief are noted as "Div. Prop. Find. ___," "Div. Prop. Concl. ___," and "Div. Br. ___," respectively. References to Respondent's Proposed Findings of Fact, Proposed Conclusions of Law, and Post Trial Brief are noted as "Resp. Prop. Find. ___," "Resp. Prop. Concl. ___," and "Resp. Br. ___," respectively. References to the Division's Post Trial Reply Brief are noted as "Div. Reply Br. ___."

its customers the institution's privacy policies and practices with respect to information sharing with both affiliates and nonaffiliated third parties. 15 U.S.C. §§ 6802(a), 6803(a). Section 502(b) of the GLB Act also gives consumers the right to opt out of disclosure, i.e., to direct the financial institution not to share nonpublic personal information with nonaffiliated companies. 15 U.S.C. § 6802(b). Section 504(a)(1) of the GLB Act requires several federal regulators, including the Commission, to prescribe regulations necessary to carry out the purposes of Title V with respect to financial institutions subject to their jurisdiction. 15 U.S.C. § 6804(a)(1). Section 504(a)(2) requires the federal regulators to work together to issue consistent and comparable rules to implement the GLB Act's privacy provisions. 15 U.S.C. § 6804(a)(2).

Sections 502(b)(2) and 502(e) of the GLB Act codify several exceptions to the prohibition on the disclosure of nonpublic personal information of consumers to nonaffiliated third parties. For example, a financial institution may provide nonpublic personal information to another financial institution under joint marketing agreements and with certain service providers, as long as the financial institution fully discloses it is providing such information and negotiates a contractual confidentiality agreement. 15 U.S.C. § 502(b)(2). The notice and opt-out requirements do not prohibit a financial institution from disclosing nonpublic personal information with the consent or at the direction of the consumer. 15 U.S.C. § 6802(e)(2). There is also an exception to the notice and opt-out requirements for disclosure that is necessary to effect, administer, or enforce a transaction requested or authorized by the consumer. 15 U.S.C. § 6802(e)(1). Other exceptions to the notice and opt-out requirements allow disclosure in connection with servicing or processing a financial service requested or authorized by the consumer, see 15 U.S.C. § 6802(e)(1)(A), or in connection with a proposed transfer of a portion of a business or operating unit if the disclosure of nonpublic personal information concerns only consumers of such business or unit, see 15 U.S.C. § 6802(e)(7).

Safeguarding Standards. Subtitle A of Title V of the GLB Act also requires the Commission and the other federal regulators to establish standards for financial institutions relating to administrative, technical, and physical safeguards for customer records and information. See 15 U.S.C. § 6801(b). As described in Section 501(b) of the GLB Act, the objectives of these standards are to: (1) insure the security and confidentiality of customer records and information; (2) protect against any anticipated threats or hazards to the security or integrity of those records; and (3) protect against unauthorized access to or use of those records or information which could result in substantial harm or inconvenience to any customer. See 15 U.S.C. §§ 6801(b)(1)-(3). The GLB Act does not define the terms "customer records and information" and "substantial harm or inconvenience."

The GLB Act does not require the federal regulators to coordinate in developing their safeguarding standards, and does not impose a deadline to establish them. By contrast, Sections 504(a)(2)-(3) of the GLB Act require the federal regulators to work together to issue consistent and comparable rules to implement the GLB Act's privacy provisions within six months after enactment. Although Section 505(b) of the GLB Act permits most of the federal regulators to develop their safeguarding standards by issuing guidelines, it requires the SEC and the Federal Trade Commission (FTC) to proceed by rule. See 15 U.S.C. § 6805(b).

Enforcement. Enforcement of Subtitle A of Title V rests solely with federal regulators and state insurance authorities with respect to financial institutions and other persons subject to their jurisdiction under applicable laws. 15 U.S.C. § 6805(a). Thus, the Commission has the

authority to enforce Subtitle A of Title V with respect to brokers, dealers, investment companies, and registered investment advisers under the federal securities laws. 15 U.S.C. §§ 6805(a)(3)-(5). Consumers cannot bring private causes of action against financial institutions that violate the provisions of Subtitle A of Title V. See Dunmire v. Morgan Stanley DW, Inc., 475 F.3d 956, 960 (8th Cir. 2007) (collecting cases).

Legislative History. Subtitle A of Title V of the GLB Act originated in the House of Representatives, which was considering H.R. 10, The Financial Services Act of 1999. When H.R. 10 was reported out by the House Banking and Financial Services Committee in March 1999, it contained no privacy protections at all. H.R. 10 was then referred to the House Energy and Commerce Committee, which marked up the bill on June 10, 1999. The Commerce Committee approved a proposal by Rep. Paul Gillmor, as amended by Rep. Edward Markey, which added several privacy protections. The House Rules Committee resolved differences between the two versions of H.R. 10 by ruling the Gillmor-Markey amendment out of order and ruling a substitute amendment proposed by Rep. Michael Oxley in order. The House of Representatives then approved the Oxley amendment and H.R. 10 on July 1, 1999. See 145 Cong. Rec. H5308-16 (July 1, 1999). With minor changes added by the conference committee, the Oxley amendment was eventually enacted as Subtitle A of Title V of the GLB Act.

The Subcommittee on Financial Institutions and Consumer Credit of the House Banking Committee held hearings on emerging financial privacy issues on July 20-21, 1999. The testimony of witnesses before congressional committees prior to passage of legislation constitutes only weak evidence of legislative intent. See Public Citizen v. Farm Credit Admin., 938 F.2d 290, 292 (D.C. Cir. 1991). This testimony came three weeks after the House had already approved the Oxley amendment and H.R. 10 and is even weaker evidence.

June 2000: The Commission Promulgates Regulation S-P

Commission representatives consulted with representatives from the other federal regulators in drafting rules to implement the privacy protections of Subtitle A of Title V. See 15 U.S.C. § 6804(a)(2). On March 2, 2000, the Commission issued a notice of proposed rulemaking (Proposing Release) (RX 13). Privacy of Consumer Financial Information (Regulation S-P), 65 Fed. Reg. 12354 (Mar. 8, 2000). On June 22, 2000, the Commission adopted final rules (Adopting Release) (RX 14). Privacy of Consumer Financial Information (Regulation S-P), 65 Fed. Reg. 40334 (June 29, 2000). Regulation S-P became effective on a voluntary basis as of November 13, 2000, and compliance was mandatory as of July 1, 2001. 17 C.F.R. § 248.18.

Privacy Protections. Regulation S-P applies to certain financial institutions regulated by the Commission, including brokers, dealers, and registered investment advisers. 17 C.F.R. §§ 248.1(b), .3(b), (l), (q). Regulation S-P requires covered financial institutions to provide privacy notices to their customers when a customer relationship is formed and annually for as long as the relationship continues. 17 C.F.R. §§ 248.4(a)(1), 248.5(a)(1). Unless an exception applies, the initial and annual privacy notices must include: (1) the categories of nonpublic personal information that the institution discloses and the categories of affiliates and nonaffiliated third parties to whom it discloses such information, other than as permitted by the exceptions in 17 C.F.R. §§ 248.14-.15; (2) an explanation of the consumer's rights under 17 C.F.R. § 248.10(a) to

opt out of the disclosure of nonpublic personal information to nonaffiliated third parties and the methods by which the consumer may opt out; and (3) where applicable, a statement that the institution discloses nonpublic personal information to nonaffiliated third parties as permitted by law. 17 C.F.R. §§ 248.6(a)-(b).

The Commission defined "nonpublic personal information" and "personally identifiable financial information" broadly. 17 C.F.R. §§ 248.3(t)-(u). The Adopting Release makes clear that "nonpublic personal information" includes any customer lists (including names, addresses, and telephone numbers) that are derived in whole or in part from information provided to a financial institution by a customer (RX 14 at 19-20 & n.83). 17 C.F.R. § 248.3(t).

Some commenters argued that "personally identifiable financial information" should not include the fact that an individual is a customer of a financial institution. The Commission rejected this argument (RX 14 at 20):

> We disagree with those commenters who maintain that customer relationships should not be considered to be personally identifiable financial information. This information is "personally identifiable" because it identifies the individual as a customer of the institution. The information is financial because it reveals a financial relationship with the institution and the receipt of financial products or services from the institution.

The GLB Act distinguishes "consumers" from "customers" for purposes of the statute's notice requirements (RX 14 at 9). The Commission defines a "consumer" as an individual who obtains or has obtained a financial product or service from a financial institution. 17 C.F.R. § 248.3(g). Typically, a consumer has no further contact with the financial institution other than the one-time delivery of products or services (RX 14 at 12). 17 C.F.R. § 248.3(k)(2)(ii). In addition, the Commission defines a "customer" as a consumer who has developed a continuing relationship with a financial institution to provide products or services. 17 C.F.R. §§ 248.3(j)-(k). The present proceeding only involves "customers" (Resp. Br. at 15 n.22).

Regulation S-P does not prescribe any specific format or standardized wording for privacy notices. Instead, financial institutions may design their own notices based on their individual practices, provided they meet the "clear and conspicuous" standard in 15 U.S.C. § 6803(a) and 17 C.F.R. § 248.3(c) and furnish the content required by 17 C.F.R. § 248.6.

Regulation S-P contains exceptions to the notice and opt-out requirements that correspond directly to the exceptions in Sections 502(b)(2) and 502(e) of the GLB Act. The Commission specifically declined to promulgate additional exceptions suggested by commenters, on the grounds that the suggestions were inconsistent with the GLB Act (RX 14 at 40-41). Some of the exceptions in Regulation S-P are arguably relevant to this proceeding (RX 13 at 17-18, RX 14 at 38-41). One such exception involves processing or servicing a financial product or service that a consumer requests or authorizes. 17 C.F.R. § 248.14(a)(1). Another exception involves disclosure to nonaffiliated third parties occurring "in connection with a proposed or actual . . . transfer . . . of all or a portion of a business or operating unit if the disclosure of nonpublic personal information concerns solely consumers of such business or unit." 17 C.F.R. § 248.15(a)(6). If an exception applies, the notice and opt-out requirements are irrelevant.

Safeguarding Standards. The Commission also proposed its safeguarding rule, Rule 30 under Regulation S-P, in March 2000. In explaining the proposal, it stated (RX 13 at 20):

> We have not prescribed specific policies or procedures that financial institutions must adopt. Rather, we believe it more appropriate for each institution to tailor its policies and procedures to its own systems of information gathering and transfer and the needs of its customers. We request comment on whether the proposed standards should be more specific, and if so, what specifications would be appropriate for particular financial institutions.

When the Commission promulgated Regulation S-P in June 2000, it adopted Rule 30, the safeguarding rule, in the form proposed (RX 14 at 43). See 17 C.F.R. § 248.30. Like the GLB Act, Rule 30 of Regulation S-P does not define the terms "customer records and information" and "substantial harm or inconvenience."

September-December 2004: The Commission Revisits the Safeguarding Rule

Following the Commission's adoption of Rule 30 under Regulation S-P, the other federal regulators issued safeguarding guidelines and regulations covering the financial institutions subject to their jurisdiction. In many instances, these regulators published considerably more detailed standards for safeguarding customer records and information than the Commission had done in Rule 30. The National Credit Union Administration (NCUA) and the banking agencies (Office of the Comptroller of the Currency (OCC), Federal Reserve System (FRS), Federal Deposit Insurance Corporation (FDIC), and Office of Thrift Supervision (OTS)) issued final guidelines that are substantially similar in 2001. NCUA Guidelines Establishing Standards for Safeguarding Member Information, 66 Fed. Reg. 8152 (Jan. 30, 2001); Interagency Guidelines Establishing Standards for Safeguarding Customer Information, 66 Fed. Reg. 8616 (Feb. 1, 2001). The FTC adopted its final safeguarding rule in 2002. Standards for Safeguarding Customer Information, 67 Fed. Reg. 36484 (May 23, 2002).

Accordingly, the Commission revisited the safeguarding rule late in 2004. Disposal of Consumer Report Information, 69 Fed. Reg. 56304 (Sept. 20, 2004). The Commission proposed to require that the safeguarding policies and procedures adopted by financial institutions under Rule 30 of Regulation S-P be in writing. Id. at 56307-08. The Commission also sought comment on whether it should revise its safeguarding rule to require financial institutions to address certain elements when crafting their safeguarding policies and procedures. As to the latter issue, the Commission specifically inquired as to whether it should revise Rule 30 under Regulation S-P to look more like the FTC's safeguarding rule:

> When we adopted the safeguard rule, we believed that brokers [and] dealers . . . should have the flexibility to tailor their policies and procedures to their own organization's specific circumstances. . . .
>
> We continue to believe that this approach is appropriate. Therefore, we are not proposing specific policies and procedures that all firms subject to the rule must implement. Nevertheless, we seek comment on ways to maintain a flexible approach, while establishing certain elements in the rule that a firm must include

> in its policies and procedures. For example, the FTC's Safeguard Rule . . . requires that financial institutions subject to the rule adopt a written information security program "appropriate to [the institution's] size and complexity, the nature and scope of [its] activities, and the sensitivity of any customer information at issue." The rule specifies certain elements each program must have, such as identifying certain reasonably foreseeable internal and external risks to the security of customer information, while allowing the institution to determine the particular risks likely to threaten its operations. We seek comment on whether the Commission should propose to amend its safeguard rule in a similar way. Delineating elements would establish more specific standards for safeguarding customer information consistent with the goals of the [GLB Act].

Id. at 56308.

In December 2004, the Commission adopted an amendment to Rule 30 requiring that safeguarding policies and procedures be written. Disposal of Consumer Report Information, 69 Fed. Reg. 71322, 71325 (Dec. 8, 2004).[2] However, the Commission decided not to propose or adopt mandatory minimum standards under its safeguarding rule at that time. Id.

March 2007: The Interagency Model Privacy Form Proposal

Congress enacted the Financial Services Regulatory Relief Act of 2006 (Regulatory Relief Act), Pub. L. No. 109-351, 120 Stat. 1966, on October 13, 2006. Section 728 of the Regulatory Relief Act directs several federal regulatory agencies, including the Commission, to "jointly develop a model form which may be used, at the option of the financial institution, for the provision of disclosures under [Section 503 of the GLB Act]." The Regulatory Relief Act stipulates that the model form shall be a safe harbor for financial institutions that elect to use it.

Section 728 further directs that the model form shall: (a) be comprehensible to consumers, with a clear format and design; (b) provide for clear and conspicuous disclosures; (c) enable consumers easily to identify the sharing practices of a financial institution and to compare privacy practices among financial institutions; and (d) be succinct, and use an easily readable type font. The provision is codified at 15 U.S.C. § 6803(e).

In March 2007, the agencies jointly proposed a safe harbor model privacy form that financial institutions may use to provide disclosures under Subtitle A of Title V of the GLB Act. Interagency Proposal for Model Privacy Form under the Gramm-Leach-Bliley Act, 72 Fed. Reg. 14940 (Mar. 29, 2007) (Proposed Rules). The agencies expressed the view that the proposed model form would be easier to understand than most privacy notices currently being disseminated. The comment period on the proposed rules closed in May 2007, and the agencies are conducting a series of in-depth interviews to test the effectiveness of the proposed model privacy form among a large number of consumers.

---

[2] The amendment became effective on January 11, 2005, and compliance was mandatory as of July 1, 2005. Id. at 71325. At the same time, the Commission re-designated its safeguarding rule, formerly Rule 30, as Rule 30(a). Id.

FINDINGS OF FACT

NEXT has been registered with the Commission as a broker, dealer, and investment adviser since 1999 (Answer; First Stip. ¶ 1). It is a private company with headquarters in Houston, and is owned and controlled by its registered representatives and employees (Answer). At the time of the hearing, NEXT had approximately 850 registered representatives nationwide (Tr. 234).

NEXT realized net income of approximately $1.4 million on revenues of $79.4 million during 2006 (First Stip. ¶ 1). Between 1999 and 2007, NEXT's staffing and revenues increased approximately 40-50% per year, making it one of the fastest growing brokerage firms in the country (Tr. 30, 32, 235). NEXT also enjoys a high retention rate; relatively few of its registered representatives leave to affiliate with other brokerage firms (Tr. 48, 51, 417-18, 927-30; DX 80).

NEXT's Recruiters and the NEXT Transition Team

NEXT offers "one of the highest payouts in the industry" to its registered representatives (Second Stip. ¶ 4; DX 1 at 47). NEXT considers its aggressive recruiting program and the services it provides its registered representatives to be the key to its growth (Tr. 235).

NEXT recruits registered representatives from other brokerage firms and encourages these recruits to bring their customer accounts with them (First Stip. ¶ 3; DX 59 at 2). NEXT employs eight or nine full-time recruiters nationwide, and pays them salaries and bonuses based on the production of the representatives they recruit (Tr. 235-36). These recruiters use cold calling, advertising, and targeted marketing campaigns (Tr. 236-37).

NEXT screens recruits through its rep review committee. Among other things, the committee is interested in recruits with clean disciplinary records and certain minimum productivity thresholds (Second Stip. ¶ 3). The committee also focuses on whether recruits have signed covenants not to compete with their current brokerage firms (Tr. 248-51; DX 6 at 9). While NEXT occasionally hires representatives who have signed covenants not to compete with their current firms, it limits the transition assistance it provides to such individuals (Tr. 248-51; RX 17 at 3). The typical NEXT recruit does not exercise discretionary authority over customer accounts (Tr. 475, 565, 605, 635).

One selling point the recruiters use to encourage recruits to join NEXT is the efficient and automated transition process NEXT has developed for assisting recruits in transferring customers to NEXT (First Stip. ¶ 3; Second Stip. ¶ 5). NEXT describes its smooth transition process on its web site (DX 1 at 25) ("Our number one goal is to eliminate your downtime during transition."). The recruiters also provide potential recruits with the "You Could Be NEXT" brochure. The brochure describes the transition services offered by NEXT (Second Stip. ¶ 2; Tr. 241-42; DX 2 at 4).

NEXT has organized a group of four to five home office employees who assist recruits in completing the transition process quickly and efficiently (Tr. 19, 22, 24-25, 92-94; DX 59 at 2). The transition team provides recruits with a "transition tools e-mail" that contains information about NEXT's business and operations, the transition process, and related forms (First Stip. ¶ 6;

DX 3, 15). During recruiting visits to Houston, recruits typically meet with members of the transition team to learn about the transition process and the home office support that is available (Tr. 453, 628-29; DX 59 at 2). NEXT does not require recruits to use the services of its transition team (Tr. 81; DX 59 at 2).

Deborah DeMarino (DeMarino) supervised the transition team until October or November 2006 (Tr. 91-92, 96). Jennifer Zittel currently supervises the transition team (Tr. 116).

NEXT Offers to "Pre-Populate" Customer
Account Transfer Forms for Recruits, 2001-January 2006

NEXT's recruiters and the transition team offered to assist recruits by "pre-populating" required customer account documents and transfer forms before the recruits became affiliated with NEXT (Second Stip. ¶ 5).[3] NEXT did so by using customer information the recruits provided to NEXT before the recruits resigned from their current brokerage firms (First Stip. ¶ 9 and Ex. F; Tr. 93, 98-99; DX 6 at 9-10).

