

FINANCIAL INDUSTRY REGULATORY AUTHORITY
LETTER OF ACCEPTANCE, WAIVER AND CONSENT
NO. 2007011877401

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TO: Department of Enforcement
Financial Industry Regulatory Authority ("FINRA")

REGISTRATION & DISCLOSURE

RE: A.G. Edwards & Sons, Inc., Respondent
Former Member Firm
(CRD No: 4)

Pursuant to Rule 9216 of the FINRA Code of Procedure, Respondent A.G. Edwards & Sons, Inc. ("Edwards" or "Respondent" or the "Firm") submits this Letter of Acceptance, Waiver and Consent ("AWC") for the purpose of settlement of the alleged rule violations described below. This AWC is submitted on the condition that, if accepted, FINRA will not bring any future actions against the Firm alleging violations based on the same factual findings described herein.

I.

ACCEPTANCE AND CONSENT

- A. The Firm hereby accepts and consents, without admitting or denying the findings, and solely for the purposes of this proceeding and any other proceeding brought by or on behalf of FINRA, or to which FINRA is a party, prior to a hearing and without an adjudication of any issue of law or fact, to the entry of the following findings by FINRA:

BACKGROUND

Edwards is a registered broker-dealer primarily engaged in retail securities brokerage, and has been a member of the NASD (n/k/a FINRA) since 1939. The Firm is based in St. Louis, Missouri with approximately 700 offices in the United States. In October 2007, Edwards was acquired by Wachovia Corp.

At all times relevant, Alfred Varricchio ("Varricchio") was employed by Edwards as the manager of its securities lending department. Varricchio was registered as a securities lending representative and an officer of the Firm.

At all times relevant, Michael McCormack ("McCormack") was employed by Edwards as a registered securities lending representative.

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OVERVIEW

Between 2003 and 2004 (the "relevant period"), two former registered securities lending representatives of Edwards facilitated improper stock loan transactions with counterparties at artificially low rates, directed or facilitated unwarranted payments to finders, and participated in transactions that served no legitimate interest of the Firm but benefited counterparties and finders who made payments back to Edwards' registered stock loan representatives. The Firm lacked supervisory systems and written procedures reasonably designed to prevent and detect such activities.

FACTS AND VIOLATIVE CONDUCT

Overview of Securities Lending

A stock loan is a collateralized, temporary exchange of securities. In a typical stock loan transaction, a financial institution that needs to borrow a security communicates that need to other financial institutions known to engage in stock loan transactions. Upon locating the security it needs, the borrowing institution will establish with the lender three financial terms of the transaction: the form of the collateral, which can be either cash or securities; the amount of collateral; and the fee that the lender will charge the borrower to borrow the securities. In a typical lending transaction, the Firm lends its securities for collateral, which may be cash or other securities, and agrees to return the collateral for its original securities at some time in the future. In return for lending the securities, the Firm receives a fee, which is a rate quoted as basis points per annum of the original market value of the loaned securities. The rate charged is driven by market forces of supply and demand, i.e., how scarce or in demand a loaned security is in the marketplace.

The stock loan borrower pays the collateral to the lender and the lender delivers the securities to the borrower. The lender invests the cash collateral at short-term (overnight Fed funds) interest rates. The lender retains part of the interest it receives on the cash collateral as its fee for lending the securities. The lender returns the remainder of the interest income on the collateral to the borrower, which is known as the rebate.

In a situation where the securities that are the subject of a loan are readily available for loan, the lender keeps only a very small portion of the interest earned on the collateral and returns, or rebates, the majority of the interest to the borrower. Conversely, when the security that is the subject of the stock loan transaction is "special," scarce, or otherwise "hard-to-borrow," the lender retains most or all of the interest on the collateral and returns little if any to the borrower of the stock. Supply and demand determine the price the borrower pays to borrow the stock. The less stock there is to borrow and/or the harder it is to locate, the more the borrower pays to borrow it.

In certain circumstances involving "special" or "hard-to-borrow" stocks, the interest earned on the cash collateral is not sufficient to cover the entire lending fee. The borrower must make payment to the lender above and beyond the interest earned on the cash collateral for the privilege of borrowing the stock, which is called a negative rebate. In almost all instances, the rebate rate associated with a particular stock loan contract is an indicator of the supply and demand of the subject security.

"Finders" are third parties to stock loan transactions who, in exchange for a fee, assist a borrower in locating securities it needs, and less frequently, assist a lender in finding a borrower for securities it has available to lend. Most finders are not registered broker-dealers and generally act only to locate the security. Electronic mail and facsimile transmission have enabled parties that engage in stock loan activities to inform each other almost instantaneously of the securities they have available to lend or need to borrow, thus eliminating, in many cases, the need for finders.