Recruits received "The Transition Process—An Overview" (Transition Overview), a booklet that described how NEXT used the customer information the recruits provided (First Stip. ¶ 9 and Ex. F; DX 6-DX 8, DX 59 at 3, 15-25). One document the transition team provided recruits was a sample Excel spreadsheet the recruit could complete to supply NEXT with information about current customers (First Stip. ¶ 6; DX 3 at 2, DX 4, DX 15 at 1, DX 31 at 1).

The information called for in the sample Excel spreadsheet included, for each customer account: (1) name of the primary account owner, trustee, or custodian and the secondary account owner; (2) brokerage account numbers; (3) direct account numbers (i.e., mutual fund account numbers and variable annuity account numbers); (4) whether or not each brokerage account is "managed"; (5) Social Security numbers or tax identification numbers of the primary and secondary account owners; (6) account types (i.e., individual retirement account (IRA), Roth IRA, joint, trust, Uniform Gift to Minors Act or Uniform Transfers to Minors Act); (7) net worth; (8) annual income; (9) years of investment experience; (10) mailing address and, if that is a post office box, the actual residential address, with suite or apartment numbers, if applicable; (11) home telephone number; (12) date of birth of the primary account owner; (13) bank name, city, state, and zip code; (14) passport number; (15) driver's license number; (16) occupations of the primary and secondary account owners; and (17) the primary and secondary account owners' employers, with their cities, states, zip codes, work telephones and facsimile numbers (First Stip. ¶ 7 and Ex. D; DX 4). I agree with the Division that each of these seventeen categories

[3] The parties defined "pre-populating" account forms to describe the practice "by which a [registered] representative [associated with one broker-dealer] provides client information to another broker-dealer for its automated preparation of client account transfer documents, which are then in turn used by the clients of the representative to transfer their accounts to the representative's new broker-dealer" (Tr. 7).

constitutes "personally identifiable financial information" within the definition of 17 C.F.R. § 248.3(u).[4]

The Transition Overview encouraged recruits to e-mail such customer information to NEXT. NEXT's web site explained that, if recruits provided NEXT with customer data in electronic format, NEXT could create new account forms, mailing labels, change of broker-dealer letters, and Automated Customer Account Transfer (ACAT) forms (Tr. 37, 102, 129-30; DX 1 at 25, DX 25, DX 26, DX 27).[5] The transition team asked recruits to provide customer information at least two weeks before the recruit's start date with NEXT, so that the account transfer documents would be ready to mail the moment the recruit became licensed with NEXT (First Stip. ¶ 9 and Ex. F; Tr. 98-99; DX 6 at 10, DX 7 at 11). Often, NEXT e-mailed the spreadsheet containing customer information back to the recruit to be reformatted or to have the recruit add information (First Stip. ¶ 9 and Ex. G; Tr. 118-19, 123).

Depending on the needs and sophistication of the recruit and on whether NEXT was familiar with the computer systems of its competitors, the transition team at times explained to recruits certain features of the recruit's current brokerage firm's computer system, including how the recruit could extract customer information and export the information onto NEXT's Excel spreadsheet (First Stip. ¶ 10; DX 59 at 5-7). At times, the transition team also instructed recruits

---

[4] NEXT initially argued that several categories of information on its model Excel spreadsheet were not "personally identifiable financial information" (Order of Nov. 7, 2007; Amended Answer, dated Nov. 15, 2007). However, the Division demonstrated that the Commission had specifically considered and rejected that argument when it adopted Regulation S-P (RX 14 at 19-20 & n.83) (discussing "derivative information"). As a result, NEXT has prudently abandoned its claim. See TransUnion LLC v. FTC, 295 F.3d 42, 49-51 (D.C. Cir. 2002) (rejecting the argument that names, addresses, and telephone numbers are not "financial" information and thus should not come within the GLB Act's definition of "nonpublic personal information" as including "personally identifiable financial information"). In so holding, the Court of Appeals ruled that "personally identifiable financial information" is an ambiguous term, that the FTC is entitled to Chevron deference in defining the term, and that the FTC's broad definition is permissible. Id. at 51. The SEC's definition of the term is identical to the FTC's definition.

[5] The National Securities Clearing Corporation administers ACAT, a system that standardizes procedures for the transfer of assets in a customer account from one brokerage firm to another. See National Association of Securities Dealers (NASD) Rule 11870 and New York Stock Exchange (NYSE) Rule 412. Under these rules, when a customer whose account is carried by one brokerage firm wishes to transfer the account to another brokerage firm, the customer must give authorizing instructions to the second brokerage firm. Thereafter, the carrying firm must validate or take exception to an instruction to transfer securities account assets within three business days following receipt of a transfer instruction from the receiving firm.

In July 2007, NASD merged with NYSE Member Regulation. The combined self-regulatory organization is now known as the Financial Industry Regulatory Authority (FINRA). In October 2007, the Commission approved FINRA's proposal to reduce the validation period in NASD Rule 11870 and NYSE Rule 412 from three business days to one business day.

how to access and download customer information from the computer systems of clearing brokers and other account information custodians (First Stip. ¶ 11; DX 59 at 5-7).

After NEXT had pre-populated the account transfer documents, it sent them to the recruit. On the recruit's official start date with NEXT, the recruit immediately sent customers notification of change letters and pre-populated forms for the customer's review and signature (First Stip. ¶ 5, Third Stip. ¶ 3). If a customer wished to proceed with the transfer of his or her account to NEXT, the customer would complete and sign the partially pre-populated documents and return them to NEXT (First Stip. ¶ 5, Third Stip. ¶ 3).

During 2004 and 2005, approximately 160 recruits provided customer nonpublic personal information to NEXT in this fashion (Tr. 877-90, 926; DX 61 at 1-9, DX 62). In general, brokers and dealers that operated with an independent contractor model knew registered representatives transferred customer nonpublic personal information to new firms before the registered representatives tendered their resignations to facilitate timely account transfers (First Stip. ¶ 17). Some brokerage firms did not know that specific representatives would be departing or that they would disclose nonpublic personal information to NEXT (Tr. 86, 457-58, 670).

NEXT did not determine whether the customers had consented to the transfer of this information to NEXT by recruits before the recruits joined NEXT (Third Stip. ¶ 9). In fact, customers were not told that recruits provided this information to NEXT and were not given a reasonable opportunity to opt out of this information sharing (Tr. 48, 271, 458, 474-75, 561, 601, 813). NEXT did not request copies of the privacy policy of a recruit's current brokerage firm and did not determine whether the privacy policy disclosed that the recruit could take customer information to a new firm in the event the recruit decided to become associated with another broker or dealer (Third Stip. ¶ 8). NEXT did not determine whether the information it collected from recruits regarding customers was publicly available information (First Stip. ¶ 17).

Excesses in NEXT's Pre-Population Program from 2001 through January 2006

At least one recruit provided customer information, including names, addresses, Social Security numbers, telephone numbers, account numbers, and account types, to a NEXT recruiter even before he had been screened by NEXT's rep review committee (Second Stip. ¶ 7; DX 57 at 3-43). Nonetheless, DeMarino told the transition team: "OK to start working on the file" (DX 57 at 2).

On a few occasions, NEXT personnel sat side-by-side with a recruit and accessed the computer system at the recruit's current brokerage firm to download customer information (Third Stip. ¶ 2; Tr. 167). In approximately twenty instances between December 2003 and May 2006, the NEXT transition team accessed the computer system of a recruit's current brokerage firm, after the recruit shared with NEXT the password and user identification that had been provided by his or her current brokerage firm (Third Stip. ¶¶ 1-2; Tr. 27-28, 38, 151-55, 167-80; DX 25, DX 39).

The transition team asked recruits to provide passwords and user identifications so that NEXT could obtain customer information on its own, outside the presence of the recruits (Tr. 453-55, 496; DX 25, DX 54 at 4). NEXT believed that this was an easier and faster way to

extract customer data to pre-populate customer account and transfer forms (Tr. 166-67). NEXT used recruits' passwords and user identifications only for transition assistance (Tr. 167).

NEXT did nothing to determine whether customers or a recruit's current brokerage firm had consented to the recruit's supplying NEXT with his or her password (Tr. 154, 171-72). NEXT management was aware that the transition team was using recruits' passwords and user identifications in this fashion (Third Stip. ¶ 6; Tr. 175, 181). NEXT's compliance officer was not aware at the time (Tr. 252). Until 2006, NEXT did not have policies and procedures that prohibited this practice (Third Stip. ¶ 7).

NEXT had no policies or procedures for purging the nonpublic personal information provided by recruits after NEXT had completed its pre-population tasks (Tr. 120, 166). NEXT stored the customer information it received from recruits indefinitely on its common server, where it could be viewed by any NEXT home office employee with network access (Third Stip. ¶ 4; Tr. 120; DX 59 at 7). On one occasion, NEXT forwarded customer nonpublic personal information to Pershing, its clearing broker, in anticipation of a recruit joining NEXT and transferring a large number of brokerage accounts to NEXT (Third Stip. ¶ 5; Tr. 43-44, 162-63). On a few occasions between 2001 and 2004, NEXT used customer data provided by recruits to pre-populate its own internal back office customer database system (Third Stip. ¶ 4; Tr. 159-60; DX 21). The NEXT back office system contains customer names, addresses, Social Security numbers, employer information, annual income, account numbers, and other financial information (Tr. 152, 159-60). This allowed NEXT to create a customer profile containing nonpublic personal information before the individual actually became a customer of NEXT (Third Stip. ¶ 4; Tr. 159-60).

On two occasions, NEXT received customer information from recruits, including names, addresses, telephone numbers, account numbers, birth dates, and Social Security numbers, but the recruits later decided not to join NEXT. In these situations, the customer information remained on the NEXT computer system (First Stip. ¶ 12; DX 43, DX 44 at 1-20, DX 45 at 1-23). If a customer did not follow a recruit by transferring his or her account to NEXT, NEXT maintained the customer's nonpublic personal information on its computer system (Tr. 166; DX 59 at 7).

Outbound Registered Representatives: 2001-January 2006

Between January 1, 2004, and February 8, 2006, 265 registered representatives resigned from NEXT (Tr. 927). Of these 265 registered representatives, sixty-eight eventually joined another broker or dealer (Tr. 927-31; DX 80).

NEXT imposes no restrictions on what a departing representative may take from the clearing broker's computer system, but it does not allow the departing representative to extract data from NEXT's back office system (Tr. 49). When a registered representative leaves NEXT to affiliate with another broker or dealer, NEXT permits the representative to retain copies of customer files and documents and to provide that information to the successor broker or dealer (Answer; First Stip. ¶ 18; Tr. 47-49, 257-58, 266). The files and documents include information such as customer names, addresses, Social Security numbers, birth dates, account numbers, and banking information (Tr. 258).

NEXT requires departing registered representatives to return all original documents to the home office (First Stip. ¶ 19). If the departing representative functions as an office of supervisory jurisdiction (OSJ), NEXT requires the return of all OSJ files and records that may be in the OSJ supervisor's possession, including records necessary to establish NEXT's supervision over its registered representatives, and any other records that are not in the home office (First Stip. ¶ 19). NEXT permits producing OSJ supervisors to keep any of their own customers' files and information, but not information about other registered representatives' customers unless all of the registered representatives in a particular office are departing together to join another broker or dealer (First Stip. ¶ 19).

The OIP does not allege that NEXT failed to distribute initial and annual privacy policy notices to all its customers. Rather, it contends that NEXT's privacy policy notices were inadequate. Before February 9, 2006, NEXT's privacy policy notices did not disclose to customers that their nonpublic personal information could leave NEXT if the registered representative servicing their account moved to a new firm (First Stip. ¶ 18; Tr. 265-66, 271; DX 10, DX 11). NEXT did not notify customers that they could opt out of this information sharing with successor brokerage firms (First Stip. ¶ 18; DX 10, DX 11).[6]

NEXT Reviews and Implements Regulation
S-P in March and June 2000

NEXT's former chief compliance officer, Karen Eyster (Eyster), was responsible for overseeing the firm's implementation of Regulation S-P (Tr. 233). Eyster reviewed the Proposing Release for Regulation S-P in or about March 2000 (Tr. 261-62). She was generally familiar with NEXT's recruiting practices and knew that the transition team sought and accepted nonpublic personal information about customers, including Social Security numbers and dates of birth, from recruits (Tr. 235, 243-44). Nonetheless, the terms of the Proposing Release did not cause Eyster any concern as they related to the practices of NEXT's transition team (Tr. 287). NEXT did not submit any comments on the proposed regulation (Tr. 284).[7]

In or about June 2000, Eyster reviewed the Adopting Release for Regulation S-P (Tr. 262, 289). The Adopting Release, like the Proposing Release, did not raise any concerns with

---

[6] NEXT changed its privacy policy notice in February 2006 to address these omissions (First Stip. ¶ 20; Tr. 273-75; DX 12). Subsequent versions of NEXT's privacy policy notice contained the same substantive information (DX 13, DX 14; RX 3). The Division does not contend that NEXT committed any primary violations of Regulation S-P after February 2006 (Posthearing Conference of Apr. 8, 2008, at 4).

[7] Eyster could not recall whether NEXT participated in the submission of comments by any industry group (Tr. 284). At the relevant time, NEXT was a member of the Financial Planning Association (FPA). Eyster routinely attended FPA meetings (Tr. 267, 292). FPA submitted comments to the Commission concerning proposed Regulation S-P. See Letter from Duane R. Thompson, FPA's Director of Government Relations, dated March 31, 2000, available at http://www.sec.gov/rules/proposed/s70600/thompso1.htm (official notice). FPA's comments did not alert the Commission to any concerns its members may have had about the application of proposed Regulation S-P in the context of recruiting or transition assistance.

Eyster (Tr. 301). At the relevant times, NEXT did not employ an in-house attorney (Tr. 64, 233). NEXT did not seek advice from an outside attorney regarding the impact of Regulation S-P on its practice of accepting nonpublic customer information from recruits (Tr. 267, 287-88, 290-92, 294, 296). NEXT published privacy policy notices, but did not otherwise alter its policies, practices, or procedures regarding transition services as a result of Regulation S-P (Tr. 184, 282-83).

Between 2000 and 2005, Eyster was responsible for drafting and/or reviewing several iterations of NEXT's written privacy policy notice (Tr. 233, 263-65, 270-71, 274, 280-81). Eyster discussed her draft of an early privacy policy notice with Jeff Auld (Auld), NEXT's president, but insisted that she had final authority as to the wording of the notice (Tr. 266-67, 269, 280-81; DX 10). Eyster, who is not an attorney, did not believe it was necessary to consult with an attorney about these draft privacy policy notices (Tr. 228, 267, 271, 273, 362). These privacy policy notices did not disclose that departing registered representatives who terminated their affiliation with NEXT would be permitted to maintain control over customer nonpublic personal information; nor did the notices offer NEXT customers a reasonable opportunity to opt out of the disclosure of their nonpublic personal information to successor brokerage firms (Tr. 266, 271; DX 10, DX 11). NEXT gave little attention to the exceptions to the notice and opt-out requirements in Regulation S-P, and Eyster did not believe the exceptions applied (Tr. 54, 293-96, 300).

NEXT circulated its written privacy policy notices among its registered representatives and its staff. There is conflicting evidence as to whether NEXT offered these individuals any training about Regulation S-P or about safeguarding customers' nonpublic personal information (Tr. 52-53, 183-84, 351-52, 461-62, 570-71, 608, 671). I credit the testimony that such training was weak or nonexistent before January 2006.

September 2005 to January 2006:
NEXT Feels the Heat

In September 2005, the Commission's Salt Lake City District Office commenced a cause examination of NEXT's books and records (Tr. 106, 324, 376, 873-74). On December 2, 2005, the Commission's staff requested NEXT to provide additional information about its transition team, recruiters, recruits, and recruiting practices (Tr. 376-77, 874; RX 16). In follow-up telephone conversations, NEXT learned that the Commission's staff was concerned about potential violations of Regulation S-P (Tr. 377-79). One week later, NEXT responded to the Commission staff's request (RX 17, RX 17A). NEXT also offered for the staff's consideration its own analysis of the GLB Act and Regulation S-P (RX 17, RX 17A). Outside counsel helped NEXT to draft its response (Tr. 363).[8]

NEXT provided the Commission's staff with raw data about approximately 437 recruits who had resigned from other brokerage firms to join NEXT during 2004 and 2005 (Tr. 132-35, 140, 925; DX 62). NEXT also provided the Commission's staff with files, principally in the

---

[8] NEXT had retained attorney Shane Hansen (Hansen) as its outside counsel well before December 2005 (Tr. 424). However, this was the first time NEXT felt the need to consult outside counsel about Regulation S-P (Tr. 267, 271, 279, 291-92, 362-63).

form of Excel spreadsheets, showing the nonpublic personal information some of these recruits had disclosed to NEXT to expedite the transfer of customer accounts from their current brokerage firms to NEXT (Tr. 875-77; DX 30).

Based on the raw data provided by NEXT, the Commission's staff determined that approximately 160 recruits provided NEXT with nonpublic personal information about their customers before the recruits joined NEXT (Tr. 925-26; DX 62). The Commission's staff also determined that the files these recruits provided to NEXT contained the following information: 36,741 customer Social Security numbers or taxpayer identification numbers; 35,960 customer account numbers; 19,866 customer birth dates; 3,081 customer income levels; 2,807 customer net worth estimates; 1,953 bits of information regarding customer investment experience; 1,810 customer driver's license numbers; 429 instances of customer banking information; and 56 customer tax brackets (Tr. 877-90; DX 61 at 9).[9]

On January 10, 2006, the Commission's Denver Regional Office wrote to NEXT, summarizing three deficiencies and concerns the staff found when it examined NEXT's books and records (DX 65). Only the first of these three deficiencies and concerns—involving possible violations of the GLB Act and Regulation S-P—is addressed in the OIP (DX 65 at 1-4). The Commission's Denver Regional Office urged NEXT to take "immediate corrective action" and to advise it within thirty days of the steps taken to remedy these deficiencies and concerns (DX 65 at 8).

February 2006 to January 2007:
NEXT Sees the Light

NEXT rewrote its privacy policy notice in February, April, and August 2006, and September 2007 (DX 12, DX 13, DX 14; RX 3). The revised notices disclose to customers that: (1) if the registered representative servicing their accounts leaves NEXT, he or she may disclose the customers' nonpublic personal information relating to those accounts to a successor firm; and (2) the customers may opt out of such disclosure to nonaffiliated third parties (First Stip. ¶ 20; Tr. 275-76; DX 12, DX 13, DX 14; RX 3).[10] From February 2006 to the present, a few customers have opted out of having their nonpublic personal information shared if the representative servicing their account leaves NEXT (First Stip. ¶ 20; Tr. 276).

---

[9] Recruits disclosed nonpublic personal information about customers in varying degrees of detail, and NEXT did not typically use all the nonpublic personal information it received (First Stip. ¶¶ 7-8). Perhaps the most unusual item on NEXT's model Excel spreadsheet is the request for customers' passport numbers. There is no evidence that any recruit ever disclosed a customer's passport number to NEXT.

[10] Paragraph II.B.22 of the OIP alleges that these changes to NEXT's privacy policy notice did not occur until June 2006. The record demonstrates that NEXT did not mail its amended privacy notice to its customers until June 2006 (DX 9 at 9). The record is silent as to whether NEXT posted the February 2006 and April 2006 revised privacy policy notices to its web site, or distributed these documents in some other manner that complied with 17 C.F.R. § 248.9.

Between March 9 and August 11, 2006, NEXT declared a moratorium and did not accept customers' nonpublic personal information from recruits due to the concerns expressed by the Commission's staff (Second Stip. ¶ 6; Tr. 244, 408). Instead, NEXT referred recruits to Laser Apps, a vendor whose software allows recruits to complete any customer account transfer documents from the recruit's office, and without NEXT's involvement (First Stip. ¶ 14, Second Stip. ¶ 6; Tr.163-64, 245-46). As an alternative, NEXT advised recruits that they could complete the account transfer forms on their own.

In August 2006, NEXT revised its Excel spreadsheet and the transition team resumed its practice of accepting customers' nonpublic personal information from recruits (Tr. 246; DX 4, DX 16). NEXT no longer asked recruits to disclose customers' Social Security numbers, birth dates, or driver's license numbers (Tr. 104-05, 182, 246-47, 301; DX 9 at 4, DX 17 at 12). However, it still solicited customers' account numbers, banking information, net worth, annual incomes, occupations, names of employers, and office telephone and facsimile numbers (DX 16).

In August 2006, NEXT's transition team also stopped obtaining user identifications and passwords to access the computer system of the recruits' current brokerage firms (First Stip. ¶ 13, Third Stip. ¶¶ 1, 7; Tr. 113-14, 182, 252, 306-07; DX 8 at 11). At the same time, the transition team began to delete customer information provided by recruits shortly after it had pre-populated the necessary account transfer documents (Tr. 121, 303). Such information no longer remained on the NEXT computer system indefinitely (Tr. 114, 121, 182-83, 404-05; DX 8 at 11, DX 17 at 12). Going forward, only NEXT transition team employees would have access to customer nonpublic personal information disclosed by recruits while the information was on the NEXT computer system. NEXT also ceased using customer information provided by recruits to pre-populate its internal databases or to send the information to Pershing in anticipation of a large transfer (First Stip. ¶ 13).

NEXT made several personnel changes during 2006. Gerald Mohr (Mohr), who oversaw the transition team as NEXT's vice president of operations, resigned in June 2006 (Tr. 13-14, 18; DX 9 at 2). Auld, NEXT's president, resigned in August 2006 (Tr. 18; DX 2 at 68). DeMarino, who had supervised the transition team since November 1999, was reassigned to other duties in October or November 2006 (Tr. 91-92, 96). She is now NEXT's vice president of special projects and has "very, very limited" contact with the transition team and recruiters (Tr. 89, 96, 115-16). Eyster, NEXT's chief compliance officer since 1999, became NEXT's chief operating officer in November 2006 (Tr. 229, 232, 423). In her current position, Eyster oversees both the compliance office and, indirectly, the transition team (Tr. 229-30).

NEXT still solicits and accepts customers' nonpublic personal information from recruits, if the recruits choose to utilize the NEXT transition team. The information now accepted includes (but is not limited to) names, addresses, telephone numbers, account numbers, and account types (First Stip. ¶ 14; Div. Prop. Find. # 83; Resp. Prop. Find. # 121). I specifically reject Eyster's vague testimony that NEXT further limited its information solicitation policies in late 2006 or early 2007 (Tr. 247, 302-03).

In January 2007, NEXT revised its written supervisory procedures manual (RX 1). The January 2007 manual describes the firm's disclosure obligations to customers under Regulation S-P and is based on guidance provided by the NASD (Tr. 363-65). The December 2004 version of NEXT's supervisory procedures manual did not discuss Regulation S-P (Tr. 349-50; DX 23).

The September 2005 version of NEXT's supervisory procedures manual contained only a brief discussion of Regulation S-P (Tr. 350-51; DX 24). The Division did not ask NEXT to produce evidence of all its written safeguarding policies and procedures, which have been required of covered financial institutions beginning on July 1, 2005.

NEXT Counterattacks

NEXT then began what it described as "an extended dialogue" with the Commission's staff (DX 70 at 3). NEXT met with the Commission's senior staff in January 2007 and submitted a Wells letter in March 2007 (DX 18 at 1). There is no evidence that the Division obtained, or attempted to obtain, an agreement tolling the statute of limitations, 28 U.S.C. § 2462, while this "extended dialogue" continued.

The Wells letter raised four issues (DX 18). First, NEXT claimed that it had no warning because the Commission did not discuss account transfers when it promulgated Regulation S-P in 2000. Second, it argued that the Division's interpretation of Regulation S-P, if embraced by the Commission, would have unintended, adverse consequences for customers. In NEXT's view, the Division's interpretation would inject significant delays into the account transfer process, which is already subject to serious public criticism. Third, NEXT contended that its transition services and related practices fell under two exceptions to the notice and opt-out requirements of the GLB Act and Regulation S-P. It urged the Commission to interpret these exceptions flexibly (i.e., broadly) to avoid these unintended consequences and achieve a pro-consumer result. Finally, NEXT recommended that the Commission revise Regulation S-P to require every broker-dealer to disclose in its privacy policy notice whether customer information may or may not be shared in account transfers when registered representatives change firms.

NEXT also took a more serpentine route to make its position known. In April 2007, NEXT persuaded the Financial Services Institute (FSI) to issue a "Member Briefing" that echoed the points in its Wells submission (DX 70).[11] The trade press also portrayed NEXT's position sympathetically.[12]

---

[11] FSI describes itself as an advocacy organization for independent broker-dealers and their registered representatives (DX 69 at 3). It was organized in January 2004. Many of the independent broker-dealers who founded FSI were previously members of the FPA—an organization that submitted comments during the rulemaking proceeding that led to the promulgation of Regulation S-P. See supra note 7. Two of the attorneys who represent NEXT in this proceeding prepared FSI's Member Briefing (Tr. 725-26; DX 70 at 13).

[12] See, e.g., Bruce Kelly, "FSI Wants SEC To Change Its Privacy Rule," Investment News (May 7, 2007) ("The SEC's pursuit of a Regulation S-P case, the first of its kind, against NEXT . . . has galvanized the [privacy] issue for independent-contractor broker-dealers."); Halah Touryalai, "You Can Take Them With You (But It's Not As Easy As You Think)," Registered Rep. (Sept. 1, 2007) ("[S]witching b/ds just became near impossible thanks to fallout from a routine (sic) audit of NEXT. . . [T]he whole mess has the potential to leave a lot of clients in limbo, and slow down the transition process . . .").

March 2008: The Commission Proposes
Amendments to Regulation S-P

The Commission recently proposed amendments to Regulation S-P. Regulation S-P: Privacy of Consumer Financial Information and Safeguarding Personal Information, 73 Fed. Reg. 13692 (Mar. 13, 2008).[13] The public comment period closed on May 12, 2008.

The proposed amendments to Rules 15 and 30(a) of Regulation S-P are potentially relevant to this proceeding. First, the proposed amendments to Rule 30(a) of Regulation S-P set forth more specific requirements for safeguarding information and broaden the scope of the information covered by the safeguarding provision of Regulation S-P. The proposed amendments to Rule 30(a) also require each institution subject to the safeguarding rule to develop, implement, and maintain a comprehensive information security program.

Second, the Commission proposed to add a new exception from the notice and opt-out provisions of Regulation S-P. Rule 15 of Regulation S-P would be amended to permit limited disclosure of customer information when a registered representative of a broker or dealer, or a supervised person of a registered investment adviser, moves from one brokerage or advisory firm to another. In contrast to the approach the Commission followed during 2000 (RX 14 at 40-41), this proposal would create a new regulatory exception that does not correspond directly to a statutory exception found in the text of Subtitle A of Title V of the GLB Act.

The Commission explained that the proposed amendment to Rule 15 "is designed to provide an orderly framework under which firms with departing representatives could share certain limited customer contact information and could supervise the information transfer." 73 Fed. Reg. at 13702 n.91 ("We . . . understand that there may be some confusion in the securities industry regarding what information may be disclosed to a departing representative's new firm consistent with the limitations in Regulation S-P, and that at times these limitations may cause inconvenience to investors. . . . [O]ur staff reports that scenarios involving representatives moving from one firm to another continue to create uncertainty regarding firms' obligations under Regulation S-P.").

The new exception, proposed Rule 15(a)(8), would permit one firm to disclose to another the customer's name, a general description of the type of account and products held by the customer, and contact information, including (but not explicitly limited to) the customer's address, telephone number, and e-mail information. 73 Fed. Reg. at 13702. The shared information could not include any customer's account number, Social Security number, or

---

[13] The proposed rulemaking devotes twelve Federal Register pages to discussing the Paperwork Reduction Act, offering a cost-benefit analysis, making an initial Regulatory Flexibility Act analysis, considering the burden on competition and promotion of efficiency, competition, and capital formation, and addressing the Small Business Enforcement Fairness Act. See 73 Fed. Reg. at 13704-16. In contrast, the March 2000 Proposing Release devoted four Federal Register pages to these issues, see 65 Fed. Reg. at 12366-69, and the June 2000 Adopting Release devoted four Federal Register pages to these issues, see 65 Fed. Reg. at 40359-62. Cf. Chamber of Commerce of the U.S. v. SEC, 443 F.3d 890 (D.C. Cir. 2006); Chamber of Commerce of the U.S. v. SEC, 412 F.3d 133 (D.C. Cir. 2005).

securities positions. The proposed limitation would also clarify that a firm may not require or expect a representative recruited from another firm to bring more information than necessary for the representative to solicit former clients. Id. at 13703. The Commission anticipates that many firms seeking to rely on the new exception would not need to revise their existing privacy policy notices because they already state in the notices that their disclosures of information not specifically described include disclosures permitted by law. In the Commission's view, this would include disclosures made pursuant to the proposed new exception and the other existing exceptions provided in Rule 15 of Regulation S-P. Id. at 13703 n.94.

Proposed Rule 15(a)(8) would not preclude the disclosure of additional information about the customer if the financial institution has provided the customer with a privacy notice describing the disclosure and given the customer a reasonable opportunity to opt out of the disclosure, and the customer has not opted out. Id. at 13703 n.98 (citing 17 C.F.R. § 248.10).

The Commission also discussed the issue of identity theft. With respect to the proposed changes in Rule 30(a), the Commission cited the enhanced risk of identity theft as a reason for strengthening Regulation S-P. Id. at 13694 ("[I]n light of the increase in reported security breaches and the potential for identity theft among the institutions we regulate, we believe that our previous approach, requiring safeguards that must be reasonably designed to meet the [GLB Act's] objectives, merits revisiting."). The Commission also proposed a definition of the term "substantial harm and inconvenience" that "is intended to include harms other than identity theft that may result from failure to safeguard sensitive information about an individual." Id. at 13695 (emphasis added). This contrasts with the Commission's approach to the proposed new exception, Rule 15(a)(8). The Commission identified the absence of a serious risk of identity theft as a reason for eliminating the existing notice and opt-out requirements in Rule 10 of Regulation S-P under certain circumstances. Id. at 13702 ("[T]his particular information . . . would be useful for a representative seeking to maintain contact with investors, but appears unlikely to put an investor at serious risk of identity theft.").

The Commission proposed the new Rule 15(a)(8) exception instead of taking an alternative approach, under which a broker, dealer, or registered investment adviser's privacy notice would have to provide specific disclosure regarding the circumstances under which the firm would share customer information with another firm when a registered representative or supervised person leaves. Id. at 13703. The Commission reasoned that: (1) a description of the disclosures to a departing representative's new firm would be difficult to distinguish from a description of disclosures made for the purposes of third-party marketing under Rules 6(a)(5) and 13 of Regulation S-P; and (2) such disclosure would further complicate already complex privacy notices. Id. Nonetheless, the Commission welcomed comments on potential alternative approaches, including requiring specific disclosure. Id.

DISCUSSION AND CONCLUSIONS

The OIP alleges that NEXT willfully violated Rules 4, 6, 10, and 30 of Regulation S-P, and that it willfully aided and abetted and caused other broker-dealers' violations of Rule 10 of Regulation S-P (OIP ¶¶ II.C.1-.5).

A. Preliminary Issues

Witness Credibility

Deborah Bell, Matthew Jenkins, Jennifer Karaczun, and Denise Nostrom were generally credible witnesses. Mohr, DeMarino, Eyster, Jeffrey Jones, and Wayne Hurley offered generally truthful testimony about background matters, but all five became much more guarded and developed poor memories when the inquiry turned to their personal involvement in NEXT's alleged misconduct. As a result, I have placed heavier reliance on documentary exhibits and the testimony of others when considering the actions of these five witnesses.

The Division urges me not to rely on the testimony of NEXT's two expert witnesses, John Hurley and Lee Pickard (Pickard) (Div. Br. at 47-50; Resp. Br. at 5 nn.8-9). Cross-examination demonstrated several reasons for discounting John Hurley's credentials to offer reliable opinion testimony (Tr. 706-18, 721-31). In contrast, Pickard has previously been accepted as an expert witness in the Commission's administrative proceedings, and the Division does not challenge his credentials. Rather, the Division chides Pickard for offering inadmissible legal opinions. As explained below, I give limited weight to the opinions of both witnesses.

Willfulness

The word "willfully" does not appear anywhere in the text of Title V of the GLB Act. Rather, it appears in Sections 15(b)(4) and 21B(a) of the Exchange Act. In this proceeding, willfulness is relevant to two of the three sanctions identified in the OIP. Before the Commission may impose a registration sanction under Section 15(b)(4) or a civil monetary penalty sanction under Section 21B(a), it must determine that NEXT "willfully violated" or "willfully aided and abetted" a violation of the Exchange Act or the rules and regulations thereunder.[14] The Division does not need to prove willfulness to obtain the third sanction identified in the OIP, a cease-and-desist order. See Jacob Wonsover, 54 S.E.C. 1, 19 & n.47 (1999), aff'd, 205 F.3d 408 (D.C. Cir. 2000).

Several judicial opinions interpreting the federal securities laws have held that willfulness is shown where a person intends to commit an act that constitutes a violation. Under this precedent, there is no requirement that the actor also be aware that he is violating any statutes or

---

[14] Congress granted the Commission authority to enforce Subtitle A of Title V of the GLB Act, as well as its implementing regulations, against brokers and dealers "under the Securities Exchange Act." See 15 U.S.C. § 6805(a)(3). I conclude that a violation of Regulation S-P by a broker is a violation of a rule "under the Securities Exchange Act."

Paragraph III.B of the OIP requires me to determine whether a remedial sanction is appropriate under Section 15(b) of the Exchange Act. However, the Division has stipulated that it does not seek any sanction under Section 15(b) (Prehearing Conference of Nov. 7, 2007, at 7; Order of Nov. 7, 2007). I infer that the OIP invokes Section 15(b) of the Exchange Act as a jurisdictional tool to permit the imposition of a civil monetary penalty sanction under Section 21B of the Exchange Act. Accordingly, for purposes of this proceeding, the issue of willfulness is relevant only to the proposed civil monetary penalty sanction.

regulations. See, e.g., Wonsover v. SEC, 205 F.3d 408, 413-15 (D.C. Cir. 2000); Arthur Lipper Corp. v. SEC, 547 F.2d 171, 180 (2d Cir. 1976); Tager v. SEC, 344 F.2d 5, 8 (2d Cir. 1965).

NEXT relies on a different definition of "willfully," arising from Safeco Ins. Co. of Am. v. Burr, 127 S. Ct. 2201, 2208-10 (2007), a recent U.S. Supreme Court opinion interpreting the Fair Credit Reporting Act (FCRA). It argues that pre-Safeco case law interpreting the word "willfully" under the federal securities laws is no longer valid. NEXT urges me to hold that Safeco's definition of the term "willfully," when used in any statute creating civil liability (including administrative proceedings under the federal securities laws), covers only knowing and reckless violations of a standard of care.

The FCRA requires that any person who takes any adverse action with respect to any consumer that is based on any information contained in a consumer report must notify the affected consumer. See 15 U.S.C. § 1681m(a). The notice must point out the adverse action, explain how to reach the agency that reported on the consumer's credit, and tell the consumer that he can get a free copy of the report and dispute its accuracy with the agency. Id. The FCRA provides a private right of action against businesses that use consumer reports, but fail to comply. A negligent violation of the notice provision entitles the affected consumer to actual damages. See 15 U.S.C. § 1681o(a). A willful violation permits the consumer to seek actual or statutory damages, as well as punitive damages. See 15 U.S.C. § 1681n(a).

Safeco involved challenges to the failure of two insurance companies to provide the adverse action notifications required by the FCRA. In its opinion, the Supreme Court read the statutory language "willfully fails to comply" as reaching reckless FCRA violations. See Safeco, 127 S. Ct. at 2208-10. It rejected the insurance companies' argument that Congress's use of the term "willfully" limited liability under 15 U.S.C. § 1681n(a) to knowing violations. Id. at 2210.

The construction set forth in Safeco "reflects common law usage, which treated actions in 'reckless disregard' of the law as 'willful' violations . . . and . . . the general rule that a common law term in a statute comes with a common law meaning, absent anything pointing another way . . ." Id. at 2208-09. However, the Supreme Court cautioned that "willfully" is a "word of many meanings whose construction is often dependent on the context in which it appears." Id. at 2208.

As explained in Wonsover, 54 S.E.C. at 18-20, there is language in the Exchange Act "pointing another way." Section 21B(a) of the Exchange Act authorizes the Commission to impose one of three tiers of civil monetary penalties in any proceeding under Sections 15(b)(4)(D)-(E) of the Exchange Act if it finds that a person has "willfully violated" or "willfully aided and abetted" a violation of certain statutes, rules, or regulations. The first tier of penalties may be imposed for any "willful" violation. The second and third tiers can be imposed only upon a person who acted "willfully" and with intent to defraud or with "deliberate or reckless disregard of a regulatory requirement." Section 21B could not be clearer that, as used in the federal securities laws, "willful" means something other than involving "deliberate or reckless disregard of a regulatory requirement."

The federal courts have not applied Safeco's interpretation of "willfulness" as expansively as NEXT believes it should be. Thus, while one court has embraced Safeco's analysis in a non-FCRA context, see In the Matter of Seagate Tech., LLC, 497 F.3d 1360, 1371 (Fed. Cir. 2007) (en banc) (holding that willful infringement under the Copyright Act requires at

least a showing of objective recklessness), two courts have declined to apply Safeco to another statutory scheme, see Lumber Jack Bldg. Ctrs. v. Alexander, 536 F. Supp. 2d 804, 808 (E.D. Mich. 2008) (holding that Safeco does not apply to willful violations of the Gun Control Act of 1968); Armalite, Inc. v. Lambert, 512 F. Supp. 2d 1070, 1073 (N.D. Ohio 2007) (same). I have not located any judicial opinions, and the parties have not cited any, in which a court has applied Safeco's definition of willfulness in the context of a Commission enforcement action.

I conclude that the Commission's analysis of the word "willfulness" in Wonsover, 54 S.E.C. at 17-21, as affirmed by the U.S. Court of Appeals for the District of Columbia Circuit, 205 F.3d at 413-15, remains the appropriate analysis to be followed in administrative enforcement proceedings under the federal securities laws. I further conclude that NEXT acted "willfully" within the meaning of Wonsover.