During the relevant period, Edwards loaned securities to, or borrowed securities from, firms that paid finders, although Edwards itself did not pay finders and had a policy prohibiting payments to finders.

Fraudulent Stock Loan Transactions

In September 2007, Edwards' stock loan supervisor Varricchio and one of the stock loan traders under his supervision, McCormack, were named as defendants in a civil suit filed by the United States Securities and Exchange Commission (the "SEC Complaint"), alleging that they participated in fraudulent schemes involving phony finder fees and illegal kickbacks in the stock loan industry.¹

According to the SEC Complaint, from September 2003 through early 2005 there were more than 2,000 stock loan transactions between Edwards and one of its counterparties in which at least \$500,000 in sham finder fees were paid, the "vast majority" of which occurred because Varricchio agreed to loan the securities at artificially low rates in exchange for cash kickbacks.² The SEC Complaint against Varricchio is pending.

The SEC Complaint also indicates that McCormack schemed with stock loan representatives at other firms to pay finder fees to DMAC Services, Inc. ("DMAC"), even though DMAC did not perform any services.³ DMAC was a company owned by McCormack's wife that McCormack and his spouse had formed in or about March 2001. According to the SEC Complaint, between March 2001 and December 2004, certain of Edwards' counterparties paid DMAC over \$600,000 in sham finder fees on thousands of stock loan transactions that McCormack had arranged on his own. McCormack caused Edwards to lend stock to these counterparties at inferior rates. The SEC Complaint McCormack used Edwards' counterparties to generate profits by on-lending securities borrowed from Edwards to other firms at better rates, and using that profit to pay DMAC a sham finder fee.⁴ E-mails from McCormack to stock loan representatives at other firms confirm that McCormack did not engage in arms-length negotiations on these transactions, and that McCormack orchestrated the transactions, telling the traders at the Firm's counterparties the inferior rates at which Edwards would lend stock to their firms; the better rates these firms would receive from other firms upon on-lending the stock; and the amount Edwards' counterparties were to pay DMAC. These e-mails further

¹ United States District Court Civil Action No. 07-3928 (EDNY), SEC Litigation Release 20290 (September 20, 2007)(amended September 24, 2007)(the "SEC Complaint").

² *Id.*, paragraphs 81-85.

³ *Id.*, paragraphs 116-119.

⁴ *Id.*

demonstrate that DMAC did not provide any finding services on any of the loans. On May 9, 2008, McCormack consented to the entry of an Order of settlement with the SEC, which imposed a sanction including a permanent bar from the securities industry.⁵

In August 2007, McCormack was charged by the United States Attorney's Office for the Eastern District of New York with arranging with stock lending representatives from several brokerage firms during the period between 2001 and 2004 for those firms to pay finder's fees to DMAC, even though DMAC provided no legitimate finder's services.⁶ In exchange, McCormack caused Edwards to enter into stock loan transactions with those counterparties in which Edwards would pay and receive rebates and negative rebates that were less favorable to Edwards than the rebates and negative rebates otherwise available in the marketplace.⁷ On August 28, 2007, McCormack pleaded guilty to the criminal charges. On March 6, 2008, he was sentenced to 36 months in prison followed by three years of supervised release and ordered to pay \$900,000 in restitution to Edwards.

Edwards' Supervisory System

Edwards designated Varricchio as its stock lending manager during the relevant period. He was not approved or registered by the NYSE as a securities lending supervisor. Varricchio was delegated frontline supervisory responsibility over the registered stock loan representatives on Edwards's stock loan desk and was responsible for reviewing a variety of reports of stock loan transactions. The Firm did not establish a separate system of follow-up and review to ensure that Varricchio was effectively performing his delegated supervisory responsibilities or properly exercising his supervisory authority.

In addition to supervising the stock loan desk, Varricchio negotiated stock loans for Edwards. Edwards' supervisory system permitted Varricchio to review his own transactions as well as those of the other traders on the desk. Edwards did not document any supervisory reviews conducted by or of Varricchio, and the Firm did not document any supervisory review of Varricchio's stock loan transactions.

Edwards' Written Supervisory Procedures

During the relevant period, Edwards' written supervisory procedures were combined with operational procedures. The Firm principally relied on the "Loanet" system to conduct and supervise its stock loan desk.⁸ Edwards utilized reports generated by Loanet to monitor the economics of its stock loan transactions. The reports, which were generated automatically, were to be viewed by the stock loan representative who received it, and

⁵ In the Matter of Michael McCormack, SEC Release No. 34-57811, Administrative Proceeding File No. 3-13041 (May 9, 2008).

⁶ United States v. Michael McCormack, Crim. Information No. 07-CR-625, United States District Court, E.D.N.Y. (August 7, 2007), paragraph 7.