To Establish a Primary Violation of Regulation S-P, the Division Must Show That a Covered Financial Institution Acted Negligently

The parties disagree about the state of mind required to demonstrate a primary violation of Regulation S-P. The Division argues that a policy of strict liability should be applied (Tr. 948; Div. Reply Br. at 3-4). NEXT contends that Regulation S-P requires a showing of scienter, and asserts that it lacked the required mental state (Respondent's Pre Trial Brief at 15-16; Resp. Br. at 32-34, 36 n.72).

It is the prosecution's burden to prove all the elements of an offense. The required mental state is not an affirmative defense, as to which a respondent bears the burden of proof. The Division offers no analysis to support its strict liability argument.[15] It merely asserts that the federal securities laws contain numerous strict liability provisions. The GLB Act is as much a federal banking law, a federal trade law, and a state insurance law as it is a federal securities law. See 15 U.S.C. §§ 6805(a)(1)-(7). There is no evidence about strict liability provisions in those statutes. I have reviewed the text of Regulation S-P and I conclude that it fails to support the Division's claim that the Commission drafted Regulation S-P as a strict liability provision. As illustrations:

- Rule 2(a): This rule of construction emphasizes the need to examine "the facts and circumstances of each individual situation" to determine if a financial institution is complying with Regulation S-P;

[15] The Division asserted its strict liability theory late in the proceeding, as it has done in the past. Cf. KPMG Peat Marwick LLP, 55 S.E.C. 1, 11 n.15 (2001) ("We recognize that the Division first made the strict liability argument in its post-hearing submission to the law judge."). Ten months ago, the members of the Commission disagreed about whether negligence or scienter should be necessary to support a violation of new Rule 206(4)-8 under the Investment Advisers Act of 1940. See Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. 44756, 44759-61 (Aug. 9, 2007) (Comm'r. Atkins, concurring). The state of mind issue is obviously a "hot topic" at the Commission. The call for strict liability requires more than showing it would simplify things for the prosecution.

- Rule 3(v)(1): "Publicly available information" is defined to mean information a financial institution "reasonably believe(s)" is lawfully made available to the general public from certain sources;

- Rule 4(e): In certain circumstances, a financial institution may provide initial notice "within a reasonable time" after establishing a customer relationship;

- Rule 7(e): A financial institution must comply with a consumer's opt-out direction "as soon as reasonably practicable" after the financial institution receives it;

- Rule 10(a)(1)(iii): A financial institution must give the consumer "a reasonable opportunity" to opt out of disclosure; and

- Rule 30(a): A financial institution's safeguarding policies and procedures must be "reasonably designed" to accomplish certain statutory objectives. Among other things, they must protect against unauthorized access that could result in "substantial harm or inconvenience" to any customer.

Each of these provisions requires the Commission to consider the totality of the circumstances. In each instance, the Division must prove by the weight of the evidence that a financial institution behaved unreasonably, i.e., at least negligently.

The text of Title V of the GLB Act refutes NEXT's claim that the Division must demonstrate scienter in order to prevail. Subtitle B of Title V of the GLB Act, captioned Fraudulent Access to Financial Information, provides administrative and criminal remedies for pretexting, i.e., the use of false pretenses to obtain or solicit consumers' personal financial information. Thus, Sections 521(a) and (b) of the GLB Act prohibit persons from obtaining, requesting a person to obtain, or disclosing customer information of a financial institution relating to another person by making certain "false, fictitious, or fraudulent statement(s)" or by providing any document to a financial institution, "knowing that the document is forged, counterfeit, lost, or stolen, was fraudulently obtained, or contains a false, fictitious, or fraudulent statement or representation." To establish a criminal violation under Section 523 of the GLB Act, a person must "knowingly and intentionally" violate or attempt to violate Section 521 of the GLB Act.

The presence of the terms "knowingly and intentionally" in Subtitle B of Title V contrasts with their absence from Subtitle A of Title V. When Congress wanted to impose a scienter requirement in Title V of the GLB Act, it did so.

The Existing Exceptions in Rule 14 and Rule 15 of Regulation S-P Do Not Apply Here

NEXT argues that the conduct at issue in this proceeding is covered by certain exceptions to the notice and opt-out requirements of Regulation S-P. The parties agree that this is an affirmative defense, as to which NEXT bears the burden of proof (Tr. 8).

This affirmative defense is plainly a lawyerly afterthought. No one at NEXT paid much attention to Rules 14 and 15 of Regulation S-P between 2000 and 2005 (Tr. 54, 293-96, 300). In

fact, NEXT raised the exceptions for the first time in December 2005, when outside counsel helped Eyster to draft a response letter to the staff of the Commission's Salt Lake City District Office (Tr. 363; RX 17, RX 17A). In answering the OIP, NEXT again omitted any mention of the exceptions in Rules 14 and 15.[16] Pickard, one of NEXT's expert witnesses, addressed the exceptions in his direct written testimony, dated November 15, 2007 (Pickard Report). However, it was not until the eve of the hearing that NEXT finally amended its Answer to assert the exceptions as an affirmative defense (Prehearing Conference of Nov. 29, 2007, at 18-20; Second Amended Answer, filed Dec. 3, 2007; Tr. 8).

The Division makes the common-sense observation that, if the existing exceptions in Rules 14 and 15 already covered the type of conduct at issue in this proceeding, there would have been no need for the Commission to propose a new exception, Rule 15(a)(8), in March 2008. When the Commission sought comments on proposed Rule 15(a)(8), it stated that it was considering a new exception, not clarifying an existing exception. NEXT belatedly agrees with the Division on this point.[17]

A review of the text of the GLB Act and Rules 14 and 15 demonstrates that NEXT's expansive reading of the existing exceptions lacks merit.

NEXT initially relies on Rule 14(a)(1) of Regulation S-P, which corresponds to Section 502(e)(1)(A) of the GLB Act. This provision excepts disclosures of nonpublic personal information as necessary to effect, administer, or enforce a transaction that a consumer requests or authorizes, or in connection with processing or servicing a financial product or service that a consumer requests or authorizes.

The record does not show that any consumer explicitly requested or authorized any such transaction. Nor did any consumer explicitly request a registered representative to transfer nonpublic personal information in connection with the registered representative's proposed change of brokerage firms. In fact, because consumers were not given notice of the transfer of nonpublic personal information, there is no way consumers could have requested the transfer of nonpublic personal information. Nonetheless, NEXT argues that ongoing customer-registered representative relationships can be interpreted as implicit requests for "continuous service" (Resp. Br. at 20 n.29). The exception is written in the singular: it refers to "a" transaction that "a" consumer requests or authorizes. NEXT cannot remake this language as if it had been written in the plural, and as if it meant that all ongoing customer-registered representative relationships necessarily imply requests for continuous service by all customers in all

---

[16] Hansen, the attorney who helped Eyster to draft RX 17 and RX 17A in December 2005, did not sign NEXT's original Answer to the OIP.

[17] NEXT submitted a comment letter in the pending rulemaking, requesting that the Commission stay the adoption of proposed Rule 15(a)(8) until such time as the present proceeding is fully adjudicated. NEXT argues that proposed Rule 15(a)(8) will be unnecessary if the Commission determines that the existing exceptions to Regulation S-P should be interpreted in the manner NEXT suggests. <u>See</u> Letter of May 12, 2008, from Bruce R. Moldovan, General Counsel, NEXT, to Secretary of the Commission, available at http://www.sec.gov/rules/proposed/comments/s70608.pdf (official notice).

circumstances. This argument also ignores the facts. The customers who dealt with the recruits who testified did not have discretionary accounts. Many followed a buy-and-hold strategy, and some communicated with their registered representatives infrequently.

NEXT also invokes Rule 15(a)(6) of Regulation S-P, which corresponds to Section 502(e)(7) of the GLB Act. This provision excepts disclosure of nonpublic personal information "in connection with a proposed or actual sale, merger, transfer, or exchange of all or a portion of a business or operating unit if the disclosure of nonpublic personal information concerns solely consumers of such business or unit." NEXT reasons that this proceeding involves the proposed transfer of a portion of one brokerage firm's business (i.e., the business of the representative who is leaving the firm) to another brokerage firm.

Under Regulation S-P, the consumer whose nonpublic personal information is being disclosed is a consumer of the brokerage firm; not a consumer of the registered representative who anticipates resigning from the brokerage firm (RX 14 at 16 n.70) ("a broker-dealer's consumer is not considered a consumer of the broker-dealer's agent"). A registered representative who is not him- or herself a separate financial institution does not have customer relationships within the meaning of Rule 3(k)(2)(i)(A) of Regulation S-P. See 17 C.F.R. § 248.3(k)(2)(i)(A). Such an individual lacks the standing to initiate a proposed transfer of one brokerage firm's business to another brokerage firm.[18]

Finally, NEXT points to Rule 15(a)(2)(v) of Regulation S-P, which corresponds to Section 502(e)(3)(E) of the GLB Act. This provision excepts disclosure of nonpublic personal information to persons acting in a fiduciary or representative capacity on behalf of the consumer.[19] NEXT argues that the transitioning representative is a fiduciary and that, once

---

[18] Three representatives who testified for the Division joined NEXT because they were dissatisfied with their prior brokerage firms (Tr. 452, 485, 624). I conclude that the Rule 15(a)(6) exception did not apply in these three instances. Two other representatives who testified for NEXT joined NEXT because their prior brokerage firm ceased to exist. Main Street Management Company (MSM) was wholly-owned by The Phoenix Companies, Inc., until June 2004, at which point it was acquired by Linsco/Private Ledger Corp. (LPL) (Tr. 535, 577; DX 60 at 142).

MSM encouraged its representatives to expedite their transition either to LPL or another broker-dealer and transfer their licenses and customer accounts before the transaction closed (RX 22). These two representatives present a closer case for applying the Rule 15(a)(6) exception. Their disclosure of nonpublic personal information to NEXT was a consequence of the sale of MSM's business to LPL and an ancillary side-effect of the sale. However, without more detail about the nature of the transaction, it is difficult to conclude that the two representatives' disclosure of nonpublic personal information to NEXT occurred "in connection with" the sale. On that basis, I conclude that NEXT has failed to sustain its affirmative defense. Nonetheless, I have given very limited weight to the conduct of these two representatives in determining whether non-party MSM violated Regulation S-P.

[19] NEXT raised this argument for the first time through Pickard's direct written testimony (Pickard Report at 8). NEXT did not address Rule 15(a)(2)(v) in Eyster's December 2005 letter to the Commission staff (RX 17, RX 17A), in its Wells submission (DX 18), or in its original

nonpublic personal information has flowed to the representative, it may go beyond the representative without restriction. I disagree. The exception governs disclosure to nonaffiliated third parties who are fiduciaries. It does not apply to fiduciaries who do not qualify as nonaffiliated third parties. Registered representatives may or may not be fiduciaries. However, as long as representatives who are recruits remain associated with their current firms, they cannot be considered nonaffiliated third parties within the definition of Rule 3(s)(1) of Regulation S-P. I read the exception as meaning that the receiving firm must be a fiduciary if the disclosing firm is to benefit from Rule 15(a)(2)(v). When a recruit discloses nonpublic personal information to the receiving brokerage firm, the receiving firm does not yet have a customer relationship, much less a fiduciary relationship, with the consumers of the original brokerage firm (Tr. 814-15). In any event, it is difficult to think that NEXT could characterize itself as a fiduciary while it was surreptitiously obtaining recruits' computer passwords and user identifications, impersonating the recruits, and extracting customer data from the computer systems of the recruits' current brokerage firms.

NEXT offers no persuasive reason why the Commission should read the existing exceptions in Rules 14 and 15 broadly and read Rule 10, which provides customers with "plain English" disclosure and an opt-out opportunity, narrowly. All that is really necessary in a privacy policy is a short explanation of the firm's policy relating to departing representatives. NEXT now gets the job done in one page, and the Division does not argue that NEXT's current privacy policy notices are inadequate (DX 12-DX 14, RX 3). NEXT does not assert that it is burdensome to prepare these notices, that the level of detail confuses its customers, or that the resulting documents are too lengthy. Because NEXT does not engage in any joint marketing agreements, there is little likelihood that its customers will confuse its disclosure of joint marketing agreements with its disclosure of transitioning representatives. The record suggests two probable reasons for a broad reading of the existing exceptions in Rules 14 and 15. First, "plain English" disclosure under Rule 10, as urged by the Division, will result in a customer opt-out rate that is unacceptably high to many independent contractor registered representatives. Second, a brokerage firm making "plain English" disclosure will incur administrative costs in tracking customers who opt out. Such costs could be avoided if the exceptions in Rules 14 and 15 were to be interpreted broadly. These are not sound public policy reasons for allowing the exceptions in Rules 14 and 15 to swallow the general practice in Rule 10. I conclude that the existing exceptions in Rule 14 and Rule 15 of Regulation S-P do not apply here.

The Exchange Act Does Not Recognize a Legitimate
Distinction Between "Independent" Brokerage
Firms and "Wirehouse" Brokerage Firms

Quite apart from Regulation S-P, there is a separate, longstanding dispute between some brokerage firms and their registered representatives about who "owns" the customer relationship when a representative resigns from one firm to associate with another. NEXT revives that dispute here, as a significant part of its defense.

Answer to the OIP. FSI did not address Rule 15(a)(2)(v) in its April 2007 Member Briefing (DX 70 at 9-12). See supra p. 17.

NEXT describes itself as an independent brokerage firm and views its registered representatives as independent financial advisers. It characterizes its registered representatives as independent contractors, not employees. Many of NEXT's registered representatives maintain their offices at remote locations, far from Houston. Many also engage in some type of business activities outside the firm, such as selling insurance or providing tax advice. NEXT distinguishes the independent brokerage firm from the wirehouse, a brokerage firm that maintains a sales force of "captive" employees. Most of NEXT's recruits come from other independent brokerage firms (DX 2 at 68).

NEXT paints a bleak picture of life under the independent contractor business model. As NEXT describes its segment of the brokerage industry, many independent contractor registered representatives are nomads, associating with one independent brokerage firm after another. According to NEXT, independent contractor registered representatives do so, not out of a crass motivation for a bigger payday, but rather, to achieve better service at lower cost for customers. Independent contractor registered representatives anticipate, without even asking customers, that most customers will want to follow them when they change brokerage firms. Finally, independent contractor registered representatives fear retaliation from their current brokerage firms. If the current firm knew that the representative was planning to jump ship, the current firm might impede the transfer of customer accounts to the new firm, or delay in paying commission income already earned.

According to NEXT, the registered representatives believe they, not the brokerage firms, have the primary relationship with customers under the independent contractor business model. In this setting, the registered representatives treat customers' nonpublic personal information as if it were their responsibility and not the firm's. NEXT argues that independent contractor registered representatives transitioning from one independent brokerage firm to another independent brokerage firm do not really "take" customer nonpublic personal information with them. Rather, independent contractor registered representatives "keep" customer nonpublic personal information already in their possession, and merely change business cards, letterhead stationery, and the sign above the office door.[20]

There is no merit to this metaphysical distinction, as it is applied to Regulation S-P. The departing representative has no property right to a customer's nonpublic personal information. Moreover, the GLB Act places the duty to protect the customer's financial privacy and to safeguard the customer's records and information on the covered financial institution, not the individual representative. If a brokerage firm permits its transitioning representatives to disclose customer nonpublic personal information to successor brokerage firms, Regulation S-P requires the brokerage firm to inform customers that this disclosure could occur. The brokerage firm must also provide customers a reasonable opportunity to opt out of the disclosure. The longstanding dispute about whether the brokerage firm or the registered representative "owns" the customer relationship is irrelevant. Customers have the freedom to choose the registered

[20] The record fails to support the purported distinction between a departing representative who "takes" nonpublic personal information and one who merely "keeps" such information. Mohr testified that "there were no restrictions to what reps could take off the Pershing system" when they resigned from NEXT (Tr. 49). Incoming recruits also accessed and downloaded information from clearing firms and other account information custodians. See supra pp. 10-11.

representatives and firms that service their brokerage accounts. See NASD Notice to Members 01-36 (June 2001); NASD IM-2110-7 (Dec. 21, 2001). Under Rule 10 of Regulation S-P, and in the absence of an exception, the customer has the right to control access to nonpublic personal information associated with his or her account.

NEXT's own experts acknowledge that the federal securities laws do not recognize the purported distinction between independent contractor brokerage firms and wirehouses (Tr. 731-32, 793). NEXT also concedes that the term "wirehouse" lacks a legal or industry definition (Tr. 829). For more than twenty-five years, the Commission's staff,[21] the Commission,[22] self-regulatory organizations,[23] and the federal courts[24] have rejected the notion that independent contractor brokerage firms should be regulated differently from other brokerage firms under the Exchange Act. In effect, NEXT is asking the Commission to abandon a quarter century of precedent and recognize that there is a legitimate distinction between registered representatives who are employees of a brokerage firm versus those who are independent contractors and are "merely" affiliated with a brokerage firm.

The flaw in this logic is evident, because Section 15(c)(3) of the Exchange Act requires registered brokers to comply with the Commission's regulations with respect to financial responsibility and related customer protective practices. Independent contractor registered

---

[21] Self-Regulatory Organizations: New York Stock Exchange, Inc., 71 Fed. Reg. 36380, 36382 & n.18 (June 26, 2006) (delegated authority rule approval by the Commission's Division of Market Regulation) ("[T]he Commission reiterates its longstanding position that the designation of an independent contractor has no relevance for purposes of the securities laws."); Letter to Gordon S. Macklin, NASD, from Director, Division of Market Regulation, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. ¶ 77,303 (June 18, 1982).

[22] Quest Capital Strategies, Inc., 55 S.E.C. 362, 372-73 (2001) ("A firm cannot permit its ability to supervise effectively to be negated or impeded by an 'independent contractor' whose right to engage in the securities business depends on affiliation with a registered firm charged with the duty to supervise."); Meritquest Group, Inc., 51 S.E.C. 223, 225 (1992); William V. Giordano, 61 SEC Docket 453, 458 (Jan. 19, 1996) (settlement order); cf. Raymond James Fin. Serv., Inc., 86 SEC Docket 711, 775 n.71 (Sept. 15, 2005) (ALJ), final, 86 SEC Docket 2274 (Nov. 21, 2005).

[23] Dept. of Market Regulation v. Yankee Fin. Group, Inc., 2006 NASD Discip. LEXIS 21, at *64 (Aug. 4, 2006) ("The notion that a broker-dealer might escape responsibility for the actions of its registered representatives by virtue of such representatives' so-called status as 'independent contractors' is antithetical to the whole purpose of the broker-dealer registration and supervision requirements."), sustained in part and remanded in part on other grounds sub nom., Richard F. Kresge, 90 SEC Docket 3072 (June 29, 2007); NASD Notice to Members 86-65, Compliance with the NASD Rules of Fair Practice in the Employment and Supervision of Off-Site Personnel (DX 71).

[24] Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1574 (9th Cir. 1990) (en banc) ("The broker-dealer's ability to deny the representative access to the markets gives the broker-dealer effective control over the representative at the most basic level.").

representatives do not affiliate with registered brokerage firms as a matter of choice, but rather, because they cannot or will not post the necessary capital to register as brokerage firms on their own.

A natural person selling securities must be registered with the Commission as a broker or a dealer under Section 15(a) of the Exchange Act, unless that person is an associated person as defined in Section 3(a)(18) of the Exchange Act. These two categories encompass the universe of persons engaged in the purchase or sale of securities. The term "independent contractor" does not appear either in the Exchange Act's definition of associated person in Section 3(a)(18) or elsewhere; thus, denoting a salesperson as an independent contractor does nothing to resolve the status under the Exchange Act of a given individual. The critical question is whether a so-called independent contractor's activities are subject to control by a broker or dealer within the scope of Section 3(a)(18). Without that control relationship, the salesperson must be registered individually as a broker or dealer.

The presumption that an independent contractor, by definition, cannot be subject to the control of an employer broker or dealer is incorrect. Contractual terms that attempt to limit broker or dealer liability for the acts of such persons under the federal securities laws are of no effect. To the extent that a brokerage firm forms a relationship with an independent contractor, that firm is responsible for either (1) ensuring that the independent contractor is registered as a broker or dealer; or (2) assuming the supervisory responsibilities attached to a relationship with an associated person.

While NEXT may treat its registered representatives as independent contractors for purposes other than the federal securities laws, such treatment cannot alter the representative's status or NEXT's responsibilities under the federal securities laws and Regulation S-P. The same is true for the non-party brokerage firms whose registered representatives become NEXT recruits. These recruits are bound by their prior firm's privacy policies until they resign from the prior firm. They are bound by NEXT's privacy policy once they become associated with NEXT.

Industry Custom and Practice Is a Relevant Factor, but Not the Controlling Factor

There are no standards or consistent industry practices for the recruitment of registered representatives in the independent broker channel (Tr. 707-08). Nonetheless, NEXT maintains that it is common practice for independent brokerage firms to provide their recruits with the sort of transition assistance it provided here (Tr. 60-61; RX 4-RX 9). It insists that many independent brokerage firms also permit their departing representatives to disseminate customer nonpublic personal information when these representatives join successor brokerage firms (Tr. 60-61, 256, 369-70; direct written testimony of John Hurley at 7-9 (Hurley Report)). NEXT also contends that, during 2004 and 2005, almost no brokerage firms had privacy policies containing the disclosure and opt-out language that the Division argues is required by Regulation S-P.[25]

---

[25] Division Exhibits 60 and 60A contain scores of privacy policy notices issued by NEXT's peers. However, only the notices prepared by LPL and Raymond James Financial Services, Inc., offer the level of disclosure the Division insists is mandatory under Rule 10 of Regulation S-P (DX 60 at 135-40, 197-201A; DX 60A at 337-38, 355-56).

NEXT further demonstrates that several large broker-dealers entered into a "Protocol for Broker Recruiting" (Protocol), beginning in August 2004 (RX 11). Under the Protocol, signatories agree not to sue one another for recruiting one another's registered representatives, if the representative takes only limited customer information to another participating firm and if the receiving firm does not engage in "raiding," an undefined term (Tr. 393; RX 11). The information the representative may take consists of each customer's name, mailing address, telephone number, e-mail address, and the account title. Registered representatives are prohibited from taking any other documents or information. Resignations must be in writing and must include a copy of the customer information that the registered representative is taking to the new firm. The information may be used at the representative's new firm only by the representative, and only for the purpose of soliciting the representative's former customers.

Based on this evidence, NEXT offers three defenses: first, it contends that the industry standard is not to provide the type of Rule 10 disclosure the Division insists is mandatory; second, it complains that, if the Division's interpretation is correct, the Protocol signatories are violating Regulation S-P and the Commission should be prosecuting them (Hurley Report at 11-12; Tr. 767; Resp. Br. at 23-24); and third, it argues that, if the Division's interpretation is correct, widespread confusion in the industry makes it preferable for the Commission to address the issue through rulemaking, rather than adjudication (DX 18 at 15, DX 69 at 6-7; Resp. Br. at 4 n.5).

I do not agree that NEXT has demonstrated the existence of an industry standard.[26] However, even if it had done so, the existence of an industry standard is merely a relevant factor, not a controlling factor, in determining the standard of care. See Monetta Fin. Servs., Inc., v. SEC, 390 F.3d 952, 956 (7th Cir. 2004) (citing SEC v. Dain Rauscher, Inc., 254 F.3d 852, 856-57 (9th Cir. 2001)); Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 135 F.3d 266, 274 (3d Cir. 1998) ("Even a universal industry practice may still be fraudulent."); Piper Capital Mgmt, Inc., 56 S.E.C. 1033, 1049 & nn.28-29 (2003); Fundamental Portfolio Advisors, Inc., 56 S.E.C. 651, 679-80 & n.45 (2003) (rejecting the claim that conduct was not reckless because it was consistent with industry practice).

Protocol signatories cannot place themselves beyond the reach of Regulation S-P by signing a contract. There is no evidence in this record demonstrating that the Protocol signatories ever obtained a "no action" letter from the Commission's staff, immunizing themselves from possible enforcement action under Regulation S-P. In these circumstances, the permissive sharing of information between contracting brokerage firms does not supersede the GLB Act right of customers to opt out from the sharing of their nonpublic personal information.

However, NEXT has not demonstrated that the Division is ignoring clear violations of Regulation S-P by Protocol signatories. The fact that one Protocol signatory promises not to sue another Protocol signatory if it releases customer-related information does not establish a per se

[26] There are few reported judicial opinions discussing the Protocol. However, one court has held that the Protocol is not evidence of an industry standard, because it applies only to those firms who sign it, and because it includes an opt-out provision that allows signatories to withdraw. See Hilliard v. Clark, 2007 U.S. Dist. LEXIS 64792, at *18 (W.D. Mich. Aug. 31, 2007).

violation of Regulation S-P. I assume that some, if not all, of the customer contact information transferred between Protocol signatories is nonpublic personal information. Nevertheless, before a violation of Regulation S-P could be proven, it would be necessary to determine whether the releasing firm's privacy policy informs customers of its disclosure practices and provides them a reasonable opportunity to opt out of the disclosure. This analysis must be done on a case-by-case basis.[27] Any decision to investigate possible violations of Regulation S-P by Protocol signatories rests in the prosecutorial discretion of the Division, and is not reviewable in this proceeding. Cf. Michael Markowski, 51 S.E.C. 553, 559 n.23 (1993) (discussing the criteria for showing impermissible selective prosecution), aff'd, 34 F.3d 99 (2d Cir. 1994).

Now that NEXT has stopped soliciting and accepting Social Security numbers, dates of birth, and driver's license numbers, it contends that the Protocol signatories are sharing "virtually the same information" as NEXT solicits through its model Excel spreadsheet (Resp. Prop. Find. # 131; Resp. Br. at 8 n.15, 23). This expansive reading of the Protocol represents wishful thinking on NEXT's part. Protocol signatories allow departing representatives access to account titles (i.e., John Doe and Jane Doe, JTWROS; Jane Doe IRA), but not account numbers, customer net worth, customer annual income, or the numerous other categories of customer nonpublic personal information NEXT continues to seek through DX 16.

Finally, it is settled law that the Commission has the discretion to establish policy either through adjudication or rulemaking. See NLRB v. Bell Aerospace Co., 416 U.S. 267, 294 (1974); SEC v. Chenery Corp., 332 U.S. 194, 202-03 (1947); Encyclopaedia Britannica, Inc. v. FTC, 605 F.2d 964, 974 (7th Cir. 1979) (holding that an agency has the power to act against one firm practicing an industry-wide illegal practice and must be accorded wide latitude in its enforcement strategy); Chasins v. Smith, Barney & Co., 438 F.2d 1167, 1171 (2d Cir. 1971) ("Even where a defendant is successful in showing that it has followed a customary course in the industry, the first litigation of such a practice is a proper occasion for its outlawry if it is in fact a violation."); Irfan Mohammed Amanat, 89 SEC Docket 714, 728 n.41 (Nov. 3, 2006), aff'd, 2008 U.S. App. LEXIS 5716 (3d Cir. Mar. 17, 2008). The Commission has already determined that there may be some confusion and uncertainty in the securities industry as to the requirements of Regulation S-P. See supra p. 18. That is a factor to consider in sanctioning, in the event that liability is established. See Arthur Lipper, 547 F.2d at 182-84.

NEXT's Outbound Representatives and NEXT's Inbound
Recruits Were Acting Within the Scope of Their Agency

NEXT contends that any misconduct in this proceeding is attributable to independent contractor registered representatives who were acting beyond the scope of their agency. Assuming arguendo that outbound representatives of NEXT disclosed nonpublic personal information about customers to nonaffiliated third parties without the customer's consent (or

---

[27] A few Protocol signatories have made an effort to revise their privacy policies to notify customers of Protocol participation and generally to explain how it may affect customers (Tr. 827, 942; RX 12B, RX 12F, RX 12I, RX 12L). Other signatories to the Protocol have not changed their privacy policies (e.g., RX 12A, RX 12C, RX 12D). The issue of whether these privacy policy notices comply with Regulation S-P is not before me, and I reach no conclusions on the subject.

notice and opt-out), NEXT argues that the registered representatives were not working on its behalf, were not performing work it assigned, and were not engaged in a course of conduct subject to its control. Rather, these outbound representatives were acting only to benefit themselves and their respective customers, and their conduct should not be attributed to NEXT. Likewise, when recruits who are independent contractors provided nonpublic personal information about customers to NEXT, the recruits were not acting as agents of their current brokerage firms. The Division responds that registered representatives routinely handle customers' nonpublic personal information, and that such duties fall within the scope of their agency.

A principal is subject to direct liability to a third party harmed by an agent's conduct when the agent acts with actual authority or the principal ratifies the agent's conduct and the agent's conduct, if that of the principal, would subject the principal to tort liability. Restatement (Third) of Agency § 7.03(1)(a)(ii) (2006). A principal that is an organization can take action only through its agents, who are typically individuals. An organization's tortious conduct consists of conduct by agents of the organization that is attributable to it. Id. § 7.03, cmt. c.

An agent acts with actual authority when, at the time of taking action that has legal consequences for the principal, the agent reasonably believes, in accordance with the principal's manifestations to the agent, that the principal wishes the agent to so act. Id. § 2.01. Acts that create no prospect of economic advantage for a principal require specific authorization. Id. § 2.02, cmt. h.

Applying these general principles of agency law to the facts of the case, I conclude that NEXT's outbound representatives and inbound recruits were acting within the scope of their agency. The record demonstrates an industry practice among independent brokerage firms that grants departing representatives actual authority to disseminate customer nonpublic personal information to successor brokerage firms (First Stip. ¶¶ 17-18; Hurley Report at 8-9). The parties have stipulated that NEXT permitted its departing representatives to engage in this practice. Registered representatives who disseminated customer nonpublic personal information to successor brokerage firms as part of the transition process reasonably believed that their current brokerage firms had specifically authorized them to do so (Tr. 61, 539-40). Cf. Dohmen-Ramirez v. CFTC, 837 F.2d 847, 858-59 (9th Cir. 1998) (holding that the fact that a principal may not have benefited from an agent's fraud does not preclude a finding that the agent was acting within the scope of his agency) (collecting cases); Rosenthal & Co. v. CFTC, 802 F.2d 963, 969 (7th Cir. 1986) ("The ascription of agency is a purposive, policy-oriented act rather than an exercise in semantics.").

B. NEXT's Primary Liability

The OIP implicitly concedes that NEXT distributed initial and annual privacy policy notices to its customers, as required. The theory of the Division's case is that NEXT's privacy policy notices were deficient until February 2006. The weight of the evidence demonstrates that NEXT willfully violated Rules 4, 6, 10, and 30(a)(1) of Regulation S-P. In committing the violation, NEXT acted at least negligently. The weight of the evidence does not demonstrate that NEXT violated Rule 30(a)(3) of Regulation S-P, or that NEXT violated a duty to encrypt its e-mail traffic with recruits.

Rule 4

Rule 4(a)(1) of Regulation S-P requires a covered financial institution to provide its customers with a clear and conspicuous notice that accurately reflects its privacy policies and practices. See 17 C.F.R. § 248.4(a)(1). The weight of the evidence supports the Division's claim that, until it was amended in February 2006, the NEXT privacy policy notice did not inform customers that NEXT allowed its departing registered representatives to disclose customer nonpublic personal information to nonaffiliated third parties (DX 10, DX 11). I also agree with the Division that NEXT's violation of Rule 4(a)(1) was willful.

I reject NEXT's argument that the early versions of its privacy policy notice did, in fact, "indicate" that customer nonpublic personal information would be used as it was used (Resp. Br. at 40-41, citing DX 10, DX 11). First, this defense cannot be reconciled with Eyster's testimony that, prior to 2006, NEXT's privacy policy notices did not specifically disclose NEXT's practice of allowing departing registered representatives to keep customer nonpublic personal information (Tr. 266, 271). Second, this defense relies on a tortured reading of the text of DX 10 and DX 11—a reading that cannot be harmonized with Rule 4(a)'s requirement that the notice must be "clear and conspicuous." Finally, I reject NEXT's effort to rely on Rules 4(a)(2) and 4(b) of Regulation S-P (Resp. Br. at 18, 20-21, 40). These provisions apply only to consumers who are not customers. Elsewhere, NEXT stipulates that this proceeding does not implicate consumers who are not customers (Resp. Br. at 15 n.22).

Rule 6

Pursuant to Rule 6(a)(2) of Regulation S-P, a covered financial institution's initial and annual privacy notices must identify the categories of nonpublic personal information that the institution discloses. See 17 C.F.R. § 248.6(a)(2). Pursuant to Rule 6(a)(3) of Regulation S-P, a covered financial institution's initial and annual privacy notices must also identify the categories of affiliates and nonaffiliated third parties to whom it discloses nonpublic personal information, other than those parties to whom it discloses information under the exceptions in Rules 14 and 15 of Regulation S-P. See 17 C.F.R. § 248.6(a)(3). The weight of the evidence supports the Division's claim that, until it was amended in February 2006, the NEXT privacy policy notice did not inform customers that NEXT allowed its departing registered representatives to disclose all categories of customer nonpublic personal information to the nonaffiliated third parties with which they intended to associate. I also agree with the Division that NEXT's violation of Rules 6(a)(2) and 6(a)(3) was willful.

For the reasons already discussed, see supra pp. 23-26, I reject NEXT's argument that the required disclosure in Rule 6(a)(3) is negated by the exceptions in Rules 14 and 15 of Regulation S-P. Even if NEXT were correct in its expansive reading of the exceptions, the exceptions would only establish a defense to a violation of Rule 6(a)(3), not Rule 6(a)(2).

Rule 10

Rule 10(a)(1) of Regulation S-P provides that, except as otherwise authorized by another provision of Regulation S-P, a covered financial institution may not disclose any nonpublic personal information about a consumer to nonaffiliated third parties without proper notice and a reasonable opportunity to opt out of the disclosure. See 17 C.F.R. § 248.10(a)(1). The weight of

the evidence shows that NEXT permits its departing registered representatives to take customer nonpublic personal information with them upon termination, and provide that information to nonaffiliated third parties. The customer nonpublic personal information includes, but is not limited to, Social Security numbers, dates of birth, account statements, banking information, and other financial information (Tr. 258). The record also shows that, when the registered representatives leave NEXT, they disclose the customer nonpublic personal information to their new brokerage firm before they join the new firm (Tr. 48-49). Finally, the weight of the evidence demonstrates that, until February 2006, NEXT's privacy policy notices did not inform customers that the firm allowed departing registered representatives to disclose customer nonpublic personal information to nonaffiliated third parties. Nor did the earliest privacy policy notices provide customers with a reasonable opportunity to opt out of the disclosure.

For the reasons discussed previously, see supra pp. 20-22, 31-32, I agree with the Division that NEXT's actions were willful and that the departing registered representatives were acting within the scope of their relationship as agents of NEXT.

NEXT argues that the Division failed to satisfy its burden of proof because it did not provide specific evidence naming the outbound representatives who disclosed nonpublic personal information to successor brokerage firms; naming the customers whose nonpublic personal information was disclosed; identifying the type of nonpublic personal information that was disclosed; and stating when and how the information was disclosed (Resp. Prop. Find. ## 24-25; Resp. Br. at 34-35).

It is true that most of the hearing evidence focused on allegations of misconduct relating to inbound recruits, and that much less of the hearing evidence involved allegations of misconduct relating to registered representatives who were leaving NEXT. Part of this evidentiary imbalance may be explained by the undisputed fact that NEXT was a growing firm, and that many more representatives joined NEXT than left NEXT during the relevant period.

The limited amount of hearing evidence about outbound representatives may also be explained by the fact that NEXT repeatedly offered to, and ultimately did, stipulate to the relevant facts.[28] As a result, the record concerning outbound violations consists of NEXT's Answer and Amended Answers admitting the allegations in OIP ¶¶ II.B.20-.21, plus Paragraphs 18-20 of the First Set of Stipulated Facts, Exhibit I thereto, the testimony of Mohr and DeMarino (Tr. 48-49, 254-58, 271), and Division Exhibits 10-11. I conclude that this evidence is sufficient to establish a primary violation of Rule 10 of Regulation S-P. See United States v. Harrison, 204 F.3d 236, 240 (D.C. Cir. 2000) (holding that a stipulation waives the defendant's right to assert the government's duty to present its proof on the stipulated element of the offense) (collecting cases); United States v. Muse, 83 F.3d 672, 679 (4th Cir. 1996) (same). To hold otherwise

[28] DX 18 at 2 (Wells submission) ("We believe there are no material disputes involving factual matters. . . The firm offered to stipulate to facts pertaining to these matters, obviating the need for on-the-record testimony."); Prehearing Conference of Sept. 26, 2007, at 13 (Mr. Anderson: "I expect that we will be able to stipulate to a fair amount.").

would condone sharp litigation tactics that have no place in the Commission's adjudicatory proceedings.[29]

Rule 30

Rule 30 of Regulation S-P requires covered financial institutions to adopt policies and procedures that address administrative, technical, and physical safeguards for the protection of customer records and information. Beginning on July 1, 2005, the policies and procedures must be in writing. OIP ¶ II.C.2 charges that NEXT willfully violated Rule 30 in the following manner: "By allowing registered representatives to take customer nonpublic personal information with them, NEXT failed to ensure the security of customer records and information, and failed to protect against unauthorized access to customer records."

The wording of this charge interprets the requirements of Rule 30 too broadly. First, the OIP implies that NEXT has an absolute duty to "ensure the security and confidentiality" of customer records and information.[30] In fact, the text of Rule 30(a)(1) only requires covered financial institutions to "adopt policies and procedures" that are "reasonably designed" to "insure" the security and confidentiality of customer records and information. Second, the OIP erroneously suggests that NEXT may be held liable if it "failed to protect against unauthorized access to customer records." However, under Rule 30(a)(3), failure to protect against unauthorized access is a violation only if it "could result in substantial harm or inconvenience to any customer." As previously noted, the phrase "substantial harm or inconvenience" is not defined in the GLB Act or in Regulation S-P.