⁷ *Id.*, paragraph 7.

⁸ The Loanet system is a proprietary application owned by SunGard Data Systems, Inc. During the relevant period, the Loanet system was used industry-wide for electronically processing and matching stock loans and borrows.

then reviewed by Varricchio or the operations manager. The supervisory procedures did not address the steps that these individuals were to take in reviewing Loanet reports, including how to determine if stock loan rates were appropriate, what activity was to be flagged as suspicious, how the reviews were to be documented, or how any documentation of the reviews was to be maintained. Edwards did not conduct any review or follow-up to ensure that Varricchio and the operations manager were actually performing these supervisory responsibilities.

Edwards was not aware that its stock loan traders were engaging in fraud and instructing counterparties to pay finders in these transactions. With respect to the collusive transactions by Varricchio and McCormack, Loanet reports that the Firm received sometimes reflected contemporaneous or near-contemporaneous stock loans by the Firm in identical securities with other counterparties, at rates different than the rates received by the firms with which Varricchio and McCormack were colluding. Edwards did not detect or make any inquiry into the artificially low rates of stock loan transactions negotiated by Varricchio or McCormack, and did not detect McCormack's e-mails directing payments to his spouse as a purported finder.

The rate discrepancies on the Loanet reports and McCormack's e-mails directing payments to a finder should have alerted the Firm that further inquiry was warranted to ensure that stock loans were being effected at arms length, consistent with Firm policy and in the Firm's best interests.

Failure to Supervise

Edwards failed to establish, maintain, and enforce a system, including written supervisory procedures, to supervise its securities lending business and registered securities lending representatives, in order to prevent and detect fraudulent stock loan transactions.

A supervisory system reasonably designed to achieve compliance with applicable securities laws and regulations and the rules of FINRA requires a member firm to establish and maintain a separate system of follow-up and review to ensure that delegated supervisory authority and responsibility are being properly exercised. During the relevant period, Edwards delegated responsibility for reviewing the economics of stock loan transactions to Varricchio and the operations manager, without performing any independent supervisory review or follow-up to ensure that these supervisors were properly performing this responsibility.

Overall, Edwards' written supervisory procedures did not satisfy the NASD's minimum procedural standards as outlined in Notice to Members 99-45 because the procedures did not include a description of what stock loan supervisors were to look for in reviewing Loanet and other supervisory reports, or the steps to be taken if suspicious activity was discovered.

As a result of these supervisory deficiencies, Edwards failed to detect and prevent Varricchio and McCormack from engaging in fraudulent schemes to participate in stock loan transactions with other firms, at rates that were inferior to rates otherwise available to a lender in the marketplace, for their own benefit and for the benefit of favored

counterparties and finders who had not performed any services in the transactions for which they were paid.

Registration of Securities Lending Supervisor

Incorporated NYSE Rule 345 (Employees-Registration, Approval, Records) provides that no member or member organization "shall permit any natural person to perform regularly the duties customarily performed by (i) a registered representative, (ii) a securities lending representative, (iii) a securities trader or (iv) a direct supervisor of (i), (ii) or (iii) above, unless such person shall have been registered with, qualified by and is acceptable to the [NYSE]."⁹

Although Varricchio was never registered, approved, or found qualified by the NYSE to be a securities lending supervisor, Edwards delegated responsibility to Varricchio for the direct supervision of its registered securities lending representatives, in violation of Incorporated NYSE Rule 345.

Failure to Retain Required Books and Records

Section 17(a) of the Securities and Exchange Act of 1934 ("the Exchange Act") and Rules 17a-3 and 17a-4 thereunder require that a broker-dealer preserve for at least three years, the first two years in an easily accessible location, originals of all communications received and copies of all communications sent by such broker-dealer, relating to its business. NASD Rules 3010, 3110, and 2110 require that every member organization make and preserve books and records as prescribed by Rule 17a-3 under the Exchange Act, and that the recordkeeping format, medium, and retention period shall comply with Rule 17a-4 under the Exchange Act.

Edwards's stock loan desk communicated extensively with counterparties by facsimile transmissions that contained information about securities that the Firm and its counterparties needed to borrow and had available to loan. Edwards failed to retain these business communications in violation of Section 17(a) of the Securities Exchange Act of 1934 ("Exchange Act") and Rules 17a-3 and 17a-4 there under, and NASD Rules 3010, 3110, and 2110.

Edwards terminated McCormack in March 2005, and Varricchio in October 2006.

Edwards' stock loan desk will be merged into the Wachovia Stock Loan desk at systems conversion for the merger, which is currently scheduled for February 2009. Prior to the systems merger, there will still be separate books and records maintained for legacy Edwards' stock loan transactions. However, the Edwards' stock loan desk and employees will combine with the Wachovia Stock Loan desk and be governed by Wachovia policy and procedures and supervised under the Wachovia system in calendar year 2nd quarter 2008.