To demonstrate that a brokerage firm violated Rule 30(a), the Division must: (1) require the brokerage firm to explain its safeguarding policies and procedures and, for alleged violations occurring after July 1, 2005, have the brokerage firm provide a copy of its written safeguarding policies and procedures; (2) demonstrate through competent evidence (and not simply through

---

[29] This is the second time that NEXT has attempted to extricate itself from the consequences of a binding stipulation (Orders of Jan. 28 and Feb. 11, 2008). <u>See</u> <u>James F. Glaza</u>, 57 S.E.C. 907, 914-16 & nn.7,13 (2004) (holding that the Commission will not set aside stipulations of fact without compelling reasons; and ruling that an Administrative Law Judge is under no obligation to second-guess tactical decisions made by counsel for a party in reaching such stipulations). NEXT's endeavors in this regard are unseemly, given its earlier assurances that "there are no material disputes involving factual matters." I conclude that NEXT is bound by its stipulations and that the stipulations are sufficient to establish liability. <u>Cf.</u> <u>Davoll v. Webb</u>, 194 F.3d 1116, 1137 (10th Cir. 1999) (concluding that district courts have broad discretion in determining whether to hold a party to a stipulation or whether the interests of justice require the stipulation to be set aside).

[30] For present purposes, it does not matter that the GLB Act and Regulation S-P do not define "customer records and information." Whatever may be the outer limits of that phrase, it is appropriate to infer that, at a minimum, it must include "nonpublic personal information" and "personally identifiable financial information," as those two terms are defined in Rules 3(t) and 3(u) of Regulation S-P. The fact that the Commission has twice declined to establish minimum safeguarding standards under Rule 30(a) presents something of a hurdle for the Division, but not an insurmountable obstacle.

argument of counsel) that the brokerage firm's policies and procedures were not "reasonably designed" to accomplish the three statutory and regulatory goals; and (3) when proceeding under Rule 30(a)(3), establish through competent evidence (and not simply through argument of counsel) that unauthorized access "could result in substantial harm or inconvenience to any customer."[31] Here, no evidence addressed substantial harm or inconvenience.

NEXT knew that it would have to adopt safeguarding policies and procedures once the Commission promulgated Regulation S-P (Tr. 285). NEXT also knew that there was a reasonably foreseeable risk that departing representatives would disclose customer nonpublic personal information to successor brokerage firms (Tr. 47-48, 256). Nonetheless, NEXT did not alter its policies, practices, or procedures with respect to outbound representatives as a result of Regulation S-P (Tr. 283). To that extent, I conclude that the weight of the evidence supports the charge in OIP ¶ II.C.2.[32]

If NEXT had designed safeguarding policies and procedures to control these risks, and/or adjusted its safeguarding policies and procedures over time, the Division would then have the burden of demonstrating that NEXT's policies and procedures were not "reasonably designed" to accomplish the three statutory and regulatory goals.[33]

At the hearing, the parties also focused attention on safeguarding policies and procedures that NEXT adopted (or failed to adopt) relating to the transition assistance NEXT provided to inbound recruits (Third Stip. ¶ 7; Tr. 760-61, 764-65). This was not the narrow safeguarding

---

[31] The level of proof is similar to that required to establish a failure-to-supervise charge under the safe-harbor provision of Section 15(b)(4)(E) of the Exchange Act. Failure-to-supervise charges often follow upon the existence of red flags that should have put the brokerage firm on notice of underlying problems. However, the absence of warning signs is not a defense where the deficiency is the failure to have reasonable supervisory procedures. See NationsSecurities and NationsBank, N.A., 53 S.E.C. 556, 572 & n.17 (1998). A firm's supervisory policies and procedures are not judged with the benefit of hindsight, and the fact that an underlying violation occurred does not automatically establish that the firm's policies and procedures were unreasonable. Cf. IFG Network Sec., Inc., 88 SEC Docket 1374, 1391-92 (July 11, 2006); James Harvey Thornton, 53 S.E.C. 1210, 1218 (1999) (Comm'r. Unger, concurring); Arthur James Huff, 50 S.E.C. 524, 528-29 & n.7 (1991); Louis R. Trujillo, 49 S.E.C. 1106, 1110 (1989).

[32] The Division has demonstrated a willful violation of Rule 30(a)(1), but it has not demonstrated any violation of Rule 30(a)(3).

[33] The parties appear to assume that NEXT's belated compliance with Rule 10 in February 2006 somehow eliminated the need for NEXT to maintain reasonable safeguards after February 2006 (i.e., written safeguarding policies and procedures in compliance with Rule 30(a)). I do not agree with this assumption, but the Division's stipulation that there were no primary violations after February 2006 effectively moots the point. See supra note 6.

issue identified in the OIP, and no liability may attach as a result.[34] Moreover, the parties developed the record as if hindsight was the only appropriate consideration: if the Commission's staff raised a specific concern, NEXT eventually amended its safeguarding policies and procedures to address that concern (Tr. 310-11, 354).[35]

In these circumstances, I conclude that the Division has partially sustained the narrow charge in OIP ¶ II.C.2. Consistent with McConville and Ponce, I decline to consider the question of whether NEXT also may have violated Rule 30 of Regulation S-P when providing transition assistance to inbound recruits.

In Violating Rules 4, 6, 10, and 30(a)(1),
NEXT Acted Negligently

Whether a respondent acted with the requisite mental state is a question of fact. Valicenti Adv. Serv., Inc. v. SEC, 198 F.3d 62, 65 (2d Cir. 1999).

NEXT assigned Eyster the responsibility for implementing Regulation S-P and preparing its initial privacy policy notice (Tr. 233). After Eyster read the Commission's Proposing Release, she did not have any concerns about NEXT's practice of allowing departing representatives to keep customer information (Tr. 287). NEXT did not alter its policies, practices, or procedures with respect to outbound representatives as a result of Regulation S-P (Tr. 283).

Eyster drafted NEXT's first privacy policy notice to customers without assistance from anyone (Tr. 263). She did not consult with any industry professionals about the substance of NEXT's privacy policy notice (Tr. 268). Eyster did not review any written guidance on Regulation S-P, other than the Commission's Proposing Release and Adopting Release (Tr. 269, 272-73). At the relevant times, NEXT did not have in-house counsel. Eyster did not seek the advice of outside counsel about NEXT's privacy policy notice until after the Commission's staff began its examination. The record is silent about how or when NEXT developed its safeguarding policies and practices.

---

34 Cf. Rita J. McConville, 85 SEC Docket 3127, 3138-39 n.27 (June 30, 2005), aff'd, 465 F.3d 780 (7th Cir. 2006); Russell Ponce, 54 S.E.C. 804, 822 n.49 (2000), aff'd, 345 F.3d 722 (9th Cir. 2003).

35 As illustrations, by mid-2006, NEXT had prepared written policies and procedures prohibiting the transition team from using a recruit's user identification and password to access the computer system of the recruit's current brokerage firm (DX 8 at 11, DX 9 at 4, 7-8, 33; RX 2 at 12); requiring the transition team immediately to purge nonpublic personal information provided by recruits after NEXT had completed its pre-population tasks (DX 8 at 11, DX 9 at 4, 33; RX 2 at 12); and telling recruits in writing not to provide customers' Social Security numbers, dates of birth, or driver's license numbers (DX 16). Based on the stipulations that NEXT did not have policies and procedures to address these matters until mid-2006, it is reasonable to infer that NEXT did not have written policies and procedures to address these matters between July 1, 2005, and mid-2006, either.

After the Commission adopted Regulation S-P, the NASD twice provided guidance to the industry.[36] NEXT was an NASD member and had access to this guidance (Tr. 311, 722).

In September 2000, NASD published its Notice to Members 00-66, summarizing Regulation S-P (DX 78). NASD noted "[u]nder Regulation S-P, any information given by consumers or customers to broker/dealers to obtain a product or service will generally be considered to be nonpublic financial information. In addition, any list, description, or other grouping of consumers and customers that is derived from this information also may be considered nonpublic information" (DX 78 at 485).

In September 2002, NASD published its Notice to Members 02-57, reminding its member firms to comply with Regulation S-P when transferring customer accounts (DX 64 at 564). The Notice stated that "[u]nless the transfer is being conducted pursuant to a permitted exception to Regulation S-P, the transferring firm should have reserved the right to transfer customer accounts in its privacy notice that was previously sent to its customers" (DX 64 at 564). Between 2000 and late 2005, no one at NEXT believed that the exceptions to Regulation S-P were relevant. Under the circumstances, NEXT should have provided its customers with appropriate notice and a reasonable opportunity to opt out.

Viewing these circumstances in their entirety, I conclude that NEXT acted at least negligently when implementing Regulation S-P, drafting its early privacy policy notices, and adopting safeguarding policies and practices.

Regulation S-P Does Not Require
NEXT to Encrypt E-Mail Traffic with Recruits

The parties agree that NEXT did not encrypt the e-mail traffic that it exchanged with recruits while it was pre-populating account transfer forms (First Stip. ¶ 9; Tr. 39, 119, 123, 494-95, 497-98, 561, 603). It is undisputed that this e-mail traffic involved personally identifiable financial information. The Division argues that NEXT's failure to encrypt such e-mail traffic (or, at the very least, to password protect such e-mail traffic) constitutes a failure to safeguard and thus a violation of Rule 30 of Regulation S-P (Prehearing Conference of Nov. 29, 2007, at 8; Div. Br. at 9, 28-29). NEXT concedes that encrypting and/or password protecting such e-mail traffic would be a good practice, but disputes that the practice is required by Regulation S-P (Tr. 762-66; Resp. Br. at 39). The Division's argument fails for two reasons.

First, OIP ¶ II.B.6 addresses NEXT's failure to encrypt e-mail traffic only in the context of the transition assistance that NEXT provided to inbound recruits—a context in which NEXT is alleged to have willfully aided and abetted and caused violations of Rule 10 of Regulation S-P by non-party brokerage firms. If a duty to encrypt e-mail traffic can be found anywhere in

[36] The Division contends that FINRA Regulatory Notice 07-36 provided guidance on a third occasion (Div. Br. at 45, citing DX 73). I agree with NEXT that DX 73, which FINRA issued in August 2007, came too late to influence the events in this proceeding (Resp. Br. at 26 n.53).

Regulation S-P, it must be found in Rule 30, not Rule 10. Because the OIP does not identify a Rule 30 violation with respect to recruits, NEXT cannot be held liable.[37]

Second, the Commission's authority to compel the encryption of e-mail traffic is nowhere near as plenary as the Division appears to believe. Three years before Congress passed the GLB Act, it enacted the Health Insurance Portability and Accountability Act of 1996 (HIPAA), Pub. L. No. 104-191, 110 Stat. 1936. Section 262 of HIPAA authorizes the Secretary of Health and Human Services (HHS Secretary) to establish uniform national standards for the secure electronic exchange of certain medical information. See 110 Stat. at 2025-26, codified at 42 U.S.C. § 1320d-2. Pursuant to that authority, the HHS Secretary promulgated detailed standards in 45 C.F.R. Part 164, Subpart C, Security Standards for the Protection of Electronic Protected Health Information. With respect to the encryption of electronically transmitted customer financial information, nothing in Title V of the GLB Act grants the Commission or any other federal regulator powers remotely comparable to those that Congress granted the HHS Secretary under HIPAA.

---

[37] The safeguarding standards required under Section 502(b) of the GLB Act are established in furtherance of the privacy obligation policy set forth in Section 501(a) of the GLB Act. The parties did not address the Congressional policy enunciated in Section 501(a) of the GLB Act, which requires each covered financial institution to respect the privacy of "its customers" and to protect the security and confidentiality of "those customers' nonpublic personal information." When NEXT provided transition assistance to recruits, it was pre-populating documents relating to individuals who were not literally "its customers." At the times NEXT transmitted or received this unencrypted e-mail traffic, these individuals were still the customers of the recruits' current brokerage firms.

The FTC specifically considered and rejected this sort of distinction when it adopted its safeguarding rule in May 2002. See 67 Fed. Reg. at 36485-86:

> Comments were split on whether the [Safeguarding] Rule should apply to customer information that a financial institution receives from another financial institution. . . [S]ome commenters opposed covering recipients on the grounds that such coverage is . . .[b]eyond the intent of section 501(a) which refers to a financial institution's obligations to "its customers". . . .
>
> After considering the comments, the [FTC] has determined that covering recipient financial institutions is consistent with the purpose and language of the [GLB] Act. The [FTC] believes that imposing safeguards obligations as to customer information that a financial institution receives about another institution's customers is the most reasonable reading of the statutory language and clearly furthers the express congressional policy to respect the privacy of these customers and to protect the security and confidentiality of their nonpublic personal information.

While the SEC may wish to take a similar approach in the future, the FTC's approach is not the theory advanced by the Division in this proceeding.

As previously discussed, the GLB Act does not require the federal regulators to harmonize their respective safeguarding standards. See supra p. 3. With respect to encryption, the guidelines and rules of the various federal agencies are anything but harmonious. For example, the safeguarding guidelines of the federal banking agencies and the NCUA do not mandate the encryption of electronically-transmitted customer records and information, but rather, require each covered financial institution to consider whether encryption is appropriate. See, e.g., 12 C.F.R. Part 208, Appendix D-2, Item III.C.1.c (FDIC); 12 C.F.R. Part 748, Appendix A, Item III.C.1.c (NCUA).[38] In contrast, the FTC's safeguarding rule establishes minimum standards, but does not explicitly discuss encryption.[39] See 16 C.F.R. Part 314. The SEC neither established minimum standards nor discussed encryption when it proposed and adopted Regulation S-P. In this regulatory vacuum, the Division cannot plausibly suggest that NEXT was required to encrypt its e-mail traffic with recruits.

C. NEXT's Secondary Liability

The weight of the evidence also demonstrates that NEXT willfully aided and abetted and caused other broker-dealers' violations of Rule 10 of Regulation S-P.

The Commission's Test for Aiding
and Abetting Liability

To show that a respondent willfully aided and abetted a violation, the Commission requires the Division to establish three elements: (1) a primary wrongdoer has committed a securities law violation; (2) the accused aider and abetter has a general awareness that its actions were part of an overall course of conduct that was illegal or improper; and (3) the accused aider and abetter substantially assisted the conduct constituting the primary violation. See Warwick Capital Mgmt., Inc., 2008 SEC LEXIS 96, at *22 (Jan. 16, 2008); Clarke T. Blizzard, 85 SEC Docket 4499, 4504 & n.18 (July 29, 2005) (EAJA Opinion); Orlando Joseph Jett, 57 S.E.C. 350, 397 & n.46 (2004); Sharon M. Graham, 53 S.E.C. 1072, 1080-81 (1998), aff'd, 222 F.3d 994, 1000 (D.C. Cir. 2000); Russo Secs., Inc., 53 S.E.C. 271, 278 & n.16 (1997); Donald T. Sheldon, 51 S.E.C. 59, 66 (1992), aff'd, 45 F.3d 1515 (11th Cir. 1995).

Without a primary violation by another actor, there can be no aiding and abetting liability by a secondary actor. See Clarke T. Blizzard, 57 S.E.C. 696, 706 & n.10 (2004) (Merits Opinion); Douglas W. Powell, 83 SEC Docket 2056, 2077 (Aug. 17, 2004) (ALJ), final, 83 SEC Docket 2889 (Sept. 22, 2004).

---

[38] "1. Each [covered financial institution] must consider whether the following security measures are appropriate for [the covered financial institution] and, if so, adopt those measures [the covered financial institution] concludes are appropriate: . . .c. Encryption of electronic [customer] information, including while in transit or in storage on networks or systems to which unauthorized individuals may have access[.]"

[39] Cf. Guin v. Brazos Higher Educ. Serv. Corp., Inc., 2006 U.S. Dist. LEXIS 4846, at *11 & n.2 (D. Minn. Feb. 7, 2006) (concluding that nothing in the GLB Act or the FTC's regulations requires that nonpublic personal information stored on a laptop computer must be encrypted).

The courts have held that a showing of "extreme recklessness" will satisfy the "substantial assistance" prong of the aiding and abetting test. See Howard v. SEC, 376 F.3d 1136, 1143 (D.C. Cir. 2004) (holding that "extreme recklessness" may support aiding and abetting liability, but concluding that "aiding and abetting liability cannot rest on the proposition that the person 'should have known' [that] he was assisting violations of the securities laws"); Graham v. SEC, 222 F.3d 994, 1004 (D.C. Cir. 2000). Extreme recklessness may be found if the alleged aider and abetter encountered red flags, or suspicious events creating reasons for doubts that should have alerted him to the improper conduct of the primary violator. Cf. Dolphin & Bradbury, Inc., 88 SEC Docket 1298, 1316 n.62 (July 13, 2006) (discussing Howard), pet. for review denied, 512 F.3d 634 (D.C. Cir. 2008); Robert J. Prager, 85 SEC Docket 3413, 3423 nn.24-25 (July 6, 2005) (same).

Irrespective of the level of proof required to establish the primary violation, the Commission has made clear that the accused aider and abetter must have acted with scienter. See Warwick, 2008 SEC LEXIS 96, at *23; Terence Michael Coxon, 56 S.E.C. 934, 949 n.32 (2003), aff'd, 137 Fed. Apx. 975 (9th Cir. June 29, 2005); Kingsley, Jennison, McNulty & Morse, Inc., 51 S.E.C. 904, 911 n.28 (1993).

Primary Violations by Non-Party Brokerage Firms

The OIP implicitly concedes that the non-party brokerage firms distributed initial and annual privacy policy statements to their customers, as required. The Division's theory is that these privacy policy statements were deficient because they failed to inform customers that departing representatives were likely to disclose nonpublic personal information to successor brokerage firms and failed to afford customers a reasonable opportunity to opt out of such disclosure.

During 2004 and 2005, numerous recruits provided customer nonpublic information to NEXT before they joined NEXT. Most of these recruits came from other brokerage firms that operated under the independent contractor business model. At the relevant times, these recruits were bound by the privacy policies of their current brokerage firms. During 2004 and 2005, the privacy policy notices of these non-party brokerage firms generally did not inform customers that the registered representatives would make such disclosures to nonaffiliated third parties, and did not provide customers a reasonable opportunity to opt out of the disclosures.

I conclude that the non-party brokerage firms acted negligently. By 2004-2005, Regulation S-P had existed for a sufficient length of time to charge the non-party brokerage firms with notice of their obligations under the law. In general, these independent brokerage firms knew that registered representatives who moved to other firms would disclose customer nonpublic personal information to the new firms before the registered representatives resigned from their current firms. Negligent conduct includes the failure to do an act which is necessary for the protection or assistance of another and which the actor is under a duty to do. Restatement (Second) of Torts § 284(b) (1965). One who fails to disclose to another a fact that he knows may justifiably induce the other to act or refrain from acting in a business transaction is subject to the same liability to the other as though he had represented the nonexistence of the matter that he has failed to disclose, if, but only if, he is under a duty to the other to exercise reasonable care to disclose the matter in question. Id. § 551(1). One party to a business transaction is under a duty to exercise reasonable care to disclose to the other before the transaction is consummated matters

known to him that he knows to be necessary to prevent his partial or ambiguous statement of the facts from being misleading. Id. § 551(2)(b). On this basis, I conclude that the recruits' current brokerage firms negligently violated Rule 10 of Regulation S-P.

NEXT contends that the evidence of a primary violation is scarce. It argues that Division Exhibits 60, 60A, and 61, as well as Appendix A to the Division's Brief, are entitled to no weight (Resp. Br. at 50-51).[40] I give full weight to DX 60 and DX 60A.

The Division believes that it should not matter whether recruits provided customer nonpublic personal information to NEXT before or after they resigned from their prior brokerage firms and associated with NEXT. According to the Division, the critical fact is that the customers were still customers of the prior brokerage firms until they transferred their accounts to NEXT and received copies of NEXT's privacy policy (Tr. 947, 950-51; DX 7 at 11). The Division's position finds support in OIP ¶ II.B.1, which alleges that NEXT encourages recruits to provide customer nonpublic information to it before the customers had consented "to the transfer of their account(s)." However, OIP ¶ II.B.1 is potentially misleading in its reference to customers "consent(ing) to the disclosure of their nonpublic personal information," because this phrase could be understood as implying that Regulation S-P contains an "opt-in" requirement. OIP ¶ II.B.1 also clashes with OIP ¶ II.B.4, which stresses that recruits provided customers' nonpublic personal information to NEXT "prior to joining NEXT." The Division places heaviest emphasis on the disclosure of nonpublic personal information to NEXT before recruits joined NEXT (Div. Prop. Find. ## 40, 58, 67, 85, 117). In evaluating DX 61, I have focused on those recruits who provided customer nonpublic personal information before they joined NEXT. I believe this group of recruits presents the strongest evidence of misconduct.

NEXT has shown reasons for according reduced weight to DX 61, but not for disregarding the exhibit in its entirety. Giving due regard for NEXT's arguments, the weight of the evidence still shows that numerous recruits provided customer nonpublic personal information to NEXT while they were subject to the privacy policies of their current firms. I offer the following as illustrations, but not an exhaustive list, of the proven primary violations by non-party brokerage firms.

John K. Richards (Richards) of Harrisburg, Pennsylvania, joined NEXT on January 2, 2004 (DX 58 at 1, DX 61 at 11, DX 62 at 9). He was previously associated with H & R Block Financial Advisors, Inc. (H & R Block). Beginning on December 14, 2003, Richards disclosed nonpublic personal information about H & R Block customers to NEXT (DX 58 at 4-38, DX 61 at 11, DX 62 at 7). The information included 642 account numbers, 567 Social Security numbers, and numerous addresses. The H & R Block privacy policy in effect at the time did not provide customers notice or an opportunity to opt out of this disclosure (DX 60 at 97-100).

Elad Goren (Goren) of Westlake Village, California, joined NEXT on December 15, 2004 (DX 61 at 11, DX 62 at 4). He was previously associated with Edward Jones. Between

---

[40] Stipulation Regarding the Authenticity and Admissibility of Trial Exhibits, dated Nov. 28, 2007; First Stip. ¶ 17 and Ex. H; Orders of Jan. 28 and Feb. 11, 2008. NEXT also requests reconsideration of my Orders admitting DX 60 and DX 60A into evidence (Resp. Br. at 53 & n.94). The request for reconsideration is denied.

October 23 and October 25, 2004, Goren disclosed nonpublic personal information about Edward Jones customers to NEXT (DX 42, DX 61 at 11, DX 62 at 4). The information included 238 account numbers, 347 Social Security numbers, 313 dates of birth, as well as numerous addresses, and statements about customers' net worth and investment experience. The Edward Jones privacy policy in effect at the time did not provide notice or an opportunity to opt out of this disclosure (DX 60 at 65-69, DX 60A at 178-95).

Robert Williams IV (Williams) of Apex, North Carolina, joined NEXT on May 27, 2005 (DX 57, DX 61 at 12, DX 62 at 9). He was previously associated with A.G. Edwards & Sons, Inc. (A.G. Edwards). Between May 16 and May 20, 2005, Williams disclosed nonpublic personal information about A.G. Edwards customers to NEXT (DX 57, DX 61 at 12, DX 62 at 9). The information included 371 account numbers, 129 Social Security numbers, as well as numerous addresses, dates of birth, and home and office telephone numbers. The A.G. Edwards privacy policy in effect at the time did not provide customers notice or an opportunity to opt out of this disclosure (DX 60 at 8-10, DX 60A at 108-18).

Lisa and David Adams (the Adamses) of Fond du Lac, Wisconsin, joined NEXT on June 21, 2005 (Tr. 153-54; DX 52 at 1-2, DX 61 at 11, DX 62 at 1). They were previously associated with SunAmerica Securities, Inc. (SunAmerica). Beginning on June 10, 2005, the Adamses disclosed nonpublic personal information about SunAmerica customers to NEXT (DX 52 at 6-19, DX 61 at 11, DX 62 at 1). The information included 759 account numbers, 293 Social Security numbers, and 249 dates of birth (DX 61 at 11). The SunAmerica privacy policy in effect at the time did not provide customers notice or an opportunity to opt out of this disclosure (DX 60 at 16-18A). I have not relied on DX 41, which involves e-mail traffic after the Adamses had joined NEXT.

NEXT renews two arguments it raised in the context of primary violations relating to outbound representatives. It claims that the exceptions in Rules 14 and 15 of Regulation S-P rendered the Rule 10 notice and opt-out requirements unnecessary. It also contends that the recruits were independent contractors who were acting contrary to the interests of their current brokerage firms when they disclosed customer nonpublic personal information to NEXT. On that basis, NEXT maintains that the recruits were acting beyond the scope of their agency with their current brokerage firms, and that no primary violation occurred. I have previously rejected these arguments, see supra pp. 23-26, 31-32, and I incorporate that discussion by reference here.

Finally, NEXT asserts that any customers who were denied an opportunity to opt out of the disclosure of their nonpublic personal information could later have cured the violation of Rule 10 by declining to transfer their accounts from the recruits' current brokerage firm to NEXT (Tr. 769-70, 774-75). The argument misreads Section 502(b)(1)(B) of the GLB Act and Rule 10(a)(1)(iii) of Regulation S-P, which afford consumers the opportunity to opt out before the time that nonpublic personal information is initially disclosed. It also ignores the fact that NEXT did not delete from its computer system nonpublic personal information provided by recruits who never joined NEXT and nonpublic personal information about customers who did not follow recruits to NEXT.

Potential Primary Violations by Registered
Investment Advisers and Others

Paragraph II.B.9 of the OIP alleges that NEXT's transition team used recruits' user identifications and passwords to access various mutual fund and annuity company databases and websites to extract nonpublic personal information. The Division has proven the allegation. However, such misconduct is not attributable to the non-party brokerage firms that are the only primary violators identified in OIP ¶ II.C.5.

Deborah Bell (Bell) of Abilene, Texas, was a registered representative of Jefferson Pilot Financial (Jefferson Pilot), a registered broker, when she and her husband decided to join NEXT in August 2004 (Tr. 482-84, 491). Bell disclosed nonpublic personal information about her Jefferson Pilot brokerage customers to NEXT while she was still bound by Jefferson Pilot's privacy policy (DX 53 at 4-6). The customers were not aware that their nonpublic personal information was being shared with NEXT, because Jefferson Pilot's privacy policy did not provide notice or an opportunity to opt out of the disclosure (Tr. 491-92; DX 53 at 22-23, DX 60 at 123-26). To this extent, I conclude that the Division has demonstrated a primary violation of Rule 10 of Regulation S-P by Jefferson Pilot.

Bell also had clients who owned mutual fund shares in the fund family of Dimensional Fund Advisors of Santa Monica, California (Tr. 488-89, 519). Bell's clients had obtained these funds through Matrix Abundant Advisors (Matrix), a registered investment adviser. Bell's Matrix clients were not Jefferson Pilot customers (Tr. 488, 499). Matrix issued its own privacy policy notice, although that document is not part of the record. At Bell's request, Matrix sent client nonpublic personal information to NEXT without providing the clients notice or an opportunity to opt out of the disclosure (Tr. 520; DX 53 at 3, 7, 18). I conclude that Jefferson Pilot was not responsible for any primary violation of Rule 10 that Matrix may have committed.[41] NEXT cannot be held liable under OIP ¶ II.C.5 for aiding and abetting a primary violation of Rule 10 by Matrix, a firm that is not registered as a broker or dealer.

Wayne Hurley (W. Hurley) of Ontario, California, was a registered representative of Veritrust Financial, LLC (Veritrust), a registered broker, before he joined NEXT in September 2005 (Tr. 615, 663). With W. Hurley's assistance, NEXT extracted nonpublic personal information about W. Hurley's customers from Veritrust's computer system (DX 39 at 1-27). W. Hurley's customers were unaware of the transfer of their nonpublic personal information and Veritrust's privacy policy did not provide them with notice or an opportunity to opt out of the disclosure (Tr. 663-68; DX 54 at 408-09; DX 60 at 264-66; DX 60A at 380-97). To this extent, I conclude that the Division has demonstrated a primary violation of Rule 10 of Regulation S-P by Veritrust.

---

[41] NEXT's model Excel spreadsheet urged recruits to disclose the names and account numbers of customers' non-brokerage business, such as mutual funds and variable annuities (DX 4). However, Bell developed her own Excel spreadsheet to transfer customer nonpublic personal information from Jefferson Pilot to NEXT (Tr. 490). She did not rely on NEXT's model Excel spreadsheet. The Division has not shown that Jefferson Pilot provided NEXT with nonpublic personal information about the non-brokerage business of Bell's mutual fund clients.

NEXT also obtained nonpublic personal information about W. Hurley's mutual fund clients by using DST Fan Mail (DX 39 at 28-37). DST Systems, Inc., is an information processor that, among other services, provides mutual fund recordkeeping systems. See No Action Letter to DST Systems, Inc., from Division of Market Regulation and Division of Investment Management, 1993 SEC No-Act. LEXIS 353 (Feb. 2, 1993). Participating mutual funds and variable annuity companies sponsor the DST Fan Mail web site to make their clients' account information available to brokers and dealers.

DeMarino helped W. Hurley enroll in DST Fan Mail (Tr. 643-44; DX 54 at 6-7). W. Hurley then downloaded client data from DST Fan Mail and provided the data to NEXT (DX 49, DX 54). In this manner, NEXT obtained access to nonpublic personal information about W. Hurley's mutual fund clients, as well as nonpublic personal information about the mutual fund clients of the other twenty-three representatives in W. Hurley's branch office (Tr. 690-91). However, the responsibility for this disclosure rests with DST Fan Mail, and/or the mutual funds and variable annuity companies that maintain the DST Fan Mail web site. The Division has not established that these entities are covered financial institutions for purposes of Regulation S-P or brokerage firms for purposes of OIP ¶ II.C.5. The Division has not shown that Veritrust was responsible for disclosing this information. NEXT cannot be held liable for aiding and abetting a primary violation of Rule 10 by DST Fan Mail and/or its mutual fund sponsors.

General Awareness

NEXT knew that it had to distribute privacy policy notices that complied with Regulation S-P; it must have known that its competitors, the source of its recruits, also had to comply with Regulation S-P. NEXT knew that its recruits were associated with nonaffiliated brokerage firms and that the customer information the recruits provided to it was nonpublic personal information. NEXT did nothing to determine whether the recruit's current brokerage firm disclosed that it was sharing nonpublic personal information with NEXT. NEXT management knew that the NEXT transition team obtained customer nonpublic personal information from recruits and used the recruits' user identifications and passwords to access the computer systems of other brokerage firms. NEXT also solicited and accepted customer nonpublic personal information from registered representatives who had no intention of transferring to NEXT, whom NEXT had not approved to join the firm, and who did not actually join NEXT. In each of these respects, NEXT's conduct was extremely reckless.

Substantial Assistance

The transition team provided recruits with a model Excel spreadsheet. NEXT encouraged recruits to transfer customer nonpublic personal information to it at least two weeks before the recruits terminated their relationships with their current brokerage firms. NEXT also helped recruits to download and organize customer nonpublic personal information.

NEXT even asked recruits to provide their user identifications and passwords, so that NEXT could access the computer systems of the recruits' current brokerage firms and extract customer nonpublic personal information. NEXT management knew that this was happening (Tr. 175, 181). Eyster acknowledged that it was not prudent to share user names and passwords, and that the practice raised a "certain potential for misuse and other unintended consequences" (Tr. 252, 307). Both of NEXT's expert witnesses conceded that using recruits' user

identifications and passwords in this fashion was not consistent with industry practice and that they did not know of any brokerage firms, other than NEXT, that had done so (Tr. 771, 832, 836). I conclude that NEXT's conduct was extremely reckless and that NEXT must have known that its conduct was highly improper.

Causing Liability

Section 21C of the Exchange Act specifies that a respondent is "a cause" of another's violation if the respondent "knew or should have known" that its act or omission would contribute to such violation.

The Commission has determined that causing liability under Section 21C(a) requires findings that: (1) a primary violation occurred; (2) an act or omission by the respondent was a cause of the violation; and (3) the respondent knew, or should have known, that its conduct would contribute to the violation. See Gateway Int'l Holdings, Inc., 88 SEC Docket 430, 444-45 (May 31, 2006); Robert M. Fuller, 56 S.E.C. 976, 984 (2003), pet. denied, 2004 U.S. App. LEXIS 12893 (D.C. Cir. Apr. 23, 2004); Erik W. Chan, 55 S.E.C. 715, 724-26 (2002).

Negligence is sufficient to establish liability for causing a primary violation that does not require scienter. Howard, 376 F.3d at 1141; KPMG Peat Marwick LLP, 54 S.E.C. 1135, 1175 (2001), recon. denied, 55 S.E.C. 1, 4 & n.8 (2001), pet. denied, 289 F.3d 109 (D.C. Cir. 2002). In Dominick & Dominick, Inc., 50 S.E.C. 571, 578 n.11 (1991), a settled proceeding, the Commission concluded that one who aids and abets a primary violation is necessarily a cause of the violation. The Commission has subsequently followed that approach in contested cases raising the same issue. See Graham, 53 S.E.C. at 1085 n.35; Adrian C. Havill, 53 S.E.C. 1060, 1070 n.26 (1998). As to NEXT, I will follow the conclusion of Dominick & Dominick here.

D. NEXT's Other Defenses

Selling Nonpublic Personal
Information vs. Sharing It

NEXT's experts assert that the GLB Act is narrowly designed to prevent the sale, but not the mere dissemination, of customer nonpublic personal information (Tr. 761, 803). I cannot rule out the prospect that such a sale occurred here. If a brokerage firm offers a recruit a signing bonus for bringing a large volume of customer accounts, that is the equivalent of purchasing customer assets. It may also involve the purchase of customer nonpublic personal information. NEXT pays its recruiters bonuses based on the productivity of the representatives they bring to the firm. It is counterintuitive to believe that recruits who are big producers do not also receive signing bonuses. However, the Division did not develop the record on this issue, and no factual findings are warranted. In any event, Section 502(a) of the GLB Act prohibits the disclosure, not only the sale, of nonpublic personal information. See 15 U.S.C. § 6802(a). If the statutory text were somehow unclear on this point, President Clinton's signing statement puts the issue to rest.[42]

[42] Statement on Signing Legislation to Reform the Financial System, 35 Weekly Comp. Pres. Doc. 2363, 2364 (Nov. 12, 1999) ("For the first time, consumers will have an absolute right to

NEXT Has Not Shown That the Division's
Interpretation of Regulation S-P Is Likely to Impede
the Timely Transfer of Customer Accounts

NEXT also contends that there is tension between protecting customers' nonpublic personal information from unauthorized dissemination, on the one hand, and facilitating the efficient transfer of customer accounts between brokerage firms, on the other hand. It observes that the orderly transfer of customer accounts from one brokerage firm to another can entail a "blackout" period during which a representative has affiliated with a successor brokerage firm but some portion of the customer records are still "in transit" between the old and new firms. NEXT argues that the Division's interpretation of Regulation S-P, if adopted by the Commission, will enlarge the blackout period. In NEXT's judgment, this would have serious consequences for small account holders, who are the most likely to be "orphaned" when a representative moves from one brokerage firm to another.

NEXT observes that there is a high level of customer dissatisfaction with the account transfer process, and that FINRA and its predecessor, NASD, have placed importance on the expeditious transfer of customer accounts from one brokerage firm to another (DX 72). NEXT argues that use of customer information by a successor brokerage firm for the limited purpose of pre-populating account transfer documents avoids delays and customer dissatisfaction over disruptive service and is not abusive or harmful to the customer. It contends that, if customer nonpublic personal information is not available for the limited purpose of preparing for the transfer of accounts, then the account transfer process will be impeded and delayed. As a practical matter, NEXT maintains that the steps to obtain the necessary information will have to occur after the registered representative terminates his association with the previous brokerage firm. The success of this approach will depend in large measure on the cooperation of the previous brokerage firm, which will have an economic and competitive incentive to withhold and delay.

This argument confuses two distinct requirements. First, Regulation S-P does not require customers to "opt in" to the disclosure of their nonpublic personal information when the registered representative servicing their accounts changes firms. If a brokerage firm's privacy policy notifies customers that the firm permits departing representatives to disclose customers' nonpublic personal information to a successor firm, provides a reasonable opportunity for customers to opt out of the disclosure, and does so at the start of the customer relationship and annually thereafter, then Regulation S-P does not require the brokerage firm to re-notify customers and afford them another opportunity to opt out when the representative actually departs for a successor firm. Thus, compliance with Rule 10 of Regulation S-P does not add one second to the time it takes to complete the transfer of customer accounts from one firm to another. NEXT knows this. Its privacy policy notices have offered appropriate disclosure since February 2006. See supra note 6. It presented no evidence of customer complaints about increased delays in transferring accounts from NEXT to successor brokerage firms between February 2006 and the present.

---

know if their financial institution intends to share or sell their personal financial data, . . .") (emphasis added).

Second, customers must authorize account transfers in writing (Tr. 58, 195-96, 469, 521-22). See supra note 5 (discussing NASD Rule 11870 and NYSE Rule 412). It is surprising how quickly NEXT "throws in the towel" on self-regulatory organization rules requiring the expeditious transfer of customer accounts from one brokerage firm to another. NEXT argues that, because some brokerage firms might drag their feet in effecting a timely asset transfer or in paying commissions to departing representatives, it is necessary to let all departing representatives disclose customer nonpublic personal information to successor firms without providing notice and an opt-out opportunity under Rule 10 of Regulation S-P. It is respectfully suggested that any problems might best be addressed by enforcing the rules governing the expeditious transfer of customer accounts, not by gutting the rules protecting customer privacy.

In raising the specter of increased delays in the account transfer process, NEXT is simply putting a different gloss on a shopworn argument last heard when NASD eliminated block transfers (Tr. 59, 73, 77, 196, 521, 534, 626; DX 64).[43]

Regulation S-P does not prevent registered representatives from using services that facilitate the account transfer process. It simply requires a financial institution to notify customers that information sharing may take place and give customers a reasonable opportunity to opt out. FINRA Regulatory Notice 07-36, which was issued after the NASD Task Force Report on which NEXT relies, does not appear to share NEXT's concerns about the adverse impact of Regulation S-P on timely account transfers (DX 73 at 2).

The Division demonstrates that NEXT's argument is overstated in several respects. Fewer than half the recruits who joined NEXT before 2006 used NEXT's transition service to pre-populate account transfer documents (First Stip. ¶¶ 2, 16; Tr. 925; DX 61, DX 62). Recruits who had signed covenants not to compete did not use NEXT's transition service at all. The Division also shows that NEXT did not suffer financial harm in comparison to competitors who continued to provide transition assistance while NEXT was under investigation. NEXT added 270 representatives during 2006, even though it discontinued transition services between March and August 2006 (Second Stip. ¶ 6; Tr. 245, 408-09; DX 66 at 2). During this six-month period, recruits either used Laser Apps software or completed the necessary transfer documents themselves, without NEXT's involvement. NEXT's revenues continued to grow exponentially during 2006. Finally, the Division notes that NEXT offers no legitimate explanation for requesting and obtaining customer nonpublic personal information more than two weeks in advance of a recruit's projected start date. Although NEXT boasts that it needs only twenty-four hours to pre-populate the necessary account transfer documents, it received customer nonpublic

---

[43] See, e.g., Bruce Kelly, "Brokers Win Battle in Block Transfer War, NASD Backs Away from Earlier Tougher Stance," Investment News (Nov. 15, 2004) ("After NASD's notice to its members last month, executives with independent broker-dealers had long discussions with NASD staff members about cutting away at firms' abilities to make block transfers. . . . Many in the industry feared that the step to get a client's positive consent would cause recruiting of brokers to grind to a halt."); Bruce Kelly, "Top Independent Firms Are Blocking The Exits," Investment News (Oct. 13, 2003) ("Independent broker-dealers are grappling with what may turn into another major hurdle facing brokers looking to change firms. . . . A stoppage of block transfers spells potential disaster for a financial planner or broker looking to change firms who has a majority of clients' assets in mutual funds, some observers say.").

personal information from W. Hurley two months before his start date, and from Jeffrey Jones seven weeks before his start date.

Proposed Rule 15(a)(8) Does
Not Validate NEXT's Actions

NEXT argues that the proposed new exception, Rule 15(a)(8) of Regulation S-P, supports the position it has taken throughout this proceeding (Resp. Br. at 2). This argument may or may not turn out to be true. As a general matter, there is no reason to assume that any agency will adopt a final rule that looks exactly like its proposed rule. See CFTC v. Schor, 478 U.S. 833, 845 (1986) ("It goes without saying that a proposed regulation does not represent an agency's considered interpretation of its statute and that an agency is entitled to consider alternative interpretations before settling on the view it considers most sound."). I will follow the Commission's general practice and apply the law in effect on the date of decision. See Zion Capital Mgmt. LLC, 57 S.E.C. 99, 120-21 n.47 (2003); Richard H. Morrow, 52 S.E.C. 199, 200 & n.3 (1995).

The rationale for proposed Rule 15(a)(8)—no serious risk of identity theft—warrants a close look as the Commission considers the comments filed in the pending rulemaking proceeding. The text of Subtitle A of Title V of the GLB Act does not mention identity theft. The Senate and House committee reports on Subtitle A of Title V of the GLB Act do not discuss identity theft, either. The Congressional purpose expressed in Section 501(a) of the GLB Act states that "each financial institution has an affirmative and continuing obligation to respect the privacy of its customers and to protect the security and confidentiality of those customers' nonpublic personal information." There is no limiting language to suggest that Congress really meant "but only if there is a serious risk of identity theft." One commenter suggests that the Commission interpreted the purpose of the GLB Act too narrowly when it stated that the only customer privacy interest worth protecting is a serious risk of identity theft. To this commenter, customer expectations about sharing personally identifiable financial information with a third party also merit due consideration, even if there is no serious risk of identity theft.

Two of the proffered reasons for disfavoring the alternative approach of full disclosure also warrant a close look as the Commission considers final changes to Regulation S-P. See supra p. 19. The Commission reasoned that a description of the disclosures made to a departing representative's new firm would be difficult to distinguish from a description of the disclosures made for the purposes of third-party marketing. 73 Fed. Reg. at 13703. The Commission did not indicate how many of the firms that engage in third-party marketing also allow departing representatives to take customer information to a new firm. If the actual number is small, the perceived problem may be small, as well. For example, NEXT's current privacy policy notice does not disclose any third-party marketing arrangements (RX 3). The Commission also stated that disclosures made to a departing representative's new firm "would further complicate already complex privacy notices." 73 Fed. Reg. at 13703. The Commission considered the level of detail required in privacy policy notices when it adopted Regulation S-P in June 2000. It then concluded that "in most cases the initial and annual disclosure requirements can be satisfied by disclosures contained in a tri-fold brochure" (RX 14 at 26). NEXT's current privacy policy notice is only one page long (RX 3). The March 2008 proposal did not identify the empirical research that may underlie the Commission's conclusion that existing privacy policy notices are

"already complex." Moreover, consumer testing of the interagency model privacy form is ongoing and the March 2007 interagency rulemaking proposal is still pending. See supra p. 7.

While it would not be accurate to characterize proposed Rule 15(a)(8) as "dead on arrival," the comments give reason to believe that it may not be finalized in precisely the form it was proposed. Some commenters suggest that the text of proposed Rule 15(a)(8) could benefit from tighter drafting. Among other things, they note that the wording of the proposal (which would allow a departing representative to take to a successor firm "a general description of the type of account and products held by the customer, and the customer's contact information, including the customer's address, telephone number, and e-mail information) offers a huge loophole for brokerage firms that recruit aggressively. These commenters also observe that, by specifying three types of personally identifiable financial information that may not be shared (customer's account number, Social Security number, and securities positions), the Commission has virtually assured that firms that recruit aggressively will interpret the "including" language of the proposed rule to permit disclosure of every other type of personally identifiable financial information. I conclude that NEXT can draw no comfort from proposed Rule 15(a)(8).

SANCTIONS

The Division seeks a cease-and-desist order and a second-tier civil penalty of $325,000 (Div. Br. at 21). NEXT maintains that no violation occurred and that no sanctions are appropriate. However, if liability is established, NEXT argues that a cease-and-desist order is unwarranted and that any monetary sanction should be minimal (compare Resp. Br. at 4 n.5 with Resp. Br. at 54). Appellate courts review sanctions imposed by the Commission for abuse of discretion. See PAZ Secs., Inc. v. SEC, 494 F.3d 1059, 1066 (D.C. Cir. 2007); McCarthy v. SEC, 406 F.3d 179, 190 (2d Cir. 2005).

There are two mitigating circumstances. NEXT has no prior violations (Resp. Prop. Find. ## 9, 169-76). I reject the Division's claim that NEXT should be treated as a recidivist, based on letters of caution it received from NASD and deficiencies in SEC examinations that were referred to the Division for possible enforcement action (Div. Prop. Find. ## 142-45). If the Commission believed these deficiencies were worth pursuing, it would have brought a case by now. I also note that the preamble to the pending rulemaking expresses the Commission's understanding that there may be "confusion" and "uncertainty" in the securities industry about financial institutions' obligations under Regulation S-P. See supra p. 18. The Commission's comments were not tentative. Nothing in the preamble suggests that the Commission's understanding is subject to reconsideration in the future. I will be guided by the Commission's understanding, as well as the holding of Arthur Lipper, 547 F.2d at 182-84.

There is also an aggravating factor. NEXT's transition team repeatedly accessed the computer system of a recruit's current brokerage firm, after the recruit shared with NEXT the password and user identification that had been provided by his or her current brokerage firm. NEXT's management was aware of this practice, which occurred about twenty times (Tr. 175, 181). NEXT's then-compliance officer was not aware of this practice at the time (Tr. 252). She has now been promoted to chief operating officer. This was not a borderline infraction. Neither of NEXT's experts even attempted to condone it. The practice comes close to meeting the criteria for a pretexting violation of 15 U.S.C. § 6821, as the Commission's staff initially suggested (DX 65). If the brokerage firms targeted by NEXT's campaign learned the particulars,

an administrative proceeding under Regulation S-P would be the least of NEXT's problems. There is no evidence to suggest that this practice was consistent with industry norms. There was no confusion or uncertainty regarding whether such conduct violated Regulation S-P. This conduct would continue to constitute a violation of Regulation S-P, even if proposed Rule 15(a)(8) were to be finalized without change.

28 U.S.C. § 2462

Certain of the misconduct alleged in the OIP, as clarified by the Division's more definite statement, may have occurred more than five years before the Commission issued the OIP, i.e., before August 24, 2002. See Division's More Definite Statement relating to OIP ¶ II.B.12 ("Between 2001 and 2004, . . ."); Third Stip. ¶ 4 ("Between 2001 and 2004, . . ."); Div. Reply Br. at 16 ("NEXT's violations commenced at the time Regulation S-P went into effect."). There is no evidence of a tolling agreement. However, NEXT did not address the applicability of 28 U.S.C. § 2462 in its pleadings.[44] I conclude that NEXT waived the opportunity to raise this affirmative defense. See Ponce, 54 S.E.C. at 824; Laurie Jones Canady, 54 S.E.C. 65, 89 (1999).

The Commission has determined that the five-year limitation period of 28 U.S.C. § 2462 does not apply to cease-and-desist orders. See Coxon, 56 S.E.C. at 966 n.60; Herbert Moskowitz, 55 S.E.C. 658, 683-84 (2002). On the other hand, the Commission has held that it will not consider misconduct occurring more than five years before the OIP when imposing a civil monetary penalty. See 28 U.S.C. § 2462 (as interpreted by Johnson v. SEC, 87 F.3d 484, 488-91 (D.C. Cir. 1996), and 3M Co. v. Browner, 17 F.3d 1453, 1455-61 & n.14 (D.C. Cir. 1994)); see also Terry T. Steen, 53 S.E.C. 618, 623-25 (1998) (holding that the Commission will look only to wrongful conduct within the five-year period before the OIP to establish liability, but stating that it may consider a respondent's earlier conduct, when relevant, to establish motive, intent, or knowledge).

Cease-and-Desist Order

Section 21C(a) of the Exchange Act authorizes the Commission to impose a cease-and-desist order upon any person who "is violating, has violated, or is about to violate" any provision of the Exchange Act or the rules and regulations thereunder. With respect to brokers and dealers, Regulation S-P is a regulation under the Exchange Act. See supra note 14. The Commission may also impose a cease-and-desist order against any person that "is, was, or would be a cause of [a] violation" due to an act or omission the person "knew or should have known would contribute to such a violation."

In KPMG, 54 S.E.C. at 1183-92, the Commission addressed the standard for issuing cease-and-desist relief. It explained that the Division must show some risk of future violations. However, it also ruled that such a showing should be "significantly less than that required for an

[44] With the possible exception of paragraph 4 of the third set of stipulated facts, I find no evidence of specific misconduct relating to inbound NEXT recruits that occurred before November 2003 (Div. Br., Appendix A). The record is silent as to when misconduct relating to outbound NEXT registered representatives may have commenced.

injunction" and that, "absent evidence to the contrary," a single past violation ordinarily suffices to raise a sufficient risk of future violations. Id. at 1185, 1191.

Along with the risk of future violations, the Commission considers the seriousness of the violation, the isolated or recurrent nature of the violation, the respondent's state of mind, the sincerity of the respondent's assurances against future violations, the respondent's recognition of the wrongful nature of his or her conduct, and the respondent's opportunity to commit future violations. Id. at 1192. In addition, the Commission considers whether the violation is recent, the degree of harm to investors or the marketplace resulting from the violation, and the remedial function to be served by the cease-and-desist order in the context of any other sanctions being sought in the same proceeding. Id. The Commission weighs these factors in light of the entire record, and no one factor is dispositive.

The U.S. Court of Appeals for the District of Columbia Circuit has insisted that the Commission adhere to the standards it announced in KPMG. See WHX Corp. v. SEC, 362 F.3d 854, 859-60 (D.C. Cir. 2004) (rejecting the Commission's explanation of the risk of future violations and vacating a cease-and-desist order).

Addressing these factors here, I conclude that the proven misconduct is very serious. Until the Commission's staff began its investigation, NEXT's program of pre-populating account transfer documents was frequently out of control. NEXT's transition team solicited and received thousands, if not tens of thousands, of pieces of customer nonpublic personal information. Some of the information concerned customers of representatives who had no intention of transferring to NEXT, whom NEXT had not approved to join the firm, or who did not actually join the firm. The misconduct was not isolated. As to outbound NEXT representatives, this misconduct continued for several years and ended only in February 2006. As to inbound recruits, the misconduct continues today. NEXT acted negligently with respect to its outbound representatives; it acted extremely recklessly with respect to its inbound recruits. NEXT does not recognize the wrongful nature of its conduct. Its expansive reading of the existing exceptions in Rules 14 and 15 of Regulation S-P is particularly troubling in this regard. NEXT's assurances against future violations are not persuasive. NEXT has taken several steps to remedy the worst of its past misconduct, but these steps were reactive. NEXT only changed its aggressive tactics after the Commission's staff forced the issue. NEXT offers an enormously broad interpretation of the Protocol, and attempts to argue that its behavior would be allowable under the Protocol. See supra pp. 30-31. I reject this argument and conclude that NEXT continues to solicit and accept customer nonpublic personal information that far exceeds anything contemplated by the Protocol. The likelihood of future violations is quite high in the absence of a cease-and-desist order. I will issue the cease-and-desist order.

Civil Monetary Penalty

Under Section 21B(a) of the Exchange Act, the Commission may assess a civil monetary penalty if a respondent has willfully violated or willfully aided and abetted any violations of the Exchange Act or the rules or regulations thereunder. The Commission must find that such a penalty is in the public interest. Six factors are relevant to the public interest determination: (1) fraud, or the deliberate or reckless disregard of a regulatory requirement; (2) harm to others; (3) unjust enrichment; (4) prior violations; (5) deterrence; and (6) such other factors as justice may

require. See Section 21B(c) of the Exchange Act. Not all factors may be relevant in a given case, and the factors need not all carry equal weight.

Section 21B(b) of the Exchange Act specifies a three-tier system identifying the maximum amount of a penalty.[45] A second-tier penalty is permissible if the "act or omission" involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement. For each "act or omission" by a corporation during the period from February 3, 2001, to February 14, 2005, the adjusted maximum amount of a penalty is $60,000 in the first tier and $300,000 in the second tier. For each "act or omission by a corporation on and after February 15, 2005, the adjusted maximum amount of a penalty is $65,000 in the first tier and $325,000 in the second tier.

The adjusted statutory maximum amount is not an overall limitation, but a limitation per violation. See Mark David Anderson, 56 S.E.C. 840, 863 (2003) (imposing a civil penalty of $1,000 for each of the respondent's ninety-six violations); cf. United States v. Reader's Digest Ass'n., 662 F.2d 955, 966, 970 (3d Cir. 1981) (holding that each individual mailing constitutes a separate violation of an FTC consent order). For that reason, I asked the Division whether it viewed the alleged misconduct as one violation or a series of violations (Order of Nov. 7, 2007). In response, the Division has stipulated that the OIP "describes a single course of conduct" and warrants "a single tier-two penalty of $325,000" (Division's More Definite Statement Regarding Civil Penalty, dated Nov. 8, 2007).

Under the Debt Collection Improvement Act of 1996, any increase in a civil monetary penalty shall apply only to violations that occur after the date the increase takes effect. The entire violation at issue here did not occur after February 14, 2005; rather, only a fraction of the violation occurred after that date.[46] Thus, the maximum permissible penalty is $60,000 in tier one, and $300,000 in tier two. I reject the Division's argument in support of a higher maximum.

The U.S. Court of Appeals for the Seventh Circuit has insisted that the Commission adhere to the statutory criteria when imposing civil penalties. See Monetta, 390 F.3d at 957 (vacating $200,000 civil penalty and other sanctions), on remand, 86 SEC Docket 1392, 1397 (Oct. 4, 2005) (reducing the $200,000 civil penalty to $40,000).

Addressing the six factors that guide the public interest analysis under Section 21B, I conclude that a second-tier civil penalty is appropriate because NEXT recklessly disregarded the requirements of Regulation S-P with respect to inbound recruits. There is no evidence of actual

---

[45] As required by the Debt Collection Improvement Act of 1996, the Commission increased the maximum penalty amounts for violations occurring after December 9, 1996; after February 2, 2001, and, again, for violations occurring after February 14, 2005. See 17 C.F.R. §§ 201.1001, .1002, .1003. In the absence of a tolling agreement, no civil monetary penalty may be imposed in this proceeding for misconduct occurring before August 24, 2002.

[46] The OIP, as clarified by the Division's more definite statement, alleges that several instances of misconduct continued after February 14, 2005. See, e.g., OIP ¶¶ II.B.4 (misconduct until February 2007), II.B.9 (misconduct until May 2006), II.B.13 (misconduct until May 2006), II.B.15 (misconduct in May and June 2005), and II.B.22 (misconduct until June 2006).

harm to customers. There are no prior violations. There is no quantifiable evidence of unjust enrichment. A meaningful civil penalty will help to deter future violations of Regulation S-P by others. I am not aware of any other factors that justice requires me to consider. I conclude that a civil penalty of $125,000 is in the public interest. A penalty at that level takes into account the fact that this was a tier-two violation, yet gives due regard for the Commission's concerns about confusion and uncertainty in the securities industry with respect to Regulation S-P. I have not considered misconduct occurring before August 24, 2002, in setting the level of the penalty. There is no confusion or uncertainty about the need to sanction NEXT for soliciting and accepting customers' Social Security numbers, dates of birth, driver's license numbers, and information about income levels, tax brackets, and net worth. There is no confusion or uncertainty about the need to sanction NEXT severely for the approximately twenty occasions that it used the user identifications and passwords of recruits to access the computer systems of the recruits' current brokerage firms and download customer nonpublic personal information.

NEXT does not argue that it is unable to pay a civil penalty under Section 21B(d) of the Exchange Act (Prehearing Conference of Nov. 7, 2007, at 8-10; Order of Nov. 7, 2007; Prehearing Conference of Nov. 29, 2007, at 5).

RECORD CERTIFICATION

Pursuant to Rule 351(b) of the Commission's Rules of Practice, I certify that the record includes the items set forth in the record index issued by the Secretary of the Commission on March 13, 2008, as revised on April 16, 2008.

ORDER

IT IS ORDERED THAT, pursuant to Section 21C of the Securities Exchange Act of 1934, NEXT Financial Group, Inc., shall cease and desist from committing or causing any violations or future violations of Rules 4, 6, 10, and 30(a)(1) of Regulation S-P, 17 C.F.R. §§ 248.4, .6, .10, and .30(a)(1); and

IT IS FURTHER ORDERED THAT, pursuant to Section 21B of the Securities Exchange Act of 1934, NEXT Financial Group, Inc., shall pay a civil penalty of $125,000.

Payment of the civil penalty shall be made on the first day following the day this Initial Decision becomes final. Payment shall be made by wire transfer, certified check, United States Postal money order, bank cashier's check, or bank money order, payable to the Securities and Exchange Commission. The payment, and a cover letter identifying the Respondent and the proceeding designation, shall be delivered to the Comptroller, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, Virginia 22312. A copy of the cover letter and the instrument of payment shall be sent to the Commission's Division of Enforcement, directed to the attention of counsel of record.

This Initial Decision shall become effective in accordance with and subject to the provisions of Rule 360 of the Commission's Rules of Practice. Pursuant to that Rule, a party may file a petition for review of this Initial Decision within twenty-one days after service of the decision. A party may also file a motion to correct a manifest error of fact within ten days of the Initial Decision pursuant to Rule 111 of the Commission's Rules of Practice. If a motion to

correct a manifest error of fact is filed by a party, then that party shall have twenty-one days to file a petition for review from the date of my order resolving the motion to correct a manifest error of fact.

The Initial Decision will not become final until the Commission enters an order of finality. The Commission will enter an order of finality unless a party files a petition for review or a motion to correct a manifest error of fact, or unless the Commission determines on its own initiative to review this Initial Decision as to any party. If any of these events occur, the Initial Decision shall not become final as to that party.

____

James T. Kelly
Administrative Law Judge