⁹ FINRA has incorporated into its rulebook certain NYSE rules (the "Incorporated NYSE Rules"), including NYSE Rule 345. The Incorporated NYSE Rules apply solely to those members of FINRA that were also members of NYSE on or after July 30, 2007 ("Dual Members"), such as Edwards.

By virtue of the foregoing conduct, Respondent Edwards violated NASD Rules 3010(a), 3010(b), 3110, and 2110, FINRA Incorporated NYSE Rule 345(a), and Section 17(a) of the Securities and Exchange Act of 1934 and Rules 17a-3 and 17a-4 thereunder.

OTHER FACTORS

B. Respondent also consents to the imposition of the following sanctions:

1. Censure; and
2. Fine in the amount of \$300,000.

Respondent agrees to pay the monetary sanction upon notice that this AWC has been accepted and that such payment is due and payable. Respondent has submitted an Election of Payment form showing the method by which it proposes to pay the fine imposed.

Respondent specifically and voluntarily waives any right to claim that it is unable to pay, now or at any time hereafter, the monetary sanction(s) imposed in this matter.

The sanctions imposed herein shall be effective on a date set by FINRA staff.

II.

WAIVER OF PROCEDURAL RIGHTS

Respondent specifically and voluntarily waives the following rights granted under the FINRA Code of Procedure:

- A. To have a Formal Complaint issued specifying the allegations against the Firm;
- B. To be notified of the Formal Complaint and have the opportunity to answer the allegations in writing;
- C. To defend against the allegations in a disciplinary hearing before a hearing panel, to have a written record of the hearing made and to have a written decision issued; and
- D. To appeal any such decision to the National Adjudicatory Council ("NAC") and then to the U.S. Securities and Exchange Commission and a U.S. Court of Appeals.

Further, Respondent specifically and voluntarily waives any right to claim bias or prejudgment of the General Counsel, the NAC, or any member of the NAC, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including acceptance or rejection of this AWC.

Respondent further specifically and voluntarily waives any right to claim that a person violated the ex parte prohibitions of NASD Rule 9143 or the separation of functions prohibitions of NASD Rule 9144, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including its acceptance or rejection.

III.

OTHER MATTERS

Respondent understands that:

- A. Submission of the AWC is voluntary and will not resolve this matter unless and until it has been reviewed and accepted by the NAC, a Review Subcommittee of the NAC, or the Office of Disciplinary Affairs ("ODA"), pursuant to NASD Rule 9216;
- B. If this AWC is not accepted, its submission will not be used as evidence to prove any of the allegations against the Firm; and
- C. If accepted:
 - 1. This AWC will become part of the Firm's permanent disciplinary record and may be considered in any future actions brought by FINRA or any other regulator against the Firm;
 - 2. This AWC will be made available through FINRA's public disclosure program in response to public inquiries about the Firm's disciplinary record;
 - 3. FINRA may make a public announcement concerning this agreement and the subject matter thereof in accordance with NASD Rule 8310 and IM-8310-3; and
 - 4. The Firm may not take any action or make or permit to be made any public statement, including in regulatory filings or otherwise, denying, directly or indirectly, any finding in this AWC or create the impression that the AWC is without factual basis. The Firm may not take any position in any proceeding brought by or on behalf of FINRA, or to which FINRA is a party, that is inconsistent with any part of this AWC. Nothing in this provision affects my right to take legal or factual positions in litigation or other legal proceedings in which FINRA is not a party.
- D. The Firm may attach a Corrective Action Statement to this AWC that is a statement of demonstrable corrective steps taken to prevent future misconduct. Respondent understands that it may not deny the charges or make any statement

that is inconsistent with the AWC in this Statement. This Statement does not constitute factual or legal findings by FINRA, nor does it reflect the views of FINRA or its staff.

Respondent certifies that it has read and understands all of the provisions of this AWC and has been given a full opportunity to ask questions about it; that it has agreed to its provisions voluntarily; and that no offer, threat, inducement, or promise of any kind, other than the terms set forth herein and the prospect of avoiding the issuance of a Complaint, has been made to induce Respondent to submit it.

6/23/08
Date

Respondent
A.G. Edwards & Sons, Inc.

Reviewed by:

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Counsel for the Respondent
Terrence J. Fleming
Lindquist & Vennum

By: [Signature]
Ronald J. Kessler
Executive Vice President

Accepted by FINRA:

6/27/08
Date

Signed on behalf of the
Director of ODA, by delegated authority

[Signature]
Linda S. Riefberg
Vice President and Chief Counsel
FINRA Department of Enforcement
14 Wall Street
New York, NY 10